The Changing Regulatory Landscape of Blockchain Technology

Jennifer M. Moore – April 10, 2018

The advent of blockchain technology within the past decade has left investors and regulators with varied emotions—ranging from intrigue, to confusion, to indifference. A blockchain is a digital ledger shared among members of a network that can be used to record financial transactions, such as exchanging assets. No centralized institution intercepts the transactions. Instead, members of the network use a "consensus" to ensure that shared ledgers are exact copies, which is designed to lower the risk of fraudulent transactions. The transactions are then linked in chronological order and validated, hence the name "blockchain." The use of blockchain technology has been popularized by the exchange of the cryptocurrency bitcoin, a type of virtual currency.

Although virtual currency is a digital representation of value that can be traded, it also has the potential to represent other rights as well. This quality of virtual currency yields it prime for regulation by federal agencies, including the Internal Revenue Service (IRS), the Financial Crimes Enforcement Network (FinCEN), and the Securities and Exchange Commission (SEC). In short, these regulatory agencies are grappling with how best to confront this phenomenon.

The IRS has primary responsibility for regulating blockchain tax concerns. In 2014, it indicated that it would treat virtual currencies as "property" rather than currency for tax purposes. When calculating one's gross income, the fair market value of virtual currency received as payment for goods or services must be reported in U.S. dollars, making the exchange of virtual currency subject to tax consequences that may lead to tax liability. *Fortune* magazine reported that Chainalysis, a company that the IRS is using to identify owners of digital wallets used to store bitcoins, has information on 25 percent of all bitcoin addresses and will use

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the information to identify those who have failed to pay taxes. However, one issue facing the IRS is that the technology underlying the blockchain is anonymous—the transactions themselves are public but are linked only to an electronic address, thus shielding the individual's identity.

FinCEN has also sought to clarify the application of the Bank Secrecy Act for individuals who exchange or create virtual currencies. In a March 2013 report, it found that a "user" of virtual currency is not a money service business (MSB), however, an "administrator" or "exchanger" *is* an MSB—specifically, a money transmitter. Thus, "administrators" and "exchangers" of virtual currencies are subject to FinCEN's registration, reporting, and recordkeeping regulations. In July 2017, FinCEN assessed a $110 million fine against a foreign-located MSB and one of the largest virtual currency exchanges, BTC-e, for facilitating "transactions involving ransomware, computer hacking, identity theft, tax refund fraud schemes, public corruption, and drug trafficking." It found that the exchange apparently embraced criminal activity taking place at the exchange, including open conversations about how to process and access money gained from illegal drug sales on darknet markets, such as Silk Road.

Similarly, the SEC has ratcheted up its regulation of many token sales, or initial coin offerings. The test articulated in *SEC v. Howey*, 328 U.S. 293, 298–99 (1946) will likely determine whether such sales are securities: (1) a person invests his money (2) in a common enterprise (3) expecting profits solely from the efforts of another party. In July 2017, it investigated whether a virtual organization executed on a distributed ledger had violated the federal securities laws, noting that the sale of tokens used to fund various projects, the reliance of customers on the organization's curators for "failsafe protection" from "malicious actors," and the customers' expectation of profits from the investment in tokens all were sufficient evidence that the tokens were in fact securities. In a statement on December 11, 2017, SEC Chairman Jay Clayton noted that calling a token a "utility token" does not prevent it from being a security, which embraces the sentiment of the Supreme Court's decision in *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943), where it held that such "novel" devices are securities if the character of the token in commerce resembles an "investment contract" or a "security." As of December 2017, no initial coin offerings had been registered with the SEC. However, in February 2018, the SEC suspended trading in three issuers of cryptocurrency for questions regarding the nature of the companies' business operations and failure to meet certain reporting requirements.

While its regulation remains unchartered territory, the use of blockchain technology in financial transactions has the potential to

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provide businesses and financial institutions with an innovative method by which to conduct their transactions.

Practice Points

- For IRS purposes, the maintenance of accurate records of all virtual currencies received or sent as payment for goods and services should be updated for accurate tax reporting.
- For FinCEN purposes, organizations should ensure that they have adequate anti-money-laundering compliance programs in place to avoid liability for failure to register as an MSB or to file suspicious activity reports.
- For SEC purposes, those who intend to sell digital assets that behave like securities should register with the SEC as a national securities exchange, or seek exemption, regardless of whether the asset is officially designated as a "security" or a "token."

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