

Virtual Currencies – basing innovation on offline regulation

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Abstract: Financial technology is evolving at an outstanding pace and, as a result, a multitude of regulatory frameworks are challenged. With this regard, elements intrinsically linked with the payment industry, namely money laundering/terrorism financing compliance or consumer protection intersect in a quite complicated logic with market specific principles like the desiderates of harmonized regulation, fostering innovation or assuring undistorted competition. In such context, the EU political will is less coherent and the decision-making process more controversial given the fact that the level of risk appetite and literacy towards novelty is different amongst both, public and private stakeholders.

List of abbreviations

AML/CTF – Anti money laundering/Counter terrorism financing

AMLD – Directive on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing

EBA – European Banking Authority

ECB – European Central Bank

EU – European Union

FATF - Financial Action Task Force

NPO – Non Profit Organization

PSD - Directive on payment services in the internal market

R&D – Research & Development

SMEs– Small and medium-sized enterprises

UK – United Kingdom

The EU bottom up regulatory outcome

The beginning of year 2015 finds virtual currencies in the middle of a proportionality assessment related to the advantages and threats they present. To this extent digital money is considered to bring benefits as increasing cross boarder transactions (especially for smaller financial institutions), decreasing account maintenance costs or providing for real time worldwide settlements.¹ On the other hand, when it comes to possible threats, the criminal activity of anonymously purchasing illegal goods or services, (e.g. Silk Road case), cybercrime/theft (e.g. Mt. Gox case), sanctions avoidance (e.g. Iran case) or money laundering (e.g. Liberty Reserve case) and terrorism financing (e.g. crowdfunding cases) have all been on the authorities' agenda all around the world.

As the 'digital currency club' is nearing 300 models with Bitcoin being at the forefront, it is crystal clear that from the early days in 2009 the development of convertible decentralized virtual currencies took place in a very effective way.²

Taking a look at that time's EU legislation, the E-Money Directive³ imposed a very narrow definition on what is to be considered electronic money. Citing, 'electronic money means electronically, [...] stored monetary value [...] which is issued on receipt of funds for the purpose of making payment transactions [...].'⁴

As an effect of this legal drafting technique, bitcoins and other modern virtual currencies evaded falling within the scope of the Directive as they are generated automatically within a network and not issued on receipt of funds.⁵ Moreover, as most of the secondary legislation dealing with payment services (3rd AMDL⁶, PSD I⁷)

¹ *Five ways Bitcoin could shake up finance* (2014) seen on: <http://www.paymentscardsandmobile.com/five-ways-bitcoin-shake-finance/> on 2015.03.03.

² *As more virtual currencies sprout, Bitcoin gang nears 300-mark* (2014) seen on: <http://www.firstpost.com/business/money/as-more-virtual-currencies-sprout-bitcoin-gang-nears-300-mark-1972273.html> on 2015.03.03.

³ Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions, OJ L 267/7

⁴ Ibid, art. 2.

⁵ Niels Vandezande, 'Between Bitcoins and mobile payments: will the European Commission's new proposal provide more legal certainty?', *International Journal of Law and Information Technology*, Vol. 1, No. 16, (2014) p. 6.

⁶ Directive 2005/60/EC of the European Parliament and of the Council of 26 October 2005 on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing OJ L 309/15.

⁷ Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market OJ L 319/1.

makes cross-references to this definition, the virtual currencies industry developed itself to this extent without any EU regulatory framework.

Leaving digital money outside the legal effects seems to have been a difficult compromise between the EU legislators (i.e. Commission, Parliament and EU Council) as the recital proves some intent for a more dynamic approach: ‘the definition of e-money should cover [...] not only all the electronic money products available today [...] but also those products which could be developed in the future.’⁸

On the other hand, even though the recital has only interpretative value – ‘the preamble to a Community act has no binding legal force and cannot be relied on as a ground for derogating from the actual provisions of the act in question’⁹ – it is a clear proof of political will for an up to date regulatory perspective.

However, as far as the legislative context developed so far, neither the newly negotiated and agreed 4th AMLD¹⁰, nor the current proposal for the PSD II¹¹ have in their text any reference to virtual currencies.

