Uncharted TERRITORY

Regulating cryptocurrencies may well increase consumer confidence, but experts are at pains to stress the dangers of over-legislating a rapidly developing sector.

While global and central banks are experimenting with cryptocurrencies, much work remains to be done in terms of their regulation under EU law. According to a working paper from the Swift Institute, legislative procedures for regulations such as the Fourth EU Anti-Money Laundering Directive and the revised payments directive (PSD2) have not paid sufficient attention to this area.

But the European Commission recently announced plans to apply the Fourth Anti-Money Laundering Directive to digital currencies, and possibly digital wallet providers, and is also considering applying the licensing and supervision rules of PSD2 to digital currency exchanges. This would in turn relate equally to its parallel directive, the E-Money Directive, explains Jacqui Hatfield, Financial Services Regulatory Partner at global law firm Reed Smith.

"Lack of transparency, regulation and protection for users of digital currencies has been a barrier to growth," says Hatfield. "The PSD2 proposals are vague and much needs to be done (including the classification of digital currencies) in order to facilitate it, but if it is treated as mainstream money remittance under PSD2, confidence is likely to grow." It is difficult to see how digital currencies can establish themselves as a viable mainstream option without regulation, she believes.

A regulatory approach is still a long way off, says Siân Jones, founder of the European Digital Currency and Blockchain Technology Forum. In time, consumer protection policy will be developed – and legislation introduced – governing virtual currency intermediaries, much like elsewhere in financial services. If the industry continues to grow, government-enforced or self-regulation covering probity, integrity, security, solvency and segregation of funds will inevitably become part of the virtual currency landscape.

REGULATING THE UNREGULATED

Jones observes that while the UK government favours industry-led self-regulation, there are currently no plans in the EU to introduce prudential legislation. "The European Banking Authority would like to see regulated governance authorities for each virtual currency, giving greater consumer confidence in cryptocurrencies."

But both under-regulation and over-regulation could have adverse effects on cryptocurrencies, warns OneCoin founder Ruja Ignatova. "The former could interfere with their development, while the latter may lead to complications and confusion. It is also essential to bear in mind that many of the components of this technology are extremely difficult to define in legal terms and rushing toward these definitions without the necessary insight may lead to needless confusion."

The founder of LEOcoin, Dan Andersson, expresses a similar view, adding that mass consumer take-up is the inevitable future for cryptocurrencies and regulations that protect and inspire confidence in consumers will accelerate this process.

"We welcome a degree of sensible regulation," he says. "Clarity on future regulation would give businesses and consumers a greater steer on how to conduct their own affairs in a cryptocurrency economy. This would support the ambitions

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"CONSUMER CONFIDENCE IN CRYPTOCURRENCIES COULD COME FROM TRUSTED PROVIDERS SUCH AS RETAIL BANKS IMPLEMENTING APPLICATIONS."

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of legitimate businesses and users to take advantage of the potential speed, lower costs, flexibility and privacy offered by cryptocurrencies. But consumers must be wary of hyper-regulation – too much regulation in a disruptive environment like that of the digital currency arena is not always a good thing and can actually have a negative impact."

Philippe Gelis, CEO of FinTech company Kantox, observes that cryptocurrencies (mainly Bitcoin) have a bad reputation because they gained traction either in relation to criminal activities or in regions experiencing economic turmoil, while the hacking of Bitcoin exchanges has not been a helpful development. "Having clear regulation would help introduce a clean playing field for cryptocurrencies and so help to increase traction."

Greater clarity on future regulation would more likely increase business willingness to invest in cryptocurrency projects than consumer confidence, says Melanie Swan, founder of the Institute for Blockchain Studies. "Consumer confidence in cryptocurrencies could come from trusted providers such as retail banks implementing applications. Consumer banks are a natural provider of cryptocurrency solutions such as e-wallets since they previously introduced innovations such as ATMs and electronic billing."

INDUSTRY INVOLVEMENT

When asked what regulators can do to ensure that regulation does not stifle innovation, Swan adds that a stance that encourages innovation would be to let the nascent cryptocurrency industry develop first to see what kinds of regulation might be relevant. "Involving industry participants in working groups can also help to identify and implement appropriate regulatory measures."

BITLICENSE:
THE ANSWER TO REGULATING THE UNREGULATED?

According to Siân Jones, the UK would not benefit from introducing a regulation similar to the BitLicense issued by the New York State Department of Financial Services. "The BitLicense regime is unnecessarily wide-ranging and burdensome for such early-stage technology. It favours large players and has driven almost all virtual currency and many distributed ledger technology start-ups out of New York State."

Dan Andersson says one of the great features of cryptocurrencies is that digital currency transfers are conducted anonymously on a public ledger maintained by a peer-to-peer network, which maintains privacy while ensuring transparency.

