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Rani Shulman

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ARE CENTRALIZED CRYPTOCURRENCY REGULATIONS THE ANSWER? THREE COUNTRIES; THREE DIFFERENT DIRECTIONS

INTRODUCTION

With the emergence of the technology known as Blockchain,¹ companies have utilized this decentralized peer-to-peer platform to cultivate a market exchange that is growing at a rapid pace and has gained exponentially increased attention since 2017.² The most commonly known cryptocurrency, Bitcoin, placed second in Google's "Year in Search 2017" as a global news topic.³ The growing hype around a decentralized exchange of cryptocurrencies has grabbed the attention of consumers worldwide and, most notably, the attention of regulators around the globe.⁴

Governments around the world are actively seeking to address the threats of terrorism, money laundering, and fraudulent initial coin offerings (ICOs)⁵ that have plagued the market.⁶ As Blockchain's decentralized technology continues to grow at a rapid pace, the extreme volatility and natural anonymity of the decentralized cryptocurrency exchange have inspired scrupulous scrutiny from banks and regulators around the world.⁷ This ever-growing concern highlights the need for measures such as "Know Your Customer" (KYC), which re-

1. Blockchain is a decentralized publicly distributed ledger that offers a unique platform for customers to transact with one another on a trust building peer-to-peer network. *See infra* Part I.A.

2. ERIK PAULSEN, JOINT ECONOMIC COMMITTEE, THE 2018 JOINT ECONOMIC REPORT 202 (2018), <https://www.congress.gov/115/crpt/hrpt596/CRPT-115hrpt596.pdf>.

3. *Year in Search 2017*, GOOGLE, <https://trends.google.com/trends/yis/2017/GLOBAL> (last visited Feb. 15, 2020).

4. *See generally* PAULSEN, *supra* note 2.

5. An ICO is a form of capital fundraising that companies have used to raise money as a base for a new application or service; however, there has been a growing concern of fraudulent behavior. *See infra* Part I.C.

6. Loi Luu, *With Blockchain, Knowing Your Customer is More Important Than Ever*, FORBES (May 17, 2018, 12:11 AM), <https://www.forbes.com/sites/luulo/2018/05/17/with-blockchain-knowing-your-customer-is-more-important-than-ever/#238590b4559c>.

7. *Id.*

quires cryptocurrency companies to undergo rigorous initial vetting processes for new customers with continuous follow-up monitoring.⁸ On the other hand, KYC can be incredibly costly and often requires companies to report suspicious activity to governmental authorities.⁹ Dating back to the 1970s and the enactment of the Bank Secrecy Act (BSA)¹⁰ in the United States (US), burdensome KYC protocols have led banks to deny financing to companies because of the cost of KYC, inhibiting innovation.¹¹ Nevertheless, KYC can be efficient using the Blockchain technology that has countries around the world racing to regulate and integrate.¹²

States have differed in their approaches to regulating the highly technical and advanced cryptocurrency marketplace. China has taken the extreme approach of a total ban on ICOs,¹³ resulting in the blocking of more than 120 offshore cryptocurrency exchanges as of late 2018,¹⁴ whereas countries such as Switzerland have implemented guidelines embracing the cryptocurrency culture and creating a safe haven for cryptocurrency

8. *Id.*

9. Eden Yago, *There's a Bigger Scam than Anything in Crypto, It's Called KYC/AML*, COINDESK (July 27, 2018), <https://www.coindesk.com/theres-a-bigger-scam-than-anything-in-crypto-its-called-kyc-aml/>.

10. See Bank Secrecy Act, 31 U.S.C. §§ 5311–5332 (2019); see also *Bank Secrecy Act and Anti-Money Laundering*, FDIC, <https://www.fdic.gov/regulations/examinations/bsa/sources2.html>

(last visited Jan. 21, 2020) (authorizing the Secretary of the Treasury to require organizations considered to be financial institutions to keep records and file certain reports that the Secretary of the Treasury deems to have a “high degree of usefulness in criminal, tax, or regulatory investigations or proceedings, or in the conduct of intelligence or counterintelligence activities, to protect against international terrorism”).

11. Yago, *supra* note 9, (“[T]he Bank Secrecy Act, which weaponized banking and financial institutions, turning them into an unofficial secret police. From then on, anyone dealing in finance was under ever-stricter orders to monitor the activity of their customers, pass details of “suspicious activity” to the authorities and block financial access to undesirables.”).

12. *How Blockchain is Solving the KYC/AML Problems*, BLOCKCHAINERZ, <http://blockchainerz.com/how-blockchain-is-solving-the-kyc-aml-problems/> (last visited Jan. 21, 2020).

13. Ali Raza, *Analyzing China's Ultimate Ban On All Crypto and ICO Websites*, CRYPTOSLATE (Feb. 7, 2018), <https://cryptoslate.com/analyzing-chinas-ultimate-ban-crypto-ico-websites/>.

14. Victor Tangermann, *China is Serious About Cracking Down on Cryptocurrency*, FUTURISM (Aug. 23, 2018), <https://futurism.com/the-byte/chinese-cryptocurrency-crackdown>.

companies.¹⁵ These so-called safe haven countries have had their fair share of kickbacks as many cryptocurrency exchanges cannot get the necessary financing from banks, an issue Switzerland has faced.¹⁶

This Note will focus on the different regulatory strategies that countries such as Switzerland, the United States, and China have implemented to keep pace with the unpredictable yet highly sophisticated cryptocurrency marketplace. This comparative assessment will ultimately analyze the challenges many states currently face regarding the regulation of the marketplace, as well as the successes countries have experienced with their regulatory schemes. Ultimately, this Note will argue that self-regulatory organizations (SROs) offer the most effective regulatory scheme for the cryptocurrency market, with minimal government intervention.

Part I of this Note will focus on the history of the cryptocurrency exchange, what an ICO is, and the importance of Blockchain technology for the exchange and the future of the industrial world. Part II will address the concerns many governments are trying to tackle by implementing regulations on the cryptocurrency exchange. Part III will focus on how past practices, such as KYC, may be enhanced with the use of Blockchain technology, and why it is so important for companies to implement these fundamental practices in conjunction with a growing and sophisticated technology such as Blockchain. Part IV will present a thorough comparative analysis of a select group of countries around the world, addressing both how these countries have failed and succeeded at the ultimate goal of creating a regulatory scheme that avoids inhibiting the growth of the cryptocurrency marketplace. Finally, Part V will analyze the successes and setbacks of the Financial Industry Regulatory Authority (FINRA), a self-regulating institution of the stock exchange in the United States, and how governments around the world should consider an industry self-regulatory scheme

15. Ricardo Esteves, *Switzerland Risks Losing Cryptocurrency Haven Status Over Increasing Regulation*, NEWS BTC (April 15, 2018, 2:33 AM), <https://www.newsbtc.com/2018/04/15/switzerland-risks-losing-cryptocurrency-haven-status-increasing-regulation/>.

16. Anna Irrera & Brenna Hughes Neghaiwi, *Switzerland Seeks to Regain Cryptocurrency Crown*, REUTERS (July 19, 2018, 6:09 AM), <https://www.reuters.com/article/us-cryptocurrencies-banking-switzerland/switzerland-seeks-to-regain-cryptocurrency-crown-idUSKBN1K91AY>.

when regulating the cryptocurrency exchange in their respective jurisdictions. At the conclusion of this comparative analysis, there will be a discussion regarding how SROs can be the healthy median between centralized governmental control and a decentralized regulatory agency. This approach has the potential to be embraced by many states around the world without fear of inhibiting the growth of a market that may be the future of the financial world.

I. THE HISTORY AND INNOVATION BEHIND THE CRYPTOCURRENCY EXCHANGE

In order to fully understand cryptocurrency and its underlying technology, Blockchain, it is important to understand the histories of both. This broader historical understanding of the industry is essential to grasping some of the more complex and nuanced aspects involved in regulating cryptocurrencies.

A. *What is Blockchain Technology?*

Blockchain is a decentralized publicly distributed ledger that offers a unique platform for customers to transact with one another on a trust building peer-to-peer network.¹⁷ The network allows for its users to confirm transactions and verify the validity of said transactions on the “chain.”¹⁸ This validation process is known as “proof-of-work,” a direct consequence of the process of “mining.”¹⁹ This allows users to race to complete a transaction by calculating an algorithm that is then shared on the chain and validated by the other users in exchange for a re-

17. David E. Fialkow, Edward J. Mikolinski & Jack S. Brodsky, *Cryptocurrency 2018: When the law catches up with game-changing technology*, K&L GATES (Jan. 30, 2018), <http://www.klgates.com/cryptocurrency-2018-when-the-law-catches-up-with-game-changing-technology-01-30-2018/>.

18. ROBIN HOUBEN & ALEXANDER SNYERS, CRYPTOCURRENCIES AND BLOCKCHAIN: LEGAL CONTEXT AND IMPLICATIONS FOR FINANCIAL CRIME, MONEY LAUNDERING AND TAX EVASION 15–18 (2018), <http://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf> (a miner is one who uses the peer-to-peer function to validate their own or other’s “cryptographic puzzle.” This validation process is known as proof-of-work. Mining requires computing power, and the more computing power one has, the more coins one can mine.); see generally Christian Catalini & Joshua Gans, *Some Simple Economics of the Blockchain* (NBER Working Paper 22952, revised June 2018), available at <http://www.nber.org/papers/w22952>.

