Regulation of cryptocurrencies

Peter Kiernan, an independent consultant specialising in compliance and financial crime, began his talk with the age-old maxim 'In the land of the blind the one-eyed man is king'. In the world of cryptocurrencies, this adage is remarkably apt, especially if talking about the one-eyed regulator.

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KIERNAN WAS SPEAKING at the Hubbis 'Compliance in Asian Wealth Management Forum' in Singapore on January 18. The subject of his talk was how the regulatory world is shaping up to control - or at worst lose control of - the growing universe of cryptocurrencies.

Kiernan is a solicitor and currently a consultant specialising in compliance and financial crime, having spent 14 years at the UK Serious Fraud Office and having risen to the rank of Deputy Director before branching out into private practice around a decade ago.

PETER KIERNAN
Consultant

Are cryptos any more tainted than cash?

"I am struck when reading about this market how many negative comments there are, for example, that cryptocurrencies are used by terrorists, by drug dealers, money launderers and other criminals. Well, yes this is quite possibly true. But, please remember that so is the mainstream banking system. Every debit card, every payment system known to man is used by terrorists, drug dealers and money launderers. Viewed in this way digital currencies are no better and no worse, than any other financial tool."

Kiernan explained that what most upsets the law enforcement community is the word 'untraceable', but he noted that cryptocurrency activity is not actually untraceable.

"Blockchain activity is public ledger, so by definition the transactions are public and traceable. The only problem is that the authorities have no idea who the parties are in the transaction. The question is how much money is law enforcement going to spend on this."

Addressing this matter, a European Central Bank governing council member has been quoted as saying that the same rules ought to apply as in any other financial transaction, namely that everyone involved should reveal their identity. He was also reported as expressing frustration that the ECB had stopped printing 500-euro notes in order to fight money laundering, while at the same time anonymous transactions in cryptocurrencies such as bitcoin were proliferating.

Cryptos have no home, therefore no home rules

Kiernan told the Hubbis audience that the market is unregulated partly because cryptocurrencies have no home, no country, so are not naturally regulated by any local jurisdiction.

"Even though every country in the world now has anti-money laundering regulations," he noted, "it was only one year ago that America brought in provisions requiring people to understand who the beneficial owners of the companies are." Implying that any expectation of global consensus on cryptocurrency regulation is still a long way off.

As cryptocurrency transactions are generally anonymous, which makes them vulnerable to being misused for unlawful activities. If a cryptocurrency intermediary is found to have used cryptocurrencies illegally, its operations could be shut down by law enforcement agencies. There is also a risk of loss should the cryptocurrency intermediary be hacked, as it may not have sufficiently robust security features.

He highlighted a key difference between cryptocurrencies and 'fiat' currencies. "Governments can print as much money as they want and typically over time real currencies deflate. Whereas theoretically because bitcoin, for example, is limited to only 21 million units it seems to differ greatly from fiat currencies."

Kiernan noted that amidst all the euphoria and negativity surrounding Bitcoin and other cryptocurrencies Singapore has, in the Monetary Authority of Singapore (MAS), the only regulator he is aware of which has spoken in favour of blockchain technology. "They see valuable real-world applications, but it is important to note that they are differentiating the technology from the digital manifestations such as Bitcoin."

So where are we on regulation?

MAS cautions against investments in cryptocurrencies

- As most operators of platforms on which cryptocurrencies are traded do not have a presence in Singapore, it would be difficult to verify their authenticity or credibility. There is greater risk of fraud when investors deal with entities whose backgrounds and operations cannot be easily verified.
- Cryptocurrency transactions are generally anonymous, which makes them vulnerable to being misused for unlawful activities. If a cryptocurrency intermediary is found to have used cryptocurrencies illegally, its operations could be shut down by law enforcement agencies. There is also a risk of loss should the cryptocurrency intermediary be hacked, as it may not have sufficiently robust security features.

But regarding the cryptocurrencies themselves, the MAS has been careful to advise the public to act with extreme caution and to understand the significant risks they take on if they choose to invest in cryptocurrencies.

Kiernan also noted that according to Andrew Bailey, head of the UK's Financial Conduct Authority (FCA), buying Bitcoin is tantamount to gambling, that it has a similar level of risk and that it is not a currency.

Regulators need night vision goggles

"The risk of misuse draws the attention of law enforcers and the Americans say that they are now developing software which will help them analyse transactions in order to identify those they want to invest more effort and time in," explained Kiernan.

"But, as it appears right now, this market is not capable of being directly regulated. Why? Because nobody knows where it is. Whilst there is a record of what has happened, there is no record of exactly where it happened and who was involved."

Kiernan also highlighted the regulatory approach being taken by Australia. "They are in the process of consulting on the application of basic standard anti-money laundering, know your customer, customer due diligence rules for exchanges." But exchanges can move jurisdictions as well, if rules or compliance become too onerous and other venues offer a simpler and less costly interface with the customer base.

"The Australian approach is a relatively simple way forward," he explained, "but unless it is mirrored globally, it might only drive exchanges elsewhere. Meanwhile, the US approach has the simplicity of treating cryptocurrencies as property and taxing profits as capital gains but requires significant, possibly huge effort to chase down tax evaders."

The US authorities, Kiernan elucidated, are taking a different approach, treating cryptocurrencies such as bitcoin as a commodity. "It is a mechanism for trying to hold people accountable and, not surprisingly as with most things in America to do with law enforcement, it is also a taxation issue and therefore has a revenue-generating aspect."

Kiernan added noted that the IRS [The Internal Revenue Service] has started to issue summons to coin exchanges to identify transactions. Kiernan also explained that aside from the US and Australian regulatory approaches, there is a wide variety of regulatory perspectives across the globe, with some countries banning cryptocurrencies, some tacitly accepting them and others sitting on the fence.

No harmonisation on the horizon

"The lack of harmonisation is a problem and that means there will be continued caution over-investing or trading in cryptocurrencies," Kiernan observed.

Kiernan concluded with a gentle warning to regulators and individuals alike: "Perhaps the biggest problem right now is that the clear majority of people do not understand the risks they are addressing."

There are various options for the regulatory world to consider at this stage. Should cryptocurrencies be treated as commodities, not currencies? How can the exchanges be regulated to provide transparency and customer protection? Should access to the exchanges be tightened via direct regulation?

For regulation to work Kiernan observed that there must be a global regulatory standard that is applied consistently. The approach must address the risks cryptocurrencies represent. And law enforcement must be targeted and enabled to allow for effective action against wrongdoers. ■