

Bitcoin, Blockchain & the Regulatory Dynamic

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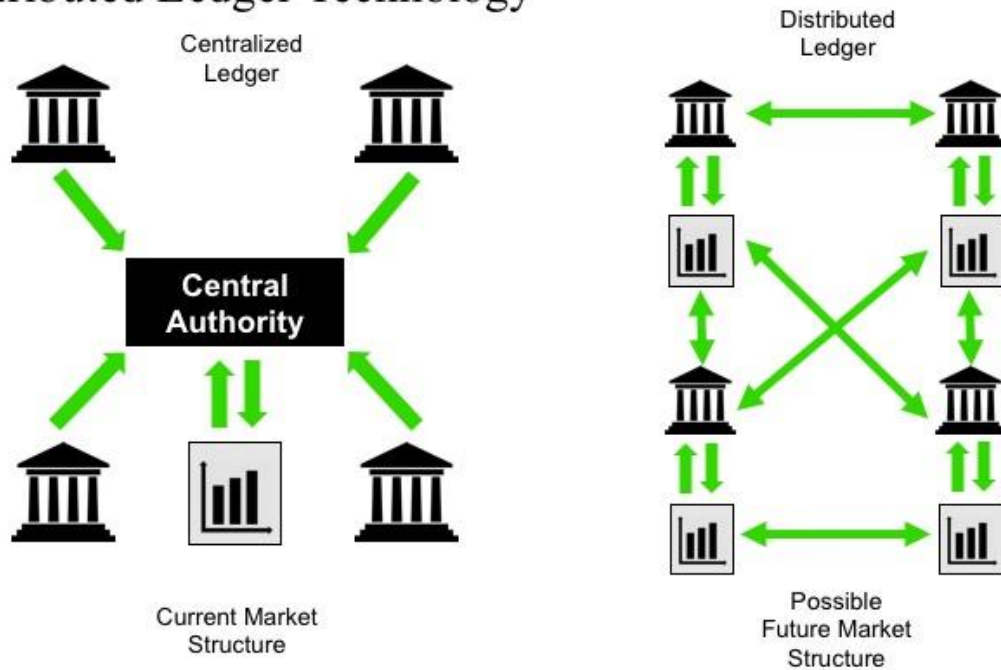


Bitcoin



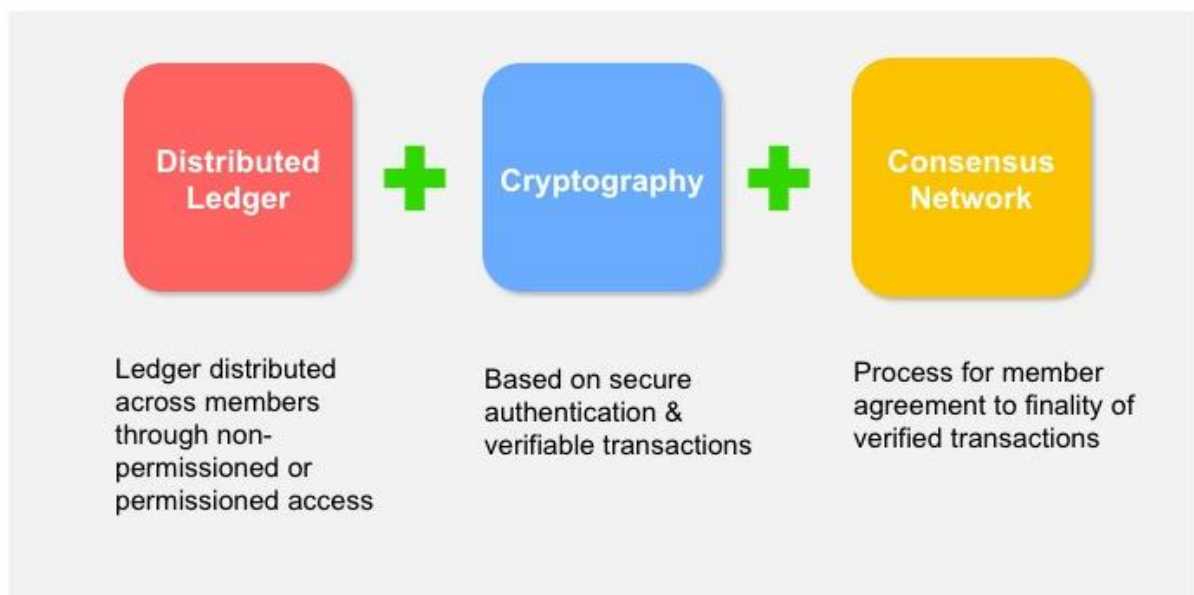
- Decentralized, partially anonymous digital “currency”
 - Relies on peer-to-peer networking
 - Changes are only possible if broadly adopted
 - Not backed or issued by any government or other legal entity
- Allows for the proof and transfer of ownership without the need for a trusted third party
- Value of bitcoins is based purely on supply and demand
 - Unlike fiat currencies, whose value is derived (in part) through regulation or law and underwritten by a state
- Proposed by a person (or group of people) under the name of Satoshi Nakamoto in 2008
 - Implementing software was first released under the same name on January 3, 2009
 - As of early 2017, Bitcoin accounted for ~90% of decentralized virtual currencies market value
 - The current total market value of virtual currencies is about US\$8 billion, which is relatively small (by comparison, U.S. currency currently in circulation is US\$1.4 trillion)