19. *Id.*

ward, a coin.²⁰ What has traditionally been recorded by banks in a centralized manner can now be completely decentralized and spread over a network of unlimited users who have access to all the information on the chain.²¹ This is why Blockchain technology has brought “greater transparency, enhanced security, improved traceability, increased efficiency . . . and reduced costs.”²²

Developers, companies, and governments have recognized that Blockchain is the future of data storage, and industries like healthcare are beginning to implement this technology to store patient data on its secure network of information.²³ Other industries are also benefiting; for example, Walmart implemented Blockchain technology when it tracked sliced mangos from farm to shelf in an effort to monitor E. Coli, resulting in a reduction in tracking time from “7 days to 2.2 seconds.”²⁴ The use of Blockchain technology in areas other than cryptocurrency is important to keep in mind during a time when governments are beginning to regulate digital currencies. Blockchain should not be hindered by its association with cryptocurrency, and governments must be cautious to separate the two given the potential Blockchain can have on all markets and industries.

B. What does Decentralization Mean, and is it Cause for Concern?

Blockchain uses a decentralized method of transactions.²⁵ Decentralization can be defined as transactions going directly from peer to peer without the need for a third-party to build trust and connect two potential transacting parties.²⁶ This third party is most commonly a bank, broker, or lawyer who acts as a “middleman” between the two parties.²⁷ Blockchain technology is about decentralizing this “middleman,” allowing

20. PAULSEN, *supra* note 2, at 205

21. *Id.*

22. Matthew Hooper, *Top Five Blockchain benefits Transforming Your Industry*, IBM (Feb. 22, 2018), <https://www.ibm.com/blogs/blockchain/2018/02/top-five-blockchain-benefits-transforming-your-industry/>.

23. PAULSEN, *supra* note 2, at 212.

24. *Id.* at 215.

25. *Id.*

26. HOUBEN & SNYER, *supra* note 18, at 17.

27. *Id.*

individuals who transact using the Blockchain to build a trust network among themselves without going through a centralized verification process, such as the bank.²⁸ This technology has benefited every industry by cutting the costs of transaction fees charged by these third party intermediaries, and it will likely continue to do so.²⁹ Importantly, this type of distributed ledger technology adds stability by reducing the risk of a single point of failure, which “is defined as any point in a system, whether a service, activity, or process, that, if it failed to work correctly, would lead to a failure of the entire system.”³⁰

However, there is cause for concern regarding the risk that a decentralized platform poses.³¹ The ledger that Blockchain technology creates can be fully open to the public, thus creating many more points of entry, increasing the risk of malicious activity, and potentially compromising the “confidentiality and integrity” of the Blockchain ledger.³² Further, traditional third party intermediaries, which build a trustworthy connection between two or more transacting parties, manage certain risks that a decentralized platform may not be able to manage.³³ For example, in a 2017 report, the Bank of International Settlements (BIS) warned that a decentralized Blockchain may increase the susceptibility to new liquidity risks.³⁴

Now that an understanding has been established with regard to some of the behind the scenes elements of cryptocurrencies, as well as the advantages to Blockchain’s decentralized nature, it is important to add some background regarding the rise of Bitcoin and rival cryptocurrencies that paved the way for the industry.

C. Bitcoin and the Rise of Rival Cryptocurrencies

Although Bitcoin was the first traded cryptocurrency to hit the digital currency world in 2009, the notion of an online cur-

28. *Id.*

29. *Id.*

30. CHAIRMAN BENOIT COEURE, BANK FOR INTERNATIONAL SETTLEMENTS, COMMITTEE ON PAYMENTS AND MARKET INFRASTRUCTURE: DISTRIBUTED LEDGER TECHNOLOGY IN PAYMENT, CLEARING AND SETTLEMENT 19 (2017), <https://www.bis.org/cpmi/publ/d157.pdf>.

31. HOUBEN & SNYER, *supra* note 18, at 17.

32. COEURE, *supra* note 30.

33. HOUBEN & SNYER, *supra* note 18.

34. *Id.* at 18.

rency accompanied by a secure encrypted ledger was no novel idea.³⁵ Dating back to 1998, a man by the name Wei Dai published a description of what he called “B-money,”³⁶ which was intended to be an anonymous system of electronic cash distribution.³⁷ Around this time, Nick Szabo, a University of Washington cryptographer, created “Bit Gold.”³⁸ Bit Gold was an electronic currency system that incorporated the proof-of-work system commonly found in cryptocurrencies today; a process Bitcoin is known for expanding.³⁹ Bitcoin and other cryptocurrencies that use this proof-of-work system ensure that the users on the Blockchain are involved for the right reasons and not there to sabotage the system; however, proof-of-work systems are susceptible to a form of denial of service attack.⁴⁰

35. Bernard Marr, *A Short History of Bitcoin and Cryptocurrency Everyone Should Read*, FORBES (Dec. 6, 2017, 12:28 AM), <https://www.forbes.com/sites/bernardmarr/2017/12/06/a-short-history-of-bitcoin-and-crypto-currency-everyone-should-read/#7fe306b23f27>.

36. See Wei Dai, *B-Money* <http://www.weidai.com/bmoney.txt> (last visited Jan. 6, 2020);

see also Morgen E. Peck, *Bitcoin: The Cryptoanarchists' Answer to Cash* (May 30, 2012, 4:33 PM), <https://spectrum.ieee.org/computing/software/bitcoin-the-cryptoanarchists-answer-to-cash>.

37. Dai, *supra* note 36.

38. Peck, *supra* note 36.

39. *Id.*

40. Even though Bitcoin maintains a strong defense against a single point of failure, the participation of major players with a majority of the computational power in the mining network brings about a whole new form of attack known as “denial of service”:

Although Bitcoin is decentralized and generally has no single point of failure, it is nevertheless susceptible to a form of denial of service attack. Individuals with a majority of the computational power in the Bitcoin mining network can effectively preclude any transaction from being processed. Such a sustained attack might significantly depress the exchange rate and lead to a collapse of confidence. Obtaining the necessary computational power is easy, but expensive. Although some question why anyone would do such a thing, several parties might have sufficient interest: governments who want to shut Bitcoin down, individuals with future liabilities in bitcoins, or hackers who want to blackmail a business that relies on bitcoins.

Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J. 159, 180–81 (2012).

A group of programmers operating under the pseudonym Satoshi Nakamoto⁴¹ launched Bitcoin in 2009 using the Blockchain peer-to-peer platform.⁴² As of January 2020, there are over 18 million Bitcoins in circulation at a value of \$8,726.05 per coin and a total market cap of more than \$158 billion.⁴³ Interestingly, since Bitcoin was only mined prior to 2010, there was no monetary value placed on Bitcoin.⁴⁴ In 2010, someone decided to trade 10,000 Bitcoin for two pizza pies.⁴⁵ In December of 2017, 10,000 Bitcoin converted into U.S. dollars would have been over \$100 million.⁴⁶

Beginning in 2011, “altcoins”—or rival alternative cryptocurrencies—started to emerge as news of decentralized and encrypted digital currencies began to spread.⁴⁷ Some well-known cryptocurrencies that arose during this period of time were Namecoin and Litecoin,⁴⁸ two currencies that rank in the top 200 cryptocurrencies as of January 2020, with Litecoin sitting at number seven and Namecoin sitting at 129.⁴⁹ Currently, there are over 2,000 cryptocurrencies according to CoinMarketCap.com,⁵⁰ with more appearing on a frequent basis.⁵¹

Given the anonymous nature of Bitcoin and altcoins, the industry has attracted substantial criminal activity.⁵² In 2014, Mt. Gox, the world’s largest Bitcoin exchange located in Japan, went offline and 850,000 Bitcoins disappeared, leaving owners

41. Jose Alvarez, *Who is Satoshi Nakamoto, We Look at the Possible Candidates*, BLOCKONOMI (Dec. 4, 2019), <https://blockonomi.com/who-is-satoshi-nakamoto/>. Speculation about the identity of Nakamoto has mostly focused on several cryptography and computer science experts of non-Japanese descent living in the United States or Europe. *Id.* The last known communication with Nakamoto was in 2011, when Nakamoto told a software developer, “I’ve moved on to other things.” *Id.* Nakamoto is believed to own up to roughly one million Bitcoins. *Id.*

42. Marr, *supra* note 35.

43. *All Cryptocurrencies*, COINMARKETCAP, <https://coinmarketcap.com/all/views/all/> (last visited Jan. 21, 2020).

44. Marr, *supra* note 35.

45. *Id.*

46. *Id.*; see also *All Cryptocurrencies*, *supra* note 43 (explaining that as of January 2020, 10,000 Bitcoin would be worth over 87 million dollars).