This was possible due to the fact that within the EU the policies towards digital money differ; for example, on one side the German Federal Financial Supervisory Authority has regulated virtual currencies as financial instruments, making them subject to AML/CTF rules. In the same time, for economical activities other than these for personal usage (e.g. exchange platforms, wallet services) there is the need for authorization.¹² Moreover, some German organizations lobby with the purpose of banning digital money due to the different risks they present for consumers (e.g. theft, volatility, money laundering/terrorism financing).¹³ In line with the German way of regulation, the French Prudential Supervisory and Resolution Authority delivered its position concerning transactions involving virtual currencies

⁸ Directive 2009/110/EC, recital 8.

⁹ Case C-134/08 *Hauptzollamt Bremen v J.E. Tyson Parketthandel GmbH* [2009] I-02875 para. 16.

¹⁰ COM (2013) 45 final – Compromise Text – Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing seen on <http://data.consilium.europa.eu/doc/document/ST-5116-2015-ADD-2/en/pdf> on 2015.03.07.

¹¹ COM/2013/0547 final - 2013/0264 (COD) Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 2002/65/EC, 2013/36/EU and 2009/110/EC and repealing Directive 2007/64/EC seen on: <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013PC0547> on 2015.03.08.

¹² *Bitcoins: Supervisory assessment and risks to users* (2014) seen on: http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2014/fa_bj_1401_bitcoins_en.html on 2015.03.08.

¹³ *Large German lobby organization supports ban on Bitcoins* (2014) seen on: <https://bitcointalk.org/index.php?topic=11061.0;wap2> on 2015.03.08.

and stressed that the act of intermediation with respect to the purchase or sale of digital money in exchange for fiat currency is that of a financial intermediary.¹⁴ As it can be seen, the major regulatory trends are either to consider virtual currencies financial instruments or have the exchange platforms categorized as reporting obliged entities.

On the other hand, in contrast with the German and French position, the UK government has embraced a financial technology friendly policy¹⁵ and never imposed a formal obligation for consumer protection or AML/CTF compliance for virtual currency businesses operating in its jurisdiction.¹⁶ Recently, the UK Treasury organized a call for information as part of the general governmental endeavor of promoting innovation and competition in the banking sector.¹⁷ This approach towards fostering fintech must also be understood in the context in which the United States have adopted burdensome legislation with regard to digital money (e.g. imposing exchange platforms the same requirements as to money transmitters) and, as a result, the UK relaxed policy option can be considered a good incentive for the different businesses to relocate.¹⁸

The existence of all these diverging views at the supranational level resulted in a lack of leadership and the absence of path dependency that could have made the 28 Member States embrace the same political agenda with regard to these novel payment instruments.

Even though the rest of the Member States recognize virtual currencies as being a threat for the financial system, very few of them took effective actions in the absence of binding rules from the EU level; to this extent the tendency has been to promote non-legislative measures (e.g. warnings based on the EBA opinion on virtual

¹⁴ *Recommendations to prevent virtual currencies from being used for fraudulent purposes and money laundering* (2014) seen on: <http://www.economie.gouv.fr/files/regulatingvirtualcurrencies.pdf> on 2015.03.10.

¹⁵ *Chancellor on developing FinTech* (2014) seen on: <https://www.gov.uk/government/speeches/chancellor-on-developing-fintech> on 2015.03.10.

¹⁶ *HMRC: UK bitcoin exchanges don't have to register under money laundering regulations* (2013) seen on: <http://www.coindesk.com/hmrc-uk-bitcoin-exchanges-dont-have-to-register-under-money-laundering-regulations/> on 2015.03.10.

¹⁷ *Digital currencies: 5 reasons we're calling for information* (2014) seen on: <https://www.gov.uk/government/news/digital-currencies-5-reasons-were-calling-for-information> on 2015.03.10.