Comparison Between Traditional Centralized Ledger and Distributed Ledger Technology



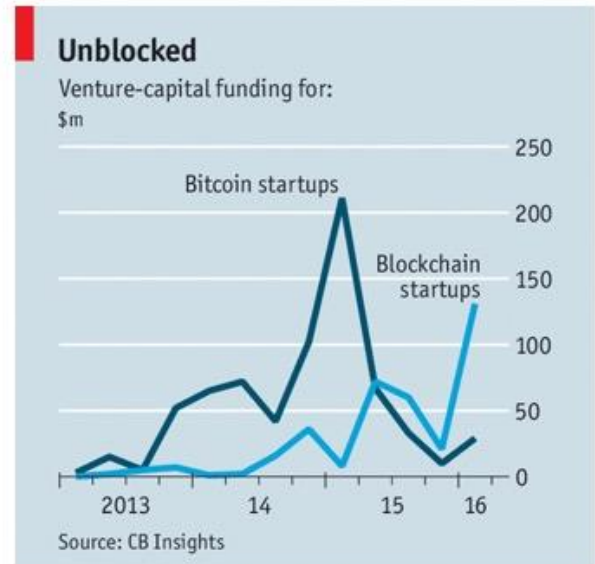
It Begins with Blockchain

What is Blockchain and How Does It Work?



Blockchain Applications: Bigger Than Bitcoin

- Trade finance
- Securities trading and issuance
- Interbank settlement
- Precious metals
- Syndicated loans
- Automated “smart contracts”
- Decentralized Autonomous Organizations
- Real estate and land registries
- Shareholder voting
- Peer-to-peer payments
- Shipping logistics
- Secured messaging services
- Fine arts and music



Economist.com

Legal and Regulatory Issues

Legal & Regulatory Issues

- **Bitcoin – created interest – and problems: Silk Road, Mt. Gox, etc.**
- **Blockchain – potential applications for trading commodities, securities and other rights, as well as a host of record-keeping/smart contract functions (DTC CDO & Delaware Blockchain initiative are examples)**
- **Framework for Legal & Regulatory Issues:**
 - Whose law applies? Comity versus extraterritoriality
 - Regulatory Responsibility? State, National, Multinational; Consistency; Competition
 - Anti-Money Laundering/Bank Secrecy Act/Terrorist Financing Issues
 - Cyber security standards, requirements and compliance
 - Commercial Law: possession, transfer, delivery, ownership? What type of interest is conveyed? Intangible right? US UCC issues
 - Securities and Commodities Regulations: what interests can be conveyed?
 - Corporate Form & Investments – functional regulation meets tech and investment!
 - Application of technical legal standards: land registries, intangible property, and personal property registries; securities (Delaware Blockchain Initiative); others
 - Liability of blockchain participants for fraud or error?

Commercial Law, Securities Regulation & Risk

Let's take a practical, hypothetical example . . .

- Permitted Blockchain for DvP settlement of securities using tokenized Securities & Cash
 - Accelerated settlement, & improved record-keeping, transaction reconciliation, capital relief, risk management, etc.