47. Marr, *supra* note 35.

48. *Id.*

49. *All Cryptocurrencies*, *supra* note 43.

50. *Id.*

51. Marr, *supra* note 35.

52. *Id.*

with no recourse to retrieve their lost investments.⁵³ Today, these lost Bitcoins would be valued at approximately \$7.4 billion.⁵⁴

In 2015, with the introduction of Ethereum⁵⁵ and its accompanying currency Ether, Bitcoin had a new competitor.⁵⁶ Ethereum uses an alternative Blockchain platform similar to the one Bitcoin and other cryptocurrencies use with an added concept of smart contracts.⁵⁷ With the emergence of Ethereum

53. *Id.*; Mt. Gox and similar thefts will be discussed later in this note. See *infra* Part II.B.

54. *All Cryptocurrencies*, *supra* note 43; Bitcoin, as of January 2020, is worth \$8,726.05. \$8,726.05 multiplied by 850,000 comes out to approximately \$7.4 billion dollars.

55. Ethereum is the world's leading programable blockchain and has an accompanying coin called Ether (ETH).

[similar to Bitcoin], it is purely digital, and can be sent to anyone anywhere in the world instantly. The supply of ETH isn't controlled by any government or company - it is decentralized, and it is scarce . . . unlike other blockchains, Ethereum can do much more. Ethereum is programmable, which means that developers can use it to build new kinds of applications. These decentralized applications (or "dapps") . . . can be trustworthy, meaning that once they are "uploaded" to Ethereum, they will always run as programmed.

What is Ethereum?, ETHEREUM, <https://ethereum.org/what-is-ethereum/> (last updated Feb. 10, 2020).

56. Marr, *supra* note 35.

57. *Id.* For an explanation of smart contracts, see Ameer Rosic, *Smart Contracts*, BLOCKGEEKS, <https://blockgeeks.com/guides/smart-contracts/> (last visited Feb. 18, 2020) ("In 1994, Nick Szabo, a legal scholar[] and cryptographer[,] realized that the decentralized ledger could be used for smart contracts. . . . In this format, contracts could be converted to computer code, stored and replicated on the system and supervised by the network of computers that run the blockchain."); This would inevitably cut out the middleman, i.e., Banks); see also, an example of a smart contract from 2018 Joint Economic Report:

[I]f economist A wants economist B to edit her paper, economist B agrees and both create a smart contract that will reward economist B with EconoCoins [or tokens] from economist A's wallet upon delivery of edits. The network will enforce the contract without a third party, but the two economists can also build in a provision that would enlist others in the network to resolve disputes for a fee.

came the ICO.⁵⁸ These offerings, similar to an initial public offering (IPO) of a stock, are used to fundraise capital from investors in exchange for tokens.⁵⁹ This is the area of cryptocurrency that governments around the world are racing to regulate efficiently. What a token represents depends on the circumstances of its offering, and governments are trying to assess whether these token offerings are currencies, assets, securities, commodities, or something else entirely.⁶⁰

D. What is an ICO?

An ICO is a strategy for developers to raise capital for their projects.⁶¹ In order for a company to incentivize investors to support their cause, these companies offer tokens in exchange for capital or seed money.⁶² These tokens can be used on the company's platform in exchange for whatever product or service the company is offering.⁶³ For example, if a company offering services for small "odd-jobs" around the house needs investments to build their company, they may publicize an ICO and offer tokens for their services in exchange for investments; this process is also called a smart contract.⁶⁴

ICOs are far less expensive than a traditional IPO, and they do not offer equity in the company in the form of shares.⁶⁵ PriceWaterhouseCoopers has researched IPOs and the costs associated with them, coming to the conclusion that IPO underwriting alone costs the issuing company between 4 to 7 percent of the capital they raise through the IPO.⁶⁶ Further, in addition to these initial costs, companies spend \$4.2 million on offering costs for their IPO, as well as one to two million dollars

PAULSEN, *supra* note 2, at 210.

58. Marr, *supra* note 35.

59. PAULSEN, *supra* note 2, at 209

60. *Id.*

61. *Id.* at 210

62. *Id.*

63. *Id.*

64. *Id.* ("With an ICO, the creators explain the concept to potential users and offer for purchase initial coins that can be used in the network. Platform users would utilize the coins on the network to obtain services."); *see also* Marr, *supra* note 35, for another example of a smart contract.

65. PAULSEN, *supra* note 2, at 210.

66. *Id.*; *see also* DEREK THOMPSON, CONSIDERING AN IPO TO FUEL YOUR COMPANY'S FUTURE?, PWC DEALS 13 (2017), <https://www.pwc.com/us/en/deals/publications/assets/cost-of-an-ipo.pdf>.

a year maintaining their status as a publicly traded company.⁶⁷ In contrast, ICOs cost a fraction of that amount, sitting at approximately \$60,000.⁶⁸

The growing number of cryptocurrencies, Blockchain's decentralized platform, and the unprecedented rise of ICOs in the industry has led to major concerns regarding the industry as a whole and how it must be regulated. The ensuing section will deal with some of the major concerns with the cryptocurrency marketplace and how the use of ICOs can present major problems when it comes to money laundering, terrorist activities, fraudulent behavior, and hacking cryptocurrency networks.

II. TREADING ON THIN ICE: THE RISKS ASSOCIATED WITH CRYPTOCURRENCIES

Many of the characteristics that make cryptocurrency and Blockchain so useful for growing industries also make it appealing for illegal activity. By focusing on the anonymity, global reach, speed, low transaction cost, and ease of use of cryptocurrency and Blockchain, one can begin to understand the appeal it has to the criminal world.⁶⁹

A. The Threat of Terrorism, Money Laundering, and Criminal Activity

Most criminals would like to keep their identity private and there is no better way than to transact anonymously. Given that cryptocurrencies are recorded on a ledger using Blockchain technology, which does not require any form of identification, financing terrorism or laundering money to offshore accounts could not be easier.⁷⁰ In conjunction with the anonymous nature of cryptocurrency through the Blockchain, the global reach of trading these cryptocurrencies allows for the coins to be transferred and converted into fiat money, leaving a trail that is very hard to track.⁷¹ Further, the speed of a given

67. PAULSEN, *supra* note 2, at 210; *see also*, THOMPSON, *supra* note 66.

68. PAULSEN, *supra* note 2, at 211.

69. ALAN BRILL & LONNIE KEENE, DEFENSE AGAINST TERRORISM REVIEW, CRYPTOCURRENCIES: THE NEXT GENERATION OF TERRORIST FINANCING 13–14 (2014), <http://www.coedat.nato.int/publication/datr/volumes/datr9.pdf>.

70. *Id.*

71. Brill and Keene provide an example of how the trading and conversion of cryptocurrencies can make it very hard for authorities to track transactions in the event that there is suspicion of criminal activity:

transaction through the peer-to-peer system, which knocks out the third-party intermediary, makes it easier to transfer funds and decreases the chance of a transaction being blocked or flagged.⁷² Interestingly, because a transaction on the Blockchain cannot be erased or reversed, a transfer remains on the ledger indefinitely and funds can only be returned by creating a new transaction.⁷³ This is an ideal format for the transferring of criminal funds,⁷⁴ even if the transferor does not know they are financing a criminal organization—perhaps a fraudulent ICO. Lastly, the ease-of-use and low transaction costs⁷⁵ make it easier for people who do not generally support criminal activity to finance nefarious organizations, such as terrorist groups like the Islamic State.⁷⁶

It is important to note that there are some aspects of cryptocurrency that make the exchange unappealing to criminals and terrorist organizations.⁷⁷ The lack of liquidity and volatile

You also want the ability to carry out transactions through third countries that you have little or no connection with to confound those trying to identify you or at least identify the country from which you are operating. You may physically be in Country A, initiate a transaction through the Internet to convert the national currency of Country B through a virtual currency exchange in Country C, and transfer the virtual currency to a wallet in Country D. The virtual currency could be transferred (possibly through intermediary steps) to the ultimate receiver's wallet in Country E. They might go through an exchange in Country F and convert to the currency of Country G. You might also choose to deal with virtual currency companies located in countries that are politically hostile to countries which you fear may be seeking your arrest.

Id. at 14.

72. *Id.*

73. IBM, WHAT IS BLOCKCHAIN? (2018), <https://www-01.ibm.com/common/ssi/cgi-bin/ssialias?htmlfid=45015045USEN&> (“Transactions [on the chain] are blocked together, creating an irreversible chain.”).

74. BRILL & KEENE, *supra* note 69, at 14.

75. *Id.*

76. Nikita Malik, *How Criminals and Terrorists Use Cryptocurrency: And How to Stop It*, FORBES (Aug. 31, 2018, 10:08 a.m.), <https://www.forbes.com/sites/nikitamalik/2018/08/31/how-criminals-and-terrorists-use-cryptocurrency-and-how-to-stop-it/#681698713990>.