¹⁸ *Request for Administrative Ruling on the Application of FinCEN's Regulations to a Virtual Currency Trading Platform* (2014) seen on: http://www.fincen.gov/news_room/rp/rulings/html/FIN-2014-R011.html on 2015.03.11.

currencies)¹⁹. However, Estonia's authorities imposed a licensing scheme for virtual currency traders²⁰ while the Belgian Financial Markets and Services Authority went the extra mile and prohibited the distribution to retail clients of financial products whose performance depends on virtual currencies.²¹

Also, after the Charlie Hebdo attack more jurisdictions are expected to embrace a regulatory approach in order to combat the anonymity related threats; while transposing the 4th AMLD several Member States may consider virtual currencies exchange platforms as obliged entities or have the different schemes analyzed in the national risk assessments. Also, as on the EU agenda²² there has been a shift from the money laundering concerns towards the terrorism financing threat, the EU legislators urge having virtual currencies introduced in one of their current or future pieces of secondary legislation. Of relevance in this matter is the French government declaration stating that action needs to be taken in respect of terrorist financing and a way to do so is by removing anonymity in most of the dealings with virtual currencies. Also, it stressed that digital money should also be included in the loop for the ML/TF risk assessments (i.e. national and supranational) that will be carried out in the next period.²³

Summing up, it can be seen that the European Member States are unanimous on recognizing threats posed by digital money; however, the level of action differs depending on how much risk appetite national governments have in the matter of novel payment instruments. As a consequence, in the absence of a coherent majoritarian view, it will be left for each jurisdiction to configure its own solution and for private operators to voluntarily raise their compliance standards.

¹⁹ *Bitcoin's Legality Around The World* (2014) seen on: <http://www.forbes.com/sites/kashmirhill/2014/01/31/bitcoins-legality-around-the-world/> on 2015.03.10.

²⁰ *FIU Regulation* (2014) seen on: <https://www.politsei.ee/et/uudised/uudis.dot?id=314939> on 2015.03.12.

²¹ *Ban on distribution of certain financial products in Belgium* (2014) seen on: <http://www.whitecase.com/files/Publication/4121732f-4639-49df-aed9-8556c8632eab/Presentation/PublicationAttachment/5aaa1585-6fae-4069-946a-b1191d7603ed/alert-ban-distribution-financial-products-belgium.pdf> on 2015.03.12.

²² *EU is stepping up the fight against terrorism* (2015) seen on: <http://europefinancing.com/eu-is-stepping-up-the-fight-against-terrorism/> on 2015.03.13.

²³ *France calls for strong regulation of Bitcoin in EU counter-terrorist financing laws following Charlie Hebdo incident and an end to anonymous financial transactions* (2015) seen on: <http://www.antimoneylaunderinglaw.com/2015/01/france-eu-call-for-expedited-regulation-of-bitcoin-to-strengthen-counter-terrorist-financing-efforts-following-charlie-hebdo-incident-and-an-end-to-all-anonymous-financial-transactions-through-repor.html> on 2015.03.13.

The impact on innovation markets

Having regard to the actual *status quo*, it is more than plausible that the different EU markets will be partitioned from a regulatory point of view. Having this as a premise, the whole virtual currencies industry will suffer due to the fact that most of the transactions take place in a cross border context. Moreover, aiming for passported services will be too burdensome or even impossible. Exemplifying, a travel agency operating worldwide will have to adapt its payment system as to accept virtual currencies in some states and not in others. In the same time, the fees for converting virtual currencies into fiat money will differ depending on the specific compliance expenses exchange platforms might experience in particular jurisdictions (e.g. customer due diligence costs).

This lack of harmonization has already developed issues related to legal certainty, trusts and also, diminished the risk appetite of private actors in incorporating virtual currencies in their services' portfolio. In consequence, a lot of virtual currencies' start-ups (SMEs) have a hard time finding banks to host their accounts; it is for sure the threats linked with their anonymous character and the risk of having 'dirty money' introduced in the banking system are the ones mainly discouraging financial institutions to engage in business relationships with the fintech entrepreneurs.

In order to understand the phenomenon better, reference must be made to the \$1.9 billion U.S. fine in a money-laundering case that HSBC was charged with in 2012.²⁴ Also, the increased media interest towards financial crime (e.g. Lux leaks, Swiss leaks)²⁵ and the huge reputational damage vulnerabilities made the banking sector have a cautious approach and decrease their risk appetite in operating with financial technology.

