

LEGAL REGULATION OF CRYPTOCURRENCIES AND APPLICABLE RISKS

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Abstract

Cryptocurrencies – a new, but quickly developing concept within the sphere of finance. Opinions regarding it still differ, not only on a personal level, but also when it comes to governments.

Overall the legal regulation regarding cryptocurrencies in the world is still in the formation stage. Currently the legal norms that do exist, are primarily directed towards the minimization of existing risks, especially in the field of money laundering. Though there is already no reason to doubt, that during the coming years the regulation will become stricter. In some countries cryptocurrencies are outright forbidden. For example, in China, in February 2018 additions to the legislation were issues, that broadened the cryptocurrencies ban.

In other countries cryptocurrencies shall be strictly regulated. For example, in Estonia, a member of EU, cryptocurrencies are fully legal. Estonia can be reviewed as a country that independently developed its own regulation in this field. Though there is no guarantee that the legislators will keep up with the quickly developing technologies.

One way or another cryptocurrencies exist and are not going anywhere. The legislation that regulates them shall be developed further and they shall become a important part of the modern financial system. The level of their influence is hard to predict, things are changing too quickly, but their existence is a fact. It is necessary to remember, that that cryptocurrencies are not a magical solution or means of profit. It is a financial instrument, new, in many ways unique, with its own special drawbacks and benefits. It is important to know and understand them, also to keep an eye on the developing technologies.

Keywords: legal regulation of cryptocurrencies, use of cryptocurrency in Estonia, cryptocurrency as a financial instrument.

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1. Introduction

In the recent years, the cryptocurrencies have gained broad use in the world. We are talking not only about famous cryptocurrencies like BitCoin, Ethereum or LitCoin, but about various other, less known cryptocurrencies, that are actively used and are the basis for investment ICO projects (ICO – Initial Coin Offering, also the term ITO is used – Initial Token Offering) [1–3].

One way or another, the world cryptocurrencies marker is a multibillion financial sphere. It is no longer just a bold idea, that was interesting and known due to its novelty. Someone thought that cryptocurrencies were some sort of an experiment, something that is in a way true, some thought it to be a clever scam to trick gullible people and take away their hard-earned savings, but in any case, initially few considered cryptocurrencies seriously.

But over time, cryptocurrencies began to gain popularity. It is hard to point out some one reason for it. Ease of use is one, speed of transactions and independence from the world financial system are other. This independence also is the main disadvantage of the cryptocurrencies, they are mostly unregulated. Many cryptocurrencies are also not secured by anything, which is the reason for their high volatility, one should just remember the famous BitCoin value shifts. Basically, the value of many cryptocurrencies is based only on the level of trust and requirement.

2. Legal regulation

It may seem strange that something as important as cryptocurrencies have no solid legal regulation. But such is typical when something new, previously unregulated appears. New technologies or new concepts can be an example. One should just look at the history of money. At first there was just natural trade and only much later people invented money – coins from precious metal of set weight and began to actively use them and also regulate them legally. Appearance of money was not spontaneous, the development of the society required a universal means of payment.

Later banknotes appeared, initially those were debt notes from the bank for the set sum of money, which is obvious from the name itself (banknote: bank and note). They were not initially meant to be used as means of payment, but people quickly noticed that they can be used as money, something that obviously made legal regulation necessary. Later it became possible to keep money electronically on a bank card, something that also required legal regulation. And for the most part all those innovations did not appear out of nowhere and were not accepted as a norm outright. It is a development process and the human society already came a long way to the position when it is no longer necessary to keep banknotes or coins in a wallet, one just needs a bank card, though of course no one has yet removed payments by cash.

So we have a question, can we consider cryptocurrencies as the next stage for money development? Quite possible. Either way it is a new and in many ways unique solution that gives an answer to many questions that the traditional financial system could not answer. But as any innovation cryptocurrencies require time and valid legal regulation.

And here we come to a very serious problem. We need to answer what cryptocurrencies are. It is hard to regulate anything legally if there is even no legal definition. And the answer is not as obvious currently, in many countries they answer it differently, search and develop their own approach. There is no unified answer on the international level. In Europe the project of the directive that should implement regulation norms is still being developed, they work towards minimization of illegal activities [4]. As of now, internationally, cryptocurrencies are viewed somewhere as money, somewhere as securities and somewhere as commodities [5, 6]. There is no need to point out that such variety of approaches is the reason for a certain level of confusion in the field of taxation. Financial operations are generally VAT free, but selling commodities or services can be subject to taxation.

The approach of countries can be very different. In China cryptocurrencies are forbidden (in February 2018 new additions to the legislation were implemented that broaden the ban [7]). In Estonia, a country that is a member of EU, cryptocurrencies are fully legal. Estonia can be viewed as an example of a country that developed its own regulation of this field.

