

The times they are a changing

The emergence of blockchain and bitcoin and an association of electronic-based currencies and assets may be the first sign of a fundamental series of changes on the way in which corporate equities, bonds and other aspects of finance are changed. This in turn will lead to related developments in law and regulation.

Since blockchain, there have been further developments in distributed ledger technology (DLT), and these normally combine several key elements, namely, data distribution, where participants keep an electronic ledger which they can access or read; decentralised platforms, where subject to controls those participating can update a ledger; and cryptography active systems and computer-coded automated systems which can automatically trigger the terms of an agreement, e.g., by making payments. Such arrangements are normally what is termed “permissioned” because permission is required to access or update the network. The earlier systems such as the one on which Bitcoin is based are termed “permissionless” because anyone can become a participant.

In the context of DLT, the emerging issue is larger than electronic currencies. Firstly, there are a range of disparate new assets that can be traded. These can be termed exchange tokens, security tokens and utility tokens. The first of these uses a DLT platform and is merely a means of investment or exchange. The second are rights of ownership, repayment or entitlement to a share in profits. They are now caught by the definition of “specified investments[1]” in the UK and are therefore regulated under the financial services regime. Finally, there are utility tokens which can be redeemed against a product or service.

From the regulatory point of view, the two key issues are the protection of consumers and the financial stability of the markets. The former is the remit of the Financial Conduct Authority (FCA) and the latter is that of the Prudential Regulation Authority (PRA) and the Bank of England. There is also a wider regulatory area here, in that regulated firms which engage in cryptoassets generally will find some of the existing regulatory regime applying to them. Key elements here will be the PRA/FCA Principles for Business and the Senior Managers and Certification Regime, which means the regulators can hold senior managers to account. There are the systems and controls provisions which bring under regulatory control such areas as organisation, risk control, record keeping and employees. Finally, the financial promotions’ regime covers any adverts that are issued in this context and requires such communications to be fair, clear and not misleading; a balanced view of the investment concerned and the relevant warnings must be given. Internal compliance rules, for example, regarding staff trading on their own account may also need to be applied here.

Additional legal issue that will arise as a result of DLT is already partly covered by the General Data Protection Regulation, which protects peoples’ personal information and regulates the way that it is stored. Contract law issues also arise, for example, in relation to enforceability of the type of contracts being discussed.

Criminal law issues are also relevant. The 5th EU laundering Directive will, once it has come into force, increase the transparency regarding cryptocurrencies. It will also require the threshold for anonymous prepaid cards being reduced to €150 from €250, and this is unlikely to be affected in the UK by our leaving the EU. “Know your client” checks will need to be carried out for remote payment transactions, or withdrawals exceeding €50. It will also require virtual currency exchange platforms and custodian wallet providers to perform due



diligence on their customers including “know your client” checks and also to be registered for anti-money laundering purposes.

Other elements that arise are the application overseas of the existing regulatory regime to some electronic currencies. For example, in the USA, the Securities and Exchange Commission (SEC) has applied the Howey test to determine whether such a currency is a security and therefore subject to regulation. *SEC v. Howey Co*[2] determined that it will amount to an “investment asset” and therefore be a security if it involved an investment of money in a common enterprise, where the investor is led to expect profits derived from the skills or management of one or more third parties. In addition, the US Commodity Futures Trading Commission has stated that virtual currencies are “commodities” and therefore governed by the Commodity Exchange Act. In consequence of both of these, serious potential regulatory and legal repercussions exist for those who issue, operate or advise on these products. Matters are made more unpredictable by the lack of certainty as to whether some products will be so caught or not. While similar issues may arise throughout the world, the USA is of particular importance because of both the long-arm approach adopted in enforcing its laws and the size of the US market, which is attractive to those issuing and operating such currencies.

In conclusion, for those in the corporate world a range of new developments are taking place in the context of cryptocurrencies and related assets, the development of electronic trading platforms and blockchain. Some of these will probably start to impact on share and bond trading systems, and the cryptocurrency market itself, though currently showing large downturn in values, is still likely to see survivors emerge which will be a significant element in future finance. The legal and regulatory issues this will all raise are in some areas complex and in many slightly unpredictable. For those engaging in such areas or advising them an ongoing study of the relevant areas of law is necessary both to determine the impact of any new laws and the developing effect of existing ones. A brave new world indeed! Watch this space.

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Notes

1. As defined by the heavily modified Financial Services and Markets Act 2000 (Regulated Activities) Order 2000. SI 2000/544.
2. 328 US 293 (1946).