Having regard to these facts, there is a legitimate expectation that most of the regulators will start from a presumption of threat when regulating the industry *per se*. This way of approaching the topic is based on the solid portfolio of already mentioned cases where anonymous virtual currencies have been misused. Of relevance are the

²⁴ *HSBC to pay \$1.9 billion U.S. fine in money-laundering case* (2012) seen on: <http://www.reuters.com/article/2012/12/11/us-hsbc-probe-idUSBRE8BA05M20121211> on 2015.03.14.

²⁵ *Jean-Claude Juncker must push through EU directive on money-laundering* (2014) seen on: <http://www.theguardian.com/world/2014/dec/09/jean-claude-juncker-must-push-through-eu-directive-on-money-laundering> on 2015.03.14.

declarations made by two successive Commissioners responsible for financial instruments (i.e. Michael Barnier²⁶ and Jonathan Hill²⁷) that talk about virtual currencies in terms of ‘financial crime risks’ and ‘threats’. On the other hand, from the same policy perspective, as it will be further developed, this way of reasoning has the potential of hindering innovation and competition in the internal market.

Transposing this new paradigm in market behavior there is a tendency for big players to be risk averse and, at the cost of losing clients, follow a very rigid and narrow compliance strategy. Generally speaking, de-risking relates to ‘the phenomenon of financial institutions terminating or restricting business relations with clients or categories of clients to avoid, rather than manage risks’.²⁸ The development of such behavior made several international actors (e.g. FATF, G20, European Banking Association or the European Commission) take concrete action and present positions and solutions for the avoidance of major market hindrances.

Giving clear examples, ‘victims’ of this new *status quo* are politically exposed persons, NPOs based in conflict areas, third-party payment processors and virtual currency businesses. In this matter, banks gave their endeavor stereotypical nuances by dropping categories of clients without always respecting a case-by-case risk analysis.²⁹ Reacting, the FATF plenary has emphasized that: ‘what is not in line with the FATF standards is the wholesale cutting loose of entire classes of customer, without taking into account, seriously and comprehensively, their level of risk or risk mitigation measures for individual customers within a particular sector’.³⁰

One of the landmark cases can be tracked back to 2013; it took place between Barclays (i.e. bank) and Dahabshiil (e.g. remittance company) and was based on competition law grounds as the Somali undertaking accused the UK bank of abusing its dominant position by refusing to deal. While bank officials announced their decision to close the accounts of about 250 money-service businesses in light of fears

²⁶ EU executive to look at regulating Bitcoin currency (2014) seen on: <http://uk.reuters.com/article/2014/07/04/uk-eu-bitcoin-barnier-idUKKBN0F916I20140704> on 2014.03.15.

²⁷ *Turning around the telescope – consumers at the center of financial services policies* (2014) seen on: http://europa.eu/rapid/press-release_SPEECH-14-1905_en.htm on 2015.03.12.

²⁸ *FATF clarifies risk-based approach: case-by-case, not wholesale de-risking* (2014) seen on: <http://www.fatf-gafi.org/documents/news/rba-and-de-risking.html> on 2015.03.09.

²⁹ *FATF warns on banks’ approach to de-risking* (2014) seen on: <http://www.ft.com/intl/cms/s/0/087afe70-66bc-11e4-91ab-00144feabdc0.html#axzz3TvWzWcAs> on 2015.03.16.

