

# The Regulation Of Crypto Currencies — A Global Overview



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Virtual commerce is one of the top emerging industries.<sup>1</sup> Within this rising commercial environment, virtual and cryptocurrencies create new opportunities when it comes to payment transactions. These currencies facilitate user anonymity, wide transferability and high independence.<sup>1</sup> By simplifying transactions and by preventing users to enter personal payment details, end users can be motivated to use virtual money. Hence, the introduction of a virtual currency for virtual goods could generate additional revenue. The possibility to earn extra virtual currency could also lock in users. Moreover, virtual currencies could be an important tool within the app market and advertising industry when designing strategies to reap benefits of the virtual goods market.<sup>2</sup> There is quite a lot of confusion however, as to what the exact regulatory framework of virtual currencies, and cryptocurrencies in particular, is. This legal brief aims to guide start-ups through the complex regulatory environment governing payment transactions. It will take a look at the current and future European legal environment and member state and foreign initiatives. This brief will focus on cryptocurrencies in particular.

## I. Virtual and Cryptocurrencies

Virtual currencies have been defined by the European Central Bank as a “**digital representation of value, not issued by a central bank, credit institution or e-money institution, which, in some circumstances, can be used as an alternative to money**”.<sup>3</sup>

**Cryptocurrencies**, of which the Bitcoin is the most successful, are a subset of virtual currency schemes. Nevertheless, due to their cryptographic nature they **differ from classic virtual payment mechanisms**, such as Facebook credits. Cryptocurrencies are based on a **decentralised peer-to-peer network, whereby an underlying algorithm generates how many value-representing units are released**. Due to their peer-to-peer nature, cryptocurrencies do **not have a central clearing house, nor does it require the intermediation of a financial institution**. Cryptocurrencies are also **created without the interference of a central authority**.

**Being decentralized, cryptocurrencies pose several dangers though**. There is **little governance built into the system**. The anonymous and encrypted nature also makes it **difficult to identify customers**. Even though anonymity may be considered an advantage for consumers, it also

**facilitates money laundering and drug trafficking**. The underlying algorithm may **also cause monetary side effects following design choices on circulation size**.<sup>4</sup> These problems have not gone unnoticed to regulators and regulatory intervention has been considered to mitigate the flaws of cryptocurrencies.

## II. European Regulation

The European legislator has remained largely silent concerning the regulation of alternative payment mechanisms, such as virtual and cryptocurrencies. The European Central Bank has tried to raise awareness concerning the potential dangers, yet at this point in time, there is no clear sign yet of regulatory intervention on an EU-wide level. The legal status of cryptocurrencies and their service providers is thus highly uncertain.

### The Current Legal Framework

**The current EU legal framework concerning payment services is set out by the Payment Services Directive (PSD)<sup>5</sup> and the E-Money Directive (EMD2).**<sup>6</sup> Whether or not virtual currencies fall under the scope of these legal instruments is highly relevant as both instruments impose several requirements on the parties subject to them, such as prudential rules and capital requirements.

#### *The Payment Services Directive*

The PSD aims to provide the legal foundation for the creation of an EU-wide internal market for payments, a single European payments area. The second objective of the directive is to provide a simplified and fully harmonised set of rules with relation to the information requirements and rights and obligations linked to the provision and use of payment services. These obligations include *inter alia* the liability of the payment service in case of misuse of a payment instrument or non-execution of a payment transaction. Although the PSD aims to cover all payments services in the EU, it is highly unlikely that cryptocurrency service providers are indeed covered by the Directive. This is because the Directive contains a wide variety of exceptions which most likely rule out the application of the Directive on cryptocurrencies.

#### *The E-Money Directive*

The EMD targets issuers of electronic money or e-money. The Directive's goal was to enable new and innovative electronic money services to be created, to provide new companies with better access to the market and to foster competition among market participants.

The application of the EMD to cryptocurrencies is unlikely however, which is primarily related to the

definition of e-money. E-money is defined as electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions and which is accepted by a natural or legal person other than the electronic money issuer.