77. BRILL & KEENE, *supra* note 69, at 15.

market make it hard for investors or fundraisers to have cash on hand.⁷⁸ Many criminals deal with cash because of its liquid nature and stable value, and criminals who use the exchange have to develop a trust with the exchange.⁷⁹ The United States Congressional Subcommittee on Terrorism and Illicit Financing concluded on September 7, 2018 that terrorist organizations, including al-Qaeda and the Islamic State, have tried to raise funds through cryptocurrency but have been generally unsuccessful, remaining loyal to fiat money.⁸⁰

B. The Theft of Cryptocurrency Exchanges: The Fall of the Tokyo-Based Exchanges Mt. Gox (2014) and Coincheck (2018)

As more money started to pour into the cryptocurrency world, exchange platforms became very popular and attracted the work of hackers and thieves.⁸¹ By February 2014, the largest cryptocurrency exchange, Mt. Gox, had lost 850,000 Bitcoin to

78. *Id.*

79. Although criminals admire the lack of ability to track transactions, it becomes hard to utilize these currencies if it cannot easily be transferred into something a criminal can use, such as fiat money:

At any given time, criminals or terrorist users of virtual currencies have the problem of converting the virtual currency into something they can use, be it a national currency, drugs, weapons or anything else. How they do this will involve a range of considerations, including the presence in the system of money transmitters and exchangers that they can trust, or whom they feel will not notice/care who they are.

Id.

80. Helen Partz, *Crypto is a Poor Form of Money for Terrorists, Congressional Hearing Concludes*, COINTELEGRAPH (Sept. 8, 2018), <https://cointelegraph.com/news/crypto-is-a-poor-form-of-money-for-terrorists-congressional-hearing-concludes>; see also Jimmy Aki, *Terrorist Prefer Cash to Cryptocurrency: Congressional Hearing Reveals*, BLOCKONOMI (Sept. 10, 2018), <https://blockonomi.com/terrorists-prefer-cash-to-crypto/>. Yaya Fanusie, Director of Analysis for the Foundation for Defense of Democracies Center on Sanctions and Illicit Finance, has said that “cold hard cash is still king,” and cryptocurrency is a “poor form of money for jihadists because they usually need to purchase goods with cash often in areas with weak technolog[ical] infrastructure.” *Id.*

81. Robert McMillan, *The Inside Story of Mt. Gox, Bitcoin’s \$460 Million Disaster*, WIRED (Mar. 3, 2014), <https://www.wired.com/2014/03/bitcoin-exchange/>.

a Russian hacker, Alexander Vinnick,⁸² resulting in a loss of over \$450 million.⁸³ Started by Jed McCaleb⁸⁴ in 2007 as a means for players of the fictional card game *Magic*⁸⁵ to trade cards, Mt. Gox found its purpose in 2010 when McCaleb recognized that his platform and website domain would be perfect for an exchange of Bitcoin.⁸⁶ After selling the company to Mark Karpeles⁸⁷ in 2011, McCaleb only returned to the scene as a founder of another cryptocurrency called Ripple.⁸⁸ With much unknown about the inner workings of Mt. Gox, many insiders have nonetheless said that Mark Karpeles was not up to the task and, when the website shut down in 2011 and Mt. Gox

82. Anna Baydakova, *\$2 Billion Lost in Mt. Gox Bitcoin Hack Can be Recovered, Lawyer Claims*, COINDESK (Sep. 12, 2019, 9:45 PM UTC), <https://www.coindesk.com/2-billion-lost-in-mt-gox-bitcoin-hack-can-be-recovered-lawyer-claims> (as of September 2019, a Moscow based law firm claimed to be able to recover 170,000 to 200,000 of the stolen coins from unknown Russian nationals, currently worth more than \$1.7 billion).

83. Marr, *supra* note 35.

84. McMillan provides a brief summary of how Jed McCaleb started Mt. Gox and how it fell into the hands of Mark Karpeles:

McCaleb had registered the Mtgox.com web domain in 2007 with the idea of turning it into a trading site for the wildly popular Magic: The Gathering game cards. He never followed through on that idea, but in late 2010, McCaleb decided to repurpose the domain as a bitcoin exchange. The idea was simple: he'd provide a single place to connect bitcoin buyers and sellers. But soon, McCaleb was getting wires for tens of thousands of dollars and, realizing he was in over his head, he sold the site to Karpeles, an avid programmer, foodie, and bitcoin enthusiast who called himself Magicaltux in online forums.

McMillan, *supra* note 81.

85. *A Mission that Matters*, WIZARDS OF THE COAST, <https://company.wizards.com/content/company> (last visited Mar. 2, 2020) (a trading and digital collectable card game played by two or more players released in 1993 by Wizards of the Coast and created by Richard Garfield. *Magic* continues to be played worldwide, with roughly 20 million players as of 2019); *see also Magic: The Gathering*, WIKIPEDIA, https://en.wikipedia.org/wiki/Magic:_The_Gathering (last visited Jan. 21, 2020).

86. McMillan, *supra* note 81.

87. *Id.* (in 2011, Karpeles purchased and rewrote Mt.gox.com's back-end software and quickly turned it into the world's most popular bitcoin exchange).

88. *Id.*

ceased to exist, Karpeles disappeared with over \$450 million worth of users' money.⁸⁹

In 2018, another Japanese cryptocurrency exchange, known as Coincheck, was hacked and over \$500 million worth of XEM tokens offered by the NEM Blockchain went missing.⁹⁰ The aftermath of Coincheck, however, was far less severe than that of Mt. Gox because the company immediately made promises to reimburse lost funds and consistently kept their investors in the loop.⁹¹ Further, Coincheck has not filed for bankruptcy and does not plan to.⁹²

C. The Fraudulent ICO

Issuers of ICOs, or “coin offerors,” generally use a documentation known as a “white paper.”⁹³ ICO white papers, as opposed to white papers for IPOs and securities offerings, give a simple description of what the ICO is raising money for and what the tokens offered support.⁹⁴ These papers often relay very little information about the backers or initiators of the

89. *Id.*

90. Darryn Pollack, *Story of Coincheck: How to Rebound After the 'Biggest Theft in the History of the World'*, COINTELEGRAPH (Apr. 3, 2018), <https://cointelegraph.com/news/story-of-coincheck-how-to-rebound-after-the-biggest-theft-in-the-history-of-the-world>.

91. *Id.*

92. *Id.*

93. Dirk A. Zetsche, et al., *The ICO Gold Rush: It's a Scam, It's a Bubble, It's a Super Challenge For Regulators*, 63 HARVARD INT'L L.J. 267, 278 (2019); A brief description of how white papers are used and who they target:

White papers have become popular marketing tools for corporations especially on the Internet since many potential customers search for information on the Web. Corporations use white papers to sell information or new products as solutions that would serve their customers' needs. Typically, the purpose of a white paper is to advocate that a certain position is the best way to go or that a certain solution is best for a particular problem. When it is used for commercial purposes, it could influence the decision-making processes of current and prospective customers.

White Paper: Purpose and Audience, PURDUE UNIVERSITY, https://owl.purdue.edu/owl/subject_specific_writing/professional_technical_writing/white_papers/index.html (last visited Mar. 2, 2020).

94. Zetsche, *supra* note 93, at 278.

ICO and do not include postal contact information.⁹⁵ This presumably leads to an asymmetry of information and a skepticism about the offering's true intentions.⁹⁶ As a result, this lack of information tends to lead more susceptible uninformed investors towards these ICOs because they are reeled in by false promises of large returns on investments but lack the sophistication to identify the risks.⁹⁷ It is hard to formulate a rational, informed decision concerning many ICOs with an inadequate amount of information, and investors need to be wary and focus on whether the ICO has invested its own resources into acquiring lawyers and other help to develop their technology.⁹⁸ Given the complex nature of the ICO marketplace, it is reasonable to assume that these offering companies have consulted with proper legal and professional counsel in order to maintain a company in compliance with legal and regulatory standards.

Further, capital misallocation is another concern that many ICO investors and regulators should consider when assessing the volatile marketplace.⁹⁹ As of October 2017, about 10 percent of tokens offered to investors could be used in a practical setting, leaving hundreds of different tokens useful for solely trading purposes, indicating speculation as to the true nature of the offering.¹⁰⁰ Currently, this "bubble" feature of ICOs not only risks harm to individuals who have invested, but also undermines the growing popularity of the Blockchain technology.¹⁰¹ Most concerning, many ICOs are not allocating the funds raised to the most productive market use; instead, these companies are using such funds for personal use, leading to fraud and government intervention.¹⁰²

95. *Id.*

96. *Id.* at 287–88.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*; see also Olga Kharif, *Only One in 10 Tokens Is in Use Following Initial Coin Offerings*, BLOOMBERG (Oct. 23, 2017), <https://www.bloomberg.com/news/articles/2017-10-23/only-one-in-10-tokens-is-in-use-following-initial-coin-offerings> (citing data gathered by Token Report analyzing the use of 226 coin sales).