³⁰ *Ibid* fn. 28.

of terrorism financing, in this particular case, the UK High Court ordered an interim injunction having in mind humanitarian concerns as the Somali GDP is in a significant percentage based on money transfers made from the diaspora.³¹

Same banking policy tends to be applied to novel financial instruments; after several important voices from the regulatory side (e.g. EBA, ECB, FATF) emphasized on the threats linked to digital money (e.g. over 70 in the EBA report),³² banks decreased their risk appetite, at least up to the moment when regulation will be put into place. For example, Ireland's Bitcoin ATM company had been refused by Bank of Ireland in its application for a bank account while the largest Nordic Bank and forex trader (i.e. SEB), made public the fact of refusing all clients' requests to open accounts for virtual currencies usage.³³ Also, very recently an important Polish bitcoin exchange has had its accounts suspended by the host bank for lacking credentials that would make costumers identifiable.³⁴

As it can be seen, the compliance requirements for more transparency are doubled by other consumer protection imperatives like the one for reducing volatility or theft threats. Linking the possible measure with the fact that most digital money businesses are in a wide majority conducted by SMEs, it is most likely that market entrance will be hindered and, as result, consumers will face less options and higher prices. In the absence of an innovative answer for complying with the expected standards – which are similar to the ones financial institutions have to respect today - the anticipated financial burden seems too high in order to grow real alternatives to the actual financial system.

Concluding remarks

It is for sure that virtual currencies, as part of the larger fintech panel, are for the moment 'stuck' in both, the political and corporate governance decision-making

³¹ *Remittance company awaits court ruling on Barclays account closure* (2013) seen on: <http://www.theguardian.com/global-development/2013/oct/16/barclays-somalia-remittances-court-ruling> on 2014.05.16.

³² European Banking Authority, *EBA Opinion on 'virtual currencies'* (2014) seen on <http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf> on 2015.03.12.

³³ *Largest Nordic Bank SEB Refuses To Accept Bitcoin Amid Risks* (2014) seen on: <http://dcmagnates.com/largest-nordic-bank-seb-refuses-to-accept-bitcoin-amid-risks/> on 2015.03.11.

³⁴ *Bank Suspends Polish Bitcoin Exchange's Accounts* (2015) seen on: <http://www.coindesk.com/bank-suspends-polish-bitcoin-exchanges-accounts/> on 2015.03.06.

schemes. In some cases, the difference in the stakeholders' views makes a compromise look impossible fact that places innovation in the legal offline.

This is for sure not a desiderate; as the EU Digital Agenda aims to foster cross-border online sales and introduce better conditions for SMEs to conduct business via internet³⁵, a clearer and more uniform policy answer with regard to virtual currencies should be established, at least at a principle level. Once things are settled this way, it will be easier for the EU legislators to revisit previous legislation (e.g. AMLD, PSD, E-Money Directive) or create special one and not engage in a short run, contextual and incomprehensive approach.

The proportionality debate involving criminal prevention on one side and innovation and competition on the other side is an artificial one as all are important market values that can coexist in the digital age; however, in order to accommodate them, viable technological solutions must be available.

In this case, the best way to keep pace with innovation is by further innovating; for example, when dealing with the anonymous characteristics and theft vulnerabilities of virtual currencies, instruments and know how similar to the ones mentioned in the e-identification³⁶ legislation could be used. Also, as some banks and financial institutions³⁷ are willing to embrace this new technology it is for them to invest in R&D projects and come with the most cost efficient and effective compliance solutions. In this race the incentive should be on the long run and any temptations of taking advantage of current legal loopholes or system vulnerabilities will come with financial and reputational damages.

Bearing this in mind, by proposing clear technological solutions (e.g. for both transparency and consumer protection) private stakeholders can be the ones shifting the paradigm from a purely political discussion to one in which technical answers can be given. Virtual currencies are not good or bad *per se*; they belong to the market and it depends on the industry and regulators how their perspective will look like.

³⁵ *Digital Agenda for Europe* (2014) seen on <http://ec.europa.eu/digital-agenda/our-targets-0> on 2015.03.16.

³⁶ Regulation (EU) No 910/2014 of the European Parliament and of the Council of 23 July 2014 on electronic identification and trust services for electronic transactions in the internal market and repealing Directive 1999/93/EC OJ L 257/73.

³⁷ *BNP Paribas Analyst Sees Bitcoin as Technological Tool For the Financial World* (2014) seen on: <http://www.coinsetter.com/bitcoin-news/2014/11/14/bnp-paribas-analyst-sees-bitcoin-technological-tool-financial-world-1768> on 2015.03.16.