Because e-money has to be issued on receipt of funds, an e-money issuer can thus not freely decide to create new e-money units at will. This conflicts with the nature of cryptocurrencies, where the underlying algorithm creates new crypto units, regardless of the issuer's will. Consequently cryptocurrencies are not caught under the EMD's legal framework.<sup>13</sup>

#### *Thoughts on the EU Framework*

Cryptocurrencies and their service providers currently do not fall under the European regime governing payment service providers. **At least, the application of the legal framework seems highly implausible.** However, **considering there have been warnings against the use of cryptocurrencies it is necessary to keep a close watch on future EU legislation, as well as Member States' legislative approaches.**

#### **Future EU Legislation**

Little can be said with absolute certainty with regards to future EU legislation concerning cryptocurrencies. The European Commission has launched a proposal for a second PSD (PSD2) and a fourth anti-money laundering directive (AMLD4). A revision of the EMD (EMD3) is also being considered. At the moment, virtual currencies remain largely untouched by the proposed regimes of the PSD2 and AMLD4. The EMD3 should be watched closely by start-ups though. Depending on the future definition of e-money, the EMD3 may become applicable to cryptocurrencies. Whether or not this will happen however, is still highly uncertain. **Therefore, we conclude this point with the mere warning for start-ups to follow-up on potential changes that may arise out of future regulatory changes.**<sup>14</sup>

### **III. Member States' Regulation**

**Most EU Member States such as, Belgium, France, Cyprus, Denmark, Netherlands, Portugal and Spain have no current regulation concerning crypto currencies, yet warnings have been made with regards to their potential dangers.**<sup>7</sup> Nevertheless, some Member States, such as Germany and the UK, have undertaken steps to regulate cryptocurrencies. Start-ups who wish to take advantage of the current lack of regulatory

environment must take into account possible changes to the legal framework of the country they operate in.

#### **Germany**

In Germany, the German federal financial supervisory authority (BaFin) qualifies Bitcoins as units of account. The creation of Bitcoins, as well as their use as a means of payment, does not require any authorisation. Nevertheless, if Bitcoins themselves are traded, they are considered to be financial instruments. This does require an authorisation under the German Banking Act if the purchasing or selling of Bitcoins is provided on a commercial scale. Prime examples of such activities are proprietary trading, the purchase and sale of financial instruments for one's own account as a service for others, or investment broking and broking transactions. If these activities are performed under the payment of a commission, they may be considered a banking business (principal broking service), which requires authorisation.<sup>8</sup>

#### **United Kingdom**

The UK government has announced a package of measures aimed at addressing key crime and consumer protection risks associated with digital currencies. Among the initiatives, the UK government intends to apply anti-money laundering regulation to digital currency exchanges. Additionally, voluntary standards for consumer protection may be developed. The Bank of England will also undertake research on central-issued digital currencies.<sup>9</sup>

### **IV. United States**

**In the United States the first steps towards the regulation of virtual currencies have been taken.** The Financial Crimes Enforcement Network (FinCEN) discerns three participants in generic virtual currency arrangements: the exchanger, administrator and user. An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds or other virtual currency. An administrator is the person engaged as a business of putting virtual currency into circulation and who has the authority to withdraw that currency from circulation. A user is the person who obtains the virtual currency in order to purchase certain goods or services on his own behalf. Exchangers and administrators are considered to be money services businesses when they accept and transmit convertible virtual currencies or buy or sell convertible virtual currencies. This would effectively require virtual currency service providers to have a license. These

entities would also have a capital requirement. Additionally, they would be subject to anti money laundering regulations.<sup>10</sup>

### Case Example – Ripple

In 2015, Ripple Labs, a virtual currency start-up, was fined 700,000 dollars by the FinCen after a settlement. The fine was imposed because Ripple Labs was considered in violation of the Bank Secrecy Act. Furthermore, Ripple Labs hadn't registered as a money services business. Additionally, they hadn't put an anti-money laundering program in place.<sup>11</sup>

### V. Asia

Although the Asian region has become quite prolific when it comes to virtual and cryptocurrencies, regulatory responses so far have been less positive. Most Asian countries have chosen to exclude virtual currencies from the scope of the law. In China for instance, cryptocurrencies aren't considered real currency. As such, the ties between cryptocurrencies and the established financial system have been severed.<sup>12</sup> **Although the use of cryptocurrencies hasn't been outlawed, financial and payment institutions are limited in their actions concerning cryptocurrencies.**

### VI. Conclusion

At this point in time little legal guidance can be given to start-ups who wish to embark upon a virtual- or cryptocurrency quest. **Although most countries recognize the potential dangers of these alternate payment methods, and cryptocurrencies in particular, little regulatory steps have been taken.** This is partly because these currencies are still considered to be in their infancy. Still, start-ups should be on the look-out for future legislation. On a pan-European level, the EMD3 seems particularly relevant. On the national level, the German model may be implemented in other EU Member States: entities involved in the commercial trade of cryptocurrencies require a license as they are considered to deal in financial instruments.

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