101. Zetsche, *supra* note 93, at 288.

102. *Id.*; see also Press Release, *SEC Stops Fraudulent ICO That Falsely Claimed SEC Approval*, SEC. & EXCHANGE COMMISSION (Oct. 11, 2018), <https://www.sec.gov/news/press-release/2018-232> (this SEC press release from October 2018 stating that the SEC is halting a planned ICO through

There are many ways to ensure that investors are well informed before turning to outright regulation. Investors can begin their own research by looking into the staff and initiators of the token offering.¹⁰³ Investors should consider the reputation of staff members, whether there are venture capitalist firms investing seed money into the company, and if there are reputable sources supporting the ICO.¹⁰⁴ Additionally, many tokens offered through ICOs have a purpose that supports the ecosystem of the company and therefore serves a greater purpose than just a tradable asset.¹⁰⁵ Investors must ask whether the company can operate without the issuance of a token and, if the token can be substituted for another cryptocurrency like Bitcoin or Ethereum, then the token is not as integral to the company as it may seem to investors.¹⁰⁶ Lastly, huge returns on investment should always be a warning sign for investors.¹⁰⁷ Simply put, the cryptocurrency world is akin to the wild west, and consumers who wish to take part must make informed decisions.

With this backdrop in mind, companies have an important role to play in mitigating the risks associated with the ICO marketplace and the volatility of the cryptocurrency industry. Investor protection is of the utmost importance to the continuing successes of these companies. Without investors, companies cannot run efficiently or have the resources and capital necessary for the growth of a company. The subsequent section will hone in on certain practices, particularly KYC, and how these practices can help a company mitigate the risks that may be imposed on investors.

court order because the initiators falsely claimed that they received SEC approval of the ICO of Blockvest, LLC).

103. Nick Paroni, *How to Know if You're Investing in a Bad ICO*, CHAIN, <https://thechain.media/how-to-know-if-youre-investing-in-a-bad-ico> (last visited Jan. 21, 2020).

104. *Id.*

105. Yuval Gov, *10 Signs You are Investing in a Bad ICO*, CRYPTOPOTATO (May 1, 2018), <https://cryptopotato.com/10-signs-investing-bad-ico/>.

106. *Id.*

107. *Id.*

III. KNOW YOUR CUSTOMER: WHAT COMPANIES CAN DO FOR YOU!

Given the risks associated with the cryptocurrency market, cryptocurrency companies can improve their efforts to ensure they are doing business with trustworthy entities.¹⁰⁸ Among traditional businesses, KYC protocols are not an unusual practice.¹⁰⁹ When implementing such measures, companies must keep in mind who they are transacting with, whether those individuals are in fact who they say they are, and what those individuals are doing.¹¹⁰ By using the banking structure to interpret KYC protocols, institutions can better understand its potential role in the cryptocurrency marketplace. These protocols, often a requirement of the federal governmental,¹¹¹ have their own drawbacks as well.¹¹²

108. Luu, *supra* note 6.

109. *Id.*

110. *Id.*

111. *See, e.g.*, Bank Secrecy Act, Pub. L. No. 91-508, 84 Stat. 1114-4 (1970). The Bank Secrecy Act was passed as a first step in the fight against money laundering. It requires businesses to keep meticulous records in an effort to fight criminal and fraudulent activities:

Congress passed the Bank Secrecy Act in 1970 as the first laws to fight money laundering in the United States. The BSA requires businesses to keep records and file reports that are determined to have a high degree of usefulness in criminal, tax, and regulatory matters. The documents filed by businesses under the BSA requirements are heavily used by law enforcement agencies, both domestic and international to identify, detect and deter money laundering whether it is in furtherance of a criminal enterprise, terrorism, tax evasion or other unlawful activity.

Bank Secrecy Act, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/bank-secrecy-act> (last visited Jan. 21, 2020).

112. John Callahan, *Know Your Customer (KYC) will be a Great Thing When it Works*, FORBES (July 10, 2018, 7:15 AM), <https://www.forbes.com/sites/forbestechcouncil/2018/07/10/know-your-customer-kyc-will-be-a-great-thing-when-it-works/#4bf43a548dbb>.

A. KYC: The Good . . .

To conform with KYC protocols, banks must first implement a vetting process when onboarding clients.¹¹³ Banks face significant regulatory risks when onboarding high-risk customers.¹¹⁴ This initial vetting process must flag suspicious customers and the potential for suspicious transactions.¹¹⁵ To do so may require customers to provide government issued forms of identification, such as a passport or driver's license.¹¹⁶ Additionally, this process, also referred to as a Customer Identification Program, screens prospective customers against lists of known criminals.¹¹⁷ At a minimum, a bank must obtain a name, date of birth, address, and identification number¹¹⁸ from each individual who wants to transact with the bank.¹¹⁹ Banks may ask for additional information and in some circumstances require non-documented identification, such as comparing the provided customer information with information obtained from consumer reporting agencies or public databases.¹²⁰

Second, banking institutions must continue this vetting process throughout the relationship by maintaining ongoing due diligence with current customers to ensure customers are still

113. Michael Volkov, *Know Your Customer ("KYC") Due Diligence Best Practices*, TRULIOO (July 30, 2015), <https://www.trulioo.com/blog/know-your-customer-kyc-due-diligence-best-practices/>.

114. *Id.*

115. *Id.*

116. Luu, *supra* note 6.

117. Volkov, *supra* note 113.

118. A brief description of an identification number for US and non-US citizens:

An identification number for a U.S. person is a taxpayer identification number (TIN) (or evidence of an application for one), and an identification number for a non-U.S. person is one or more of the following: a TIN; a passport number and country of issuance; an alien identification card number; or . . . any other unexpired government-issued document.

Customer Identification Program- Overview, FED. FIN. INSTITUTIONS EXAMINATION COUNCIL, n. 48, http://web.archive.org/web/20190517193953/https://www.ffiec.gov/bsa_aml_infobase/pages_manual/olm_011.htm (last visited Jan. 21, 2020).

119. *Id.*

120. *Id.*

who they claim to be.¹²¹ This practice is known as Customer Due Diligence, and in certain circumstances banks require Enhanced Due Diligence.¹²² This ongoing function of KYC includes continuous scrutiny over financial transactions and accounts.¹²³ Within a client's profile, banks develop a threshold to determine when a customer poses a risk to the bank.¹²⁴ In order for a bank to remain efficient with its KYC protocols, it should refresh and perform continuous due diligence checks every six to twelve months.¹²⁵

B. . . . The Bad and the Ugly

On the surface, KYC seems to protect financial institutions, mitigate risks from unknown customers, and save money.¹²⁶ On the contrary, KYC protocols cost companies billions of dollars each year.¹²⁷ When enacted, the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act, or the PATRIOT Act,¹²⁸ did not specify standards as to how to implement KYC measures or efficiently verify customers.¹²⁹ This was an intentional omission by regulators because they did not want to set clear guidelines for sufficient KYC measures out of fear that companies would only perform the minimum requirements.¹³⁰ As a result, financial institutions may now create their own procedures, often

121. Luu, *supra* note 6.

122. If a customer proves to be a risk, such as by having a history of money laundering or involvement in terrorist activity and funding, the bank must take enhanced measures to ensure the customer is reliable. *Customer Due Diligence: Ensuring You Know Your Customer*, TRULIOO (Aug. 23, 2016), <https://www.trulioo.com/blog/customer-due-diligence/>.

123. Volkov, *supra* note 113.

124. *Id.*

125. *Id.*

126. Callahan, *supra* note 112.

127. *Id.*

128. See FINANCIAL CRIMES ENFORCEMENT NETWORK: USA PATRIOT ACT, FINCEN, <https://www.fincen.gov/resources/statutes-regulations/usa-patriot-act> (last visited Jan. 21, 2020). One of the main purposes of the United States PATRIOT Act is to enhance law enforcement investigatory tools. *Id.* Other purposes include strengthening US measures to prevent, detect, and prosecute international money laundering and financing terrorism, as well as requiring the financial services industry to report potential high-risk account holders. *Id.*

129. Callahan, *supra* note 112.

130. *Id.*

going far beyond the necessary measures out of fear of being subject to fines.¹³¹ This has had a negative consequence on the KYC system in a number of ways, particularly with regard to the money spent on this practice. As mentioned above, without the necessary guidelines by regulators, companies are not running efficiently and are allocating far too much capital towards KYC measures when such funds can be more impactful in other areas of the company.

There are two main reasons why KYC is not the regulatory answer to financial institutions and, by association, cryptocurrency. First, KYC protocols have increased client-agent friction.¹³² According to a 2017 survey by Thomson Reuters, customer onboarding time increased by 22 percent in 2016 and was expected to increase another 18 percent in 2017.¹³³ In their 2018 survey, Thomson Reuters discovered that 61 percent of firms were increasing their compliance budget, an increase from 53 percent in 2017.¹³⁴ Taking all of this into consideration, banks are taking an average of twenty-four days to complete the onboarding process for new customers.¹³⁵ As a result, the 2017 survey found that 12 percent of the participating companies had changed banks because of the more intrusive nature of the KYC protocols.¹³⁶

Second, the costs of keeping up with these protocols increase year by year.¹³⁷ Ten percent of the top financial institutions in the world are spending more than \$100 million per year, with the average institution spending around \$48 million a year, including labor and third-party costs.¹³⁸ In 2015, Citibank used about half of its \$3.4 billion efficiency savings on additional investments in their regulatory and compliance departments,

131. *Id.*

132. *Id.*

133. *Id.*; see generally STACEY ENGLISH & SUSANNAH HAMMOND, COST OF COMPLIANCE 2017: HOW DO YOU NAVIGATE THE REGULATORY LANDSCAPE (2017), <https://risk.thomsonreuters.com/content/dam/openweb/documents/pdf/risk/report/cost-of-compliance-2017.pdf>.