"Enforcing a stringent framework on the digital currency industry, requiring it to record the personal details of users, monitor their activity and retain that information for several years, nullifies these advantages," he suggests. "This level of centralised control feels like a retrograde step. Furthermore, setting the resources needed to obtain a licence too high serves to drive illegal activity underground and either stifle innovation or force it elsewhere."

Ruja Ignatova takes a different view, suggesting that a UK licensing regime could result in a 'cleansing' of the market where only the best cryptocurrency companies survive. "The people who will benefit most are the general public and users, who will be safer and can rest assured their dealings with cryptocurrencies will be secure."

The UK should ensure it does not require licensing ahead of the EU, suggests Jacqui Hatfield. "Arbitrage will not be possible as the licence requirement becomes more widespread or if the EU/ UK require providers of digital currency platforms who want to access their customers to comply

With a few exceptions (such as New York State – see sidebar), policymakers and regulators have not generally rushed to legislate virtual currencies or virtual currency businesses. "Recognising that virtual currencies and distributed ledger technology are still very new, the European parliament has adopted a balanced approach: one that allows both the technology and use cases to develop, while recognising potential money laundering and terrorist financing risks and remaining vigilant to possible future prudential and systemic risks," says Jones.

According to Ignatova, regulators are on the right track. She believes that making sure anonymous transactions are impossible would disrupt any claims that cryptocurrencies can be used for dubious or criminal activity, such as terrorist financing, human trafficking or arms dealing.

"Unfortunately, a number of cryptocurrencies actually focus on being anonymous as one of their key selling points, and that practice should cease as soon as possible," she continues. "New technologies adapt and are created quickly and it usually

DIGITAL CURRENCY DECODED

Virtual currencies (VCs) are digital representations of value, issued by private developers and denominated in their own unit of account.

Virtual currencies can be obtained, stored, accessed and transacted electronically, and can be used for a variety of purposes, as long as the transaction parties agree to them.

But the concept of VCs covers a wider array of "currencies", ranging from simple IOUs of issuers – such as internet

with the EU/UK licensing requirement or have an equivalent regime."

According to Melanie Swan, the lesson to be learned from the actions of the New York State Department of Financial Services is that regulators acted too quickly before the market had a chance to develop organically. "The BitLicense did not have a stimulatory effect on the development of the cryptocurrency industry. With liberal regulatory and investment policies, London could become a leader in the development of the cryptocurrency industry."

takes time for them to be properly regulated. One of the focal points for all regulatory bodies must be co-operation with the business sector, aimed at achieving a better understanding from a technological perspective and in terms of usability and efficiency."

"LACK OF TRANSPARENCY, REGULATION AND PROTECTION FOR USERS OF DIGITAL CURRENCIES HAS BEEN A BARRIER TO GROWTH."

A PRICE WORTH PAYING

Andersson accepts that some regulation may be favourable, to provide a level of legitimacy for cryptocurrencies. "Perhaps this might be the price we pay for wider acceptance. But regulators must ensure therefore that regulation does not set the barriers for entry so high that only big businesses and banks have access to the technology. Cryptocurrencies should not simply be the preserve of the financial elite, they should also be in the hands of the people."

If digital currency providers are treated as licensed money remitters in the EU and the UK, the mere fact of being licensed will not in itself stifle innovation, says Hatfield. "It is relatively light touch in terms of requirements, in particular in respect of small payment institutions. Since becoming licensed is costly, it may act as a barrier to entry for start-ups, but they would be able to take advantage of the light touch regime for small payment institutions which is designed to be less costly and time consuming."

She suggests it is possible that the UK will not implement PSD2 in a post-hard Brexit world, but that this is unlikely as the UK recognises that PSD2 will open up payments to non-bank institutions and provide much-needed competition in the payment sector.

This is one reason why she is convinced that post-Brexit London remains an international centre for FinTech. "The FCA has set up Project Innovate to encourage FinTech and introduced the Sandbox, where innovative ideas can be tested without fear of enforcement action. We have a number of providers of digital currency platforms already based in London, and although they are currently unable to open UK bank accounts, legitimising them by way of regulation will address this issue."

While the nature of digital currencies means they can be used in any jurisdiction and don't require a physical infrastructure in the style of fiat currencies, the City's pool of talent sets it apart as a unique hub for FinTech and its development, agrees Andersson.

or mobile coupons and airline miles), VCs backed by assets such as gold, and cryptocurrencies such as Bitcoin.

As digital representations of value, VCs fall within the broader category of digital currencies, but they differ from other digital currencies – such as e-money, which is a digital payment mechanism for (and denominated in) fiat currency. VCs, however, are not denominated in fiat currency and have their own unit of account.
Source: IMF