3. Estonian legal regulation of cryptocurrencies

Initially the cryptocurrencies were first regulated by the Estonian legislation in 2016, as valid additions to the Money Laundering and Terrorism Finance prevention act were implemented [8]. Cryptocurrency was defined as “Alternative means of payment”, in other words an alternative way to make payments. From January 2018 the provisions of the law in the field of cryptocurrency regulation were changed and broadened [9]. Cryptocurrency is now called “Virtual value”, also virtual value wallet service, basically the type of an account for keeping cryptocurrencies, is regulated.

Thus in Estonia cryptocurrencies are viewed primarily as means of payment, in other words, as money. At the same time to issue cryptocurrencies, open e-wallets and overall to work in this field one must obtain the required licenses.

Obtaining a license is a part of a separate proceeding, that is initiated by presenting an application to the Money Laundering Prevention Bureau of Estonia, that is a part of the Estonian Police and Customs board (est. Politsei ja Piirivalveamet). The required documentation must be added to the application, including the company money laundering prevention policy (AML – Anti-money laundering policy) [10].

Said rules are the basis for the activities of the company, they must include the required procedures, including means for client identity verification (KYC – Know Your Customer/Client), means of controlling client activities in regards to money laundering risks, cooperation with state authorities, information storage rules and other. This means, that in order to legally work with cryptocurrencies in Estonia, the company must act in accordance with applicable legislation and take responsibility for who they are working with.

Said legal norms are directed primarily to combat illegal activities, as during the last years cryptocurrencies were also used for money laundering due to the high anonymity level that they offered. Many such service providers use holes in legislation and did not control who and how operates

through their systems. As such, countering such activities became the priority of cryptocurrencies legal regulation.

Another factor that had a negative effect of the cryptocurrency reputation is that among many ICO and ITO projects, there are many failed projects and quite a few scam projects [11]. In this area high level of responsibility is with the clients themselves as they should take a very careful approach when it comes to participating in such projects and should carefully review the available documentation. In Estonia among other documents, in order to obtain the license, the company must present confirmation that the key officials in the company have no prior criminal legal sentences and that they have the required level of competence. Of course, this does not guarantee that the project will be highly profitable, but the very least gives the reason to think that there are competent people involved and the project is in conformity with the law.

But all of the stated above is only applicable in Estonia if the functionality of the given cryptocurrency is in conformity with the law – if it is an alternative means of payment. The problem is that modern technologies and the specifics of any given platform may significantly alter the functionality of the cryptocurrency. One way it is often used, as was already stated, is the alternative way to pay for something or to provide bonuses (utility token). But often, cryptocurrency tokens are given another function.

We are talking about a security token. This type of cryptocurrency token is often used in various investment projects. The main idea is that the holder of the token is entitled in the future to the part of the profit generated by the project, basically the right to dividends. Such functionality drastically changes the whole approach. As was stated by the Financial Inspection of Estonia (the main financial control authority in Estonia), such tokens are basically securities [12]. In order to work with securities another type of license is needed and the conditions for obtaining it are far stricter [13]. In other words, such activities are not forbidden, but are very strictly regulated and that is often a very serious obstacle. The ICO and ITO projects are relatively cheap, but the license to work with securities entails high monetary costs and will require much time.

Should be noted that a similar approach is in USA. SEC (US Securities and Exchange Commission) overall states that specific registration is required for such projects. [14]. Regular consumers are considered too vulnerable for various scam schemes.

4. Conclusion

Overall the legal regulation of cryptocurrencies in the world is being developed. Currently the norms that do exist are directed for risk minimization, especially when it comes to money laundering. Though there is already no reason to doubt, that during the coming years the regulation will become stricter. In some countries cryptocurrencies are outright forbidden. In other countries cryptocurrencies shall be strictly regulated. Though there is no guarantee that the legislators will keep up with the quickly developing technologies.

Also, aside from the purely legal risks, cryptocurrencies along with many benefits have many faults. First of all the already mentioned volatility and the low level of trust from regular consumers. Not everyone is willing to keep their savings in an asset that may instantly lose value. In the end cryptocurrency is a program code, that is given some value. But if one thinks, is it so different from regular currencies, they are mostly no longer secured by a gold standard and many types of currencies exist purely due to the level of trust and their universal applicability.

One way or another cryptocurrencies exist and are not going anywhere. The legislation that regulates them shall be developed further and they shall become an important part of the modern financial system. The level of their influence is hard to predict, things are changing too quickly, but their existence is a fact.

As for those who wish to use cryptocurrencies or wish to try themselves out in the field, they should first of all carefully study and understand what exactly they are dealing with. Projects created and working in the jurisdiction with a more or less solid legal regulation, with licensing norms and state control, are as a general rule, much more reliable. If there is any doubt one should consult a lawyer or send an inquiry to state organs. In other words cryptocurrencies require a careful and thoughtful approach. Promises of quick profit is like the well known cheese that can only be found

in a mousetrap. But among ICO projects, among many types of cryptocurrencies, there are quite a few interesting and profitable projects. One just should remember, cryptocurrencies are not magical solutions, not foolproof way of earning. It is a financial instrument, with specific drawbacks and advantages. One should just know and understand them and also keep an eye on the development in the field of legal regulation.

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