134. STACEY ENGLISH & SUSANNAH HAMMOND, COST OF COMPLIANCE 2018: WITH A NEW REGULATORY ALERT ISSUED EVERY 7 MINUTES, HOW DO I ENSURE COMPLIANCE? 5 (2018), <https://legal.thomsonreuters.com/content/dam/ewp-m/documents/legal/en/pdf/reports/cost-of-compliance-special-report-2018.pdf>.

135. Callahan, *supra* note 112.

136. *Id.*

137. *Id.*

138. *Id.*

and JPMorgan Chase employed 5,000 more people to their compliance team, spending an additional \$1 billion on controls and internal infrastructure.¹³⁹ These statistics raise concerns that banking institutions are not allocating enough time towards their usual daily functions.¹⁴⁰

C. Can Blockchain Solve These KYC Inefficiencies?

Interestingly, Blockchain technology can mitigate these KYC inefficiencies. The transparent peer-to-peer process of using a Blockchain ledger allows financial institutions and cryptocurrency companies access to “clean, up to date and secure consumer data.”¹⁴¹ The idea is that financial institutions can upload client data onto a ledger that other accredited institutions have access to.¹⁴² This can eliminate companies’ time-intensive, continuous, and repetitive efforts to collect customer information when onboarding new customers.¹⁴³ A secure and organized database, where financial institutions can log on and verify a new customer, would decrease onboarding times and costs by 25 to 50 percent.¹⁴⁴ This would not only enable a smoother customer experience, but would also offer institutions the ability to minimize the cost of KYC measures.¹⁴⁵ Lastly, opening up a Blockchain ledger would not only give financial institutions the ability to access customer data amongst themselves, but “tax authorities, company registries, law enforcement bureaus,

139. *Id.*

140. *Id.*

141. EAMONN MAGUIRE ET AL., COULD BLOCKCHAIN BE THE FOUNDATION OF A VIABLE KYC UTILITY?, KPMG 3 (2018), <https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2018/03/kpmg-blockchain-kyc-utility.pdf>.

142. *Id.*

143. *Id.*

144. *Id.* at 2. KPMG and Bluzelle networks worked with a consortium of three banks in Singapore—HSBC, OCBC, and Mitsubishi UFJ Financial Group—as well as the Singaporean regulator, Infocomm Media Development Authority, to develop a proof-of-concept KYC utility on a blockchain platform. *Id.* The prototype successfully passed the Monetary Authority of Singapore’s test scenarios. *Id.* “In addition to stability, efficiency and security, the platform could result in estimated cost savings of 25-50 percent by reducing duplication and providing a clear audit trail.” *Id.*

145. *Id.* at 3.

media houses, judicial bodies, banks and corporate [institutions]” can upload and retrieve data at real time speeds.¹⁴⁶

KYC protocols are just one of many proactive measures companies can take in order to ensure investor security; however, as stated above, there are limitations and concerns revolving around KYC and its implementations. In general, these are measures that governments should require companies to practice, but, in addition, governments need to take a strong stance on what exactly a cryptocurrency is with regards to its place within financial markets. Governments around the world have responded to this question in the form of regulations; however, government intervention has had its fair share of negative consequences as the ensuing section will discuss in depth. An important consideration to keep in mind throughout the following section is whether the government should be the entity to legislate, control, and enforce these regulations, or should it be a different entity entirely, one that comes from inside the cryptocurrency industry and marketplace.

IV. THE TRIANGLE OF REGULATION

The ensuing subsections will discuss the varied approaches governments around the world have taken or plan to take regarding the regulation of the cryptocurrency exchange and, in particular, the ICO market. Using a score system put together by the Brooklyn Law Incubator & Policy clinic (BLIP) spearheaded by Professor Jonathan Askin,¹⁴⁷ this Note will first look to China, a government with little interest in supporting the cryptocurrency exchange and ICO market. Then, this section

146. *KYC and Blockchain*, FINEXTRA (Mar. 30, 2017), <https://www.finextra.com/blogposting/13903/kyc-and-blockchain>.

147. Brooklyn Law Incubator and Policy Clinic, *Global Spreadsheet of Blockchain Regulation*, https://docs.google.com/spreadsheets/d/1EljFkq_92irqhTWYGzAxM_1vYOnNtGsb8wz7AzthZaE/edit#gid=0. (last visited Jan. 21, 2020) [hereinafter BLIP Spreadsheet]. The spreadsheet breaks down the approach of twenty different countries around the world. *Id.* The spreadsheet rates each category out of five, with one being unsupportive and five being very supportive. *Id.* The four categories are “Policy,” “Priority,” “Implemented Regulation,” and “Actual Use.” *Id.* As an example, a five for “Policy” translates into the government fully embracing Blockchain technology and companies that use it (*i.e.*, cryptocurrency companies); a one represents that the government either has restrictions in place or the technology is banned completely. *Id.* After a score is given for each category, an average score is broken down. *Id.*

will discuss the United States, which shows a stronger interest in supporting the market and increasing its domestic activity. Finally, this section will conclude with Switzerland, a country very interested in supporting the cryptocurrency world by creating a safe haven for cryptocurrency companies. This comparative analysis will focus on three different areas of the regulatory spectrum to give a general perspective on the regulation of cryptocurrency and Blockchain technology.

*A. China: 1.39*¹⁴⁸

In September 2017, China declared an all-out ban on the sale of ICOs and denied access to cryptocurrency websites nationwide.¹⁴⁹ China's main concern in establishing and maintaining this ban has been the possible bubble that may form given that the industry is mushrooming¹⁵⁰ at an alarming rate.¹⁵¹ With the craze of fundraising through ICOs and the accompanying cryptocurrency marketplace, China fears that this industry is unsustainable in its current form.¹⁵² This practicable concern, alongside China's longstanding political agenda, presents a bias of negativity towards a marketplace that otherwise is greeted with open arms by other countries.¹⁵³

1. Cryptocurrencies and ICOs Threaten China's Centralized Governmental Ideals

It is relevant to consider the communist ideals of the Chinese government in analyzing its approach to cryptocurrencies.¹⁵⁴ A decentralized industry runs contrary to many of the core beliefs of the heavily centralized Chinese government.¹⁵⁵ In January 2018, China's Communist Party paper stated, "[i]rrespective of whether it is assessed on price or value, bitcoin is flooded with

148. *Id.*

149. Raza, *supra* note 13.

150. According to the Merriam-Webster dictionary, "mushroom" used as a verb means "to well up and spread out laterally from a central source," "to spring up suddenly or multiply rapidly." *Mushroom*, MERRIAM-WEBSTER'S DICTIONARY, available at <https://www.merriam-webster.com/dictionary/mushroom> (last visited Jan. 21, 2020).

151. Raza, *supra* note 13, at 2.

152. *See generally id.*

153. *Id.*

154. *Id.*

155. *Id.*

froth; its so-called advantages – scarcity, authenticity, strong liquidity, transparency and decentralization – are only covers for speculation and cannot support its volatile price.”¹⁵⁶ Further, China has sought to minimize the outflow of Chinese money away from its government and citizens.¹⁵⁷ Without complete control over a sector of its financial industry, China’s control and power is threatened.¹⁵⁸ Mark McFarland, Chief Economist at Union Bancaire Privee SA HK, argued that the ban on the cryptocurrency marketplace suggests that this is just the beginning of a continuous stronghold on financial activities outside of the “normal monetary realm.”¹⁵⁹

In late 2018, rumors circulated about China lifting the ban on the marketplace, though they had little credibility.¹⁶⁰ Cryptocurrency-focused publications released certain stories claiming that China had lifted the ban, but these assertions were a misrepresentation of a court ruling in the Shenzhen Court of International Arbitration.¹⁶¹ In fact, the trading of cryptocurrencies and fundraising through ICOs are strictly prohibited¹⁶² as of late 2019.¹⁶³ Reports such as these can be a problem for impatient investors.¹⁶⁴ They create an unfounded optimism in the short-term that has severe consequences on the market by in-

156. Sidney Leng, *China’s Communist Party Paper [Peoples Daily] Bashes Bitcoin But Still No Sign of “Bubble” Bursting*, SOUTH CHINA MORNING POST (Jan. 3, 2018, 10:02 PM), <https://www.scmp.com/news/china/economy/article/2126727/chinas-communist-party-paper-bashes-bitcoin-still-no-sign-bubble>.

157. Bloomberg, *This is How China is Stifling Cryptocurrency and Bitcoin*, FORTUNE (Jan. 17, 2018, 11:42 AM EST), <http://fortune.com/2018/01/17/china-bitcoin-cryptocurrency-crackdown/>.