Sample Legal Issues (there are more!):

- Commercial Law: Cash & Securities “tokens” – Allow participants to transfer securities.
 - Article 8 of US UCC allows “security entitlements” to be held by “securities intermediary” and credited to a “securities account” – allowing Blockchain transfer from one participant to another.
- Securities Law:
 - Tokens – “Securities”? - are they “investment contracts”? If merely evidence of a transfer and not motivated by “traditional investment considerations”, so probably not
 - SEC registration and regulation required for “clearing agency” – “intermediary in making payments or deliveries . . . or provides facilities for comparison of data”; given ambiguities, consider exemptions for “banks” or seek relief from SEC
 - Broker-dealers and security-based swap-dealers using blockchain to hold or pledge tokens as collateral must ensure held in a manner consistent with requirements related to the segregation of margin
- State Law: “Money transmission”? State securities laws? State consumer protection laws? State taxes?
- Insolvency Laws: Who holds the risk of loss? Are tokens property of operator? Who then? And when?

Anti-Money Laundering & Reporting

- By virtue of Silk Road and progeny, National Regulators focus closely on AML/Bank Secrecy/Terrorist Financing Issues
- US Financial Crimes Enforcement Network (“**FinCEN**”) broadly defines regulation of “money transmitters”
 - Imposes certain transaction reporting, record-keeping, and monitoring obligations
 - FinCEN interpretations broadly cover clearing and settlement systems and transfers of funds on a blockchain
 - However, using Blockchain to record transactions is not money transmission.
- Recent Examples:
 - In FIN-2013-G001, FinCEN specified that blockchain transfer solely to settle “a bona fide purchase or sale of the real currency or other commodities for or with a customer” not acting as a money transmitter. However, freely transferrable “tokens” with value is money transmission.
 - In FIN-2015-R001, FinCEN ruled that an e-precious metals company using a blockchain ledger that issued “freely transferable digital warehouse receipts” was a money transmitter. FinCEN stated “when the Company issues a freely transferable digital certificate of ownership to buyers, it is allowing the unrestricted transfer of value from a customer’s commodity position to the position of another customer or a third-party.”
 - Fairly ambiguous, but broad ruling – distinction appears to turn on the use of digital certificates of ownership themselves as a medium of exchange between parties who are not connected to a direct purchase and sale of the commodity.

Potential Applicability of U.S. State Regulatory Regimes

- Debate over National FinTech charter vs. State regulation (and regulators’ lawsuits)
- Traditional state regulations may cover blockchain applications
 - Consumer protection
 - Money transmitter services
 - Transfer services
 - Corporate structure
 - Securities and commodities transactions
 - Taxes
- On June 3, 2015, the New York State Department of Financial Services (DFS) finalized the first comprehensive regulatory framework for virtual currency in the United States – the so-called “BitLicense” framework
 - Also covers transactions undertaken for non-financial purposes – a critical point for the development of new products using blockchain technology

Potential Applicability of State Regulatory Regimes (continued)

- By contrast, North Carolina Office of the Commissioner of Banks has published FAQs exempting several blockchain technologies from its Money Transmitters Act (“NC MTA”)
 - Blockchain “technology includes such software innovations as . . . smart contracts (i.e. agreements implemented on a virtual distributed ledger), and smart property (i.e. property that is titled using a virtual distributed ledger). These uses of the blockchain generally do not involve the use of virtual currency as a medium of exchange. As a result, these software innovations are not regulated by the NC MTA.”
- California, to date, has not adopted a state statute preferring to take a wait-and-see approach

Considerations for Regulators

Risks and Strategy for Regulation

- Highly competitive landscape
 - Large, established financial institutions are incumbents
- Increased regulatory scrutiny as industry grows is likely in multiple jurisdictions
 - Overlapping or potentially conflicting regulatory frameworks
- Start up nature of most fintech companies can mean less robust internal processes and compliance
 - Cybersecurity
 - Consumer Protection
 - Compliance with normally applicable regulatory framework
 - BSA and AML requirements; market regulation; payments requirements; etc.
 - Cross-border issues
- As with any new industry, the questions are when, who, and how to regulate?

The answers depend on the goals of regulation.

 - What are the risks that you wish to control?
 - What risks are you comfortable with the companies running?
 - What trade-offs are you willing to make to promote innovation?

Questions for FinTech Companies

- Key issues to consider
 - What is the business?
 - Follow the money – what is the strategy for profit and what are the risks?
 - Regulatory compliance
 - What type of compliance framework and governance process is there for consumer protection, AML, banking secrecy and sanctions issues, market regulation and payment systems access
 - Cybersecurity and privacy
 - Capital and funding
 - Contracts and third party rights
 - Organizational documents
 - Contingent liabilities
- Structure and regulation of ownership
- Information sharing and confidentiality
- Who are the owners and what are their interests?



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