158. *Id.*

159. *Id.*

160. Joseph Young, *No China Has Not Legalized Nor Put An End To Bitcoin Ban; Inaccurate Reports*, CRYPTOSLATE (Nov. 9, 2018, 3:30 AM UTC), <https://cryptoslate.com/no-china-has-not-legalized-nor-put-an-end-to-bitcoin-ban-inaccurate-reports/>.

161. *Id.*

162. Young, *supra* note 160.

163. See generally Adrian Zmudzinski, *China’s Crackdown on Cryptocurrency Trading: A 2019 Recap*, COINTELEGRAPH (Dec. 30, 2019), <https://cointelegraph.com/news/chinas-crackdown-on-cryptocurrency-trading-a-2019-recap>; see also Zheping Huang & Olga Kharif, *All You Need to Know About China’s Latest Crypto Crackdown*, BLOOMBERG (Nov. 27, 2019, 10:33 AM EST), <https://www.bloomberg.com/news/articles/2019-11-27/all-you-need-to-know-about-china-s-latest-crypto-crackdown>.

164. Young, *supra* note 160.

citing people to invest in a market that will not see returns in the near future, or possibly ever, within China's borders.¹⁶⁵

2. China is Not Opposed to Integrating Blockchain Technology

Although China is determined to keep cryptocurrency exchanges and ICO issuances six feet under, the technology behind the industry can provide clear advantages to grow China's industries, advance its economic position in the world, and modernize its financial systems, all in an effort to become the world leader in Blockchain technology.¹⁶⁶ China is currently attempting to integrate Blockchain into its governmental infrastructure, spending approximately \$3.57 million since 2016, as of late 2018.¹⁶⁷ It is clear that China has been endorsing Blockchain in recent years and has placed the technology at the forefront of its technological advancements.¹⁶⁸ Indeed, in August 2017, the Chinese government announced plans to use Blockchain to collect taxes and issue electronic invoices.¹⁶⁹ Exactly one year later, in August 2018, China issued its first digital invoice on the Blockchain in Shenzhen.¹⁷⁰ As of late 2019, China

165. *Id.*

166. Shen Wenhua, *Cryptocurrency Laws and Regulations in China*, ASIA BUS. L. J. (July 12, 2018), <https://www.vantageasia.com/cryptocurrency-law-china/>.

167. Evelyn Cheng, *China Clamps Down on Cryptocurrency Speculation*, CNBC (Sept. 3, 2018, 3:48 AM), <https://www.cnbc.com/2018/09/03/china-clamps-down-on-cryptocurrency-speculation.html>.

168. Wenhua, *supra* note 166.

169. *China Will Experiment With Using Blockchain To Collect Taxes*, MIT TECH. REV. (Aug. 7, 2017), <https://www.technologyreview.com/the-download/608570/china-will-experiment-with-using-blockchain-to-collect-taxes/>.

170. Although the Chinese government has taken a strong stance against the trading of cryptocurrencies, its open-arms policy with regards to Blockchain technology comes as no surprise given the potential of the seamless platform. China has used this technology to issue electronic invoices and collect taxes from the consumer public:

EEO [local news platform in Shenzhen] reports that the debut invoice was issued August 10 by a local Shenzhen restaurant. Several other local merchants have already been given access to the system, including a parking lot, auto repair shop, and cafe. The system allowed for a consumer payment via WeChat to generate an invoice that would be eligible for inspection and management by tax authorities. Cai Yunge, general manager of blockchain at Tencent, is

has been stirring the pot with news of its own electronic currency, amplifying its efforts as a direct response to Facebook's own currency, Libra.¹⁷¹

*B. United States of America: 3.22*¹⁷²

The United States has intentionally stalled the promulgation of a proper regulatory scheme for cryptocurrencies and ICOs. At the end of 2017, the US was ranked number one when it came to raising funds through ICOs, but since then it has dropped off.¹⁷³ At this point, with Switzerland making significant advancements toward a regulatory scheme that would allow for companies to feel more comfortable investing, the United States has faced more pressure to implement concrete regulations in order to stay with the pack.¹⁷⁴

At the forefront of cryptocurrency regulation is Congressman Warren Davidson, a Republican representative from Ohio.¹⁷⁵ Davidson is adamant about creating some structure to deal with cryptocurrencies and that there needs to be a definitive definition as to where cryptocurrencies fall within the financial scheme.¹⁷⁶ The biggest question that arises is whether cryptocurrencies fall within the Securities and Exchange Commission's (SEC) jurisdiction as a security or under the Commodity Futures Trading Commission's (CTFC) jurisdiction as a com-

quoted by EEO as saying that the new system achieves a frictionless link between consumer scenarios and tax services.

Marie Huillet, *China Issues First Tax Authority Approved Invoice On Blockchain*, COINTELEGRAPH (Aug. 10, 2018), <https://cointelegraph.com/news/china-issues-first-tax-authority-approved-invoice-on-blockchain>.

171. See generally Raymond Zhong, *China's Cryptocurrency Plan Has a Powerful Partner: Big Brother*, N.Y. TIMES (Oct. 18, 2019), <https://www.nytimes.com/2019/10/18/technology/china-cryptocurrency-facebook-libra.html>.

172. BLIP Spreadsheet, *supra* note 147.

173. Ralph Atkins, *Switzerland Embraces Cryptocurrency Culture*, FIN. TIMES (Jan. 25, 2018), <https://www.ft.com/content/c2098ef6-ff84-11e7-9650-9c0ad2d7c5b5>.

174. *Id.*; see also Kate Rooney, *Crypto Industry Leaders Warn Congress: Figure out Regulation, or Watch Innovation Leave the U.S.*, CNBC (Sept. 25, 2018, 10:36 PM), <https://www.cnbc.com/2018/09/26/crypto-leaders-to-congress-figure-out-regulation-or-innovation-leaves.html>.

175. Rooney, *supra* note 174.

176. *Id.*

modity.¹⁷⁷ As Davidson posited, “we [should not] start legislating before we start listening.”¹⁷⁸ Davidson’s goal is to present legislation that can classify “Utility Tokens” as their own category, similar to Switzerland, and allow for the industry to grow in the United States and avoid being hindered by a mass exodus of companies fleeing to more accommodating countries.¹⁷⁹

In late December 2018, Davidson, along with Congressman Darren Soto,¹⁸⁰ filed a bill known as the Token Taxonomy Act of 2018.¹⁸¹ The bill seeks to exclude digital tokens from being categorized as a security and, most importantly, elucidates that a digital token is not a “representation of a financial interest in a company.”¹⁸² As Davidson said:

This bill provides the certainty American markets need to compete with Singapore, Switzerland, and others who are aggressively growing their blockchain economies . . . [t]o be certain, there will be other regulatory initiatives at some point, but this legislation is an essential first step to keeping this market alive in the United States.¹⁸³

In April 2019, the Token Taxonomy Act was reintroduced by the House of Representatives, and it continues to take a strong stance against cryptocurrencies being classified as securities.¹⁸⁴

Currently, the SEC classifies cryptocurrencies as assets subject to securities laws, and, further, the Internal Revenue Service recognizes cryptocurrency gains as a capital tax gain that

177. *Id.*

178. *Id.*

179. *Id.*

180. Elected in 2016, Darren Soto is a democratic congressman who represents Florida’s Ninth Congressional District. *About, DARREN SOTO*, <https://soto.house.gov/about> (last visited Apr. 19, 2020).

181. Stan Higgins, *U.S. Lawmakers File Bill to Exempt Cryptocurrencies from Securities Laws*, COINDESK (Dec. 20, 2018, 8:33 PM), <https://www.coindesk.com/us-lawmakers-file-bill-to-exempt-cryptocurrencies-from-securities-laws>.

182. *Id.*

183. *Id.*

184. Ana Alexandre, *US Legislators Reintroduce Token Taxonomy Act to Exclude Crypto From Securities Laws*, COINTELEGRAPH (Apr. 10, 2019), <https://cointelegraph.com/news/us-legislators-reintroduce-token-taxonomy-act-to-exclude-crypto-from-securities-laws>.

is subject to taxation.¹⁸⁵ The only two cryptocurrencies that fall within the CTFC's jurisdiction are Bitcoin and Ether, all other coins fall under the SEC and are treated as securities.¹⁸⁶ It is quite clear that the United States remains uncertain as to how to maintain the industry domestically while protecting consumers and investors from potential fraud and illicit behavior; however, it seems as though the United States is looking to be more of a friend than a foe towards cryptocurrencies and ICOs.

*C. Switzerland: 4.11*¹⁸⁷

Zug, Switzerland—nicknamed the “Crypto Valley”— has taken significant strides toward helping Switzerland become the “Crypto Nation.”¹⁸⁸ Switzerland has been a significant player in the cryptocurrency market for years, particularly during the ICO craze throughout 2017.¹⁸⁹ Of the ten most profitable ICOs launched between January and October 2017, Switzerland had raised \$550 million for those ten ICOs, with the United States raising \$580 million and Singapore raising \$184 million.¹⁹⁰ Switzerland, a country with a spoiled reputation due to past scandals over its private banks helping wealthy clients evade taxes, has seized an opportunity to take advantage of an industry that can return a positive reputation to their financial industry.¹⁹¹ According to Oliver Bussman, President of Crypto Valley Association,¹⁹² Switzerland's goal is to avoid the same

185. Adrian Zmudzinski, *U.S. Congressman Announces Plans for Federal Cryptocurrency and ICO Regulation*, COINTELEGRAPH (Dec. 4, 2018), <https://cointelegraph.com/news/report-us-congressman-announces-plans-for-federal-cryptocurrency-and-ico-regulation>.

186. Kate Rooney, *Bipartisan Lawmakers Seek Cryptocurrency Rules to Protect Consumers and Keep the U.S. Competitive*, CNBC (Dec. 6, 2018, 11:30 AM), <https://www.cnbc.com/2018/12/06/bipartisan-lawmakers-seek-cryptocurrency-rules-to-keep-us-competitive.html>.

187. BLIP Spreadsheet, *supra* note 147.

188. Atkins, *supra* note 173.

189. *Id.*

190. *Id.*

191. Sanya Khetani, *What Next? The Incredible History of Secretive Swiss banking*, BUS. INSIDER (Feb. 4, 2012, 4:08 PM), <https://www.businessinsider.com/swiss-banking-privacy-secret-2012-2>.

192. Crypto Valley Association was established in Zug in 2013 with the explicit aim of drawing startups involved in virtual currency technologies, creation and trading to town. *Switzerland at Epicentre of Cryptocurrency Revolution*, PHYS ORG (Mar. 29, 2018), <https://phys.org/news/2018-03-switzerland-epicentre-cryptocurrency-revolution.html>.

mistakes by being sensitive to KYC and Anti-Money Laundering (AML) protocols.¹⁹³ Jörg Gasser, State Secretary at the Swiss Finance Ministry, has expressed concern that the market is not disciplined yet, urging the state to be careful not to tarnish the integrity of Switzerland's financial markets.¹⁹⁴

1. FINMA and its “Forward-Looking” Regulatory Scheme

On February 16, 2018, the Swiss Financial Market Supervisory Authority (FINMA), published guidelines for the offering of ICOs under Switzerland's KYC, AML, and securities laws.¹⁹⁵ The press release is merely a set of guidelines that must be followed, but it is not an ICO specific regulation and, additionally, there is no relevant case law or legal doctrine.¹⁹⁶ In other words, given that Swiss financial market law does not encompass specific provisions governing the trade of virtual currencies, FINMA may still require the organization to acquire approval or authorization from FINMA.¹⁹⁷ Further, FINMA places trading platforms and payment services under the scrutiny of their Anti-Money Laundering Act.¹⁹⁸ FINMA has stated that each ICO will be dealt with on a case-by-case basis within the context of existing AML and KYC regulations, as these laws are most relevant to ICOs.¹⁹⁹ FINMA Chief Executive Officer (CEO) Mark Branson commented that “[o]ur balanced approach to handling ICO projects and enquiries allows legitimate innovators to navigate the regulatory landscape and so launch their projects in a way consistent with our laws protecting investors and the integrity of the financial system.”²⁰⁰

FINMA has welcomed an approach similar to that of Singapore and Australia, which compartmentalizes ICO tokens into

193. Atkins, *supra* note 173.

194. *Id.*

195. Selva Ozelli, *Why Switzerland is Becoming a Crypto Nation with a Flourishing ICO Market: Expert Take*, COINTELEGRAPH (Feb. 18, 2018), <https://cointelegraph.com/news/why-switzerland-is-becoming-a-crypto-nation-with-a-flourishing-ico-market-expert-take>.

196. *FINMA Publishes ICO Guidelines*, FINMA (Feb. 16, 2018), <https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/>.

197. *Fact Sheet: Virtual Currencies*, FINMA (Jan. 1, 2020), <https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/faktenblaetter/faktenblatt-virtuelle-waehrungen.pdf?la=en>.

198. *Id.*

199. FINMA, *supra* note 196.

200. *Id.*; see also Ozelli, *supra* note 195.

three categories: (1) Payment Tokens, (2) Utility Tokens, and (3) Asset Tokens.²⁰¹ Given its concern regarding adherence to AML and securities laws, FINMA clarified which “type” of token falls within the bounds of these laws.²⁰² Additionally, the press release added a section entitled “Information to Investors,” warning of the risks and volatility of the ICO marketplace, as well as the legality regarding contracts executed via Blockchain technology.²⁰³

201. FINMA clarifies the distinctions between payment, utility, and asset token with regard to varying cryptocurrencies as follows:

Payment tokens are synonymous with cryptocurrencies and have no further functions or links to other development projects. Tokens may in some cases only develop the necessary functionality and become accepted as a means of payment over a period of time. Utility tokens are tokens which are intended to provide digital access to an application or service. Asset tokens represent assets such as participations in real physical underlyings, companies, or earnings streams, or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds or derivatives.

FINMA, *supra* note 196.

202. FINMA clarifies the distinctions between payment, utility, and asset tokens with regard to varying ICO uses and offerings as follows:

Payment ICOs: For ICOs where the token is intended to function as a means of payment and can already be transferred, FINMA will require compliance with anti-money laundering regulations. FINMA will not, however, treat such tokens as securities. Utility ICOs: These tokens do not qualify as securities only if their sole purpose is to confer digital access rights to an application or service and if the utility token can already be used in this way at the point of issue. If a utility token functions solely or partially as an investment in economic terms, FINMA will treat such tokens as securities (i.e. in the same way as asset tokens). Asset ICOs: FINMA regards asset tokens as securities, which means that there are securities law requirements for trading in such tokens, as well as civil law requirements under the Swiss Code of Obligations (e.g. prospectus requirements).

Id.

203. *Id.*

Switzerland's goal is to open doors for new cryptocurrency companies, in a way much different than that of China, yet keep the investors and those at risk of financial harm safe. Without the institution of outright legal regulations, FINMA is creating a non-hostile environment that can allow the industry to flourish. Inhibiting the growth of cryptocurrency is the opposite of what one would expect of a governing authority given the potential for the industry's positive economic impact. More so, Blockchain is a valuable technology that must not be overlooked, and its uses are most noticeable, at this point, within cyptocurrency.

2. The Exodus of Cryptocurrency Projects from the Crypto Valley and the Reluctance of the Swiss National Bank

Throughout 2018, the Crypto Valley experienced a negative response to its "regulations."²⁰⁴ After two important banks withdrew from Zug's small but flourishing cryptocurrency industry, investors, industry pioneers, and the local government expressed concern that subsequent company exits from the "promised land" may throw Zug off its current path of becoming the official home of cryptocurrency start-ups.²⁰⁵ These departures present the beginning of a trend that has taken business to other, more lenient countries, such as Liechtenstein, Gibraltar, and the Cayman Islands.²⁰⁶

One major concern is the limited access to the banking system within Switzerland.²⁰⁷ In order to keep Zug's hopes alive, FINMA must take appropriate action to clarify the rules that apply to cryptocurrency companies in order for skeptical banks to feel more comfortable opening accounts with these companies.²⁰⁸ Establishing the necessary legal foundation for banks

204. *See generally* Irrera & Neghaiwi, *supra* note 16.

205. *Id.*

206. *Id.* at 2.

207. *Id.*

208. Banks in Switzerland have shown major concerns regarding the lack of monitoring and reporting that many ICO companies display. These actions can not only affect the company itself, but the banks associated with the company, as seen with Zuercher Kantonalbank.

Zuercher Kantonalbank ("ZKB"), the fourth largest Swiss bank and one of the few big banks in the world to welcome issuers of cryptocurrencies, has closed the accounts of more than 20 companies in the last year. A spokesman for ZKB

to feel more comfortable doing business with cryptocurrency companies is no easy feat;²⁰⁹ however, Thomas Moser, a member of the governing board of the Swiss National Bank (SNB), has said that “[the bank] would not want to close the door on the opportunities that such innovation (cryptocurrencies) might bring.”²¹⁰

In response, Swiss Finance Minister, Ueli Maurer, invited FINMA, the SNB, and the Swiss Bankers Association to a roundtable to discuss and assemble a set of protocols banks can follow when opening an account with a cryptocurrency company.²¹¹ These discussions were in addition to the guidelines that FINMA released in February 2018, which only classified ICOs into certain enumerated categories.²¹² Most notably, in 2019, Switzerland saw innovation and integration at its peak when “Sygnum and SEBA were awarded provisional banking and securities dealer licenses by Switzerland’s financial regula-

declined to comment on any former or existing clients relationships, but said the bank does not do business with any cryptocurrency groups... Swiss banks are worried because some companies that carried out ICOs did not do anti-money laundering (AML) checks on their contributors, industry sources said. This means the banks themselves could fall foul of AML rules.

Id.

209. *Id.*

210. *Id.*

211. *Id.*

212. Given the less stringent nature of Switzerland’s stance on AML laws and securities regulations, FINMA may authorize that certain ICOs adhere to Switzerland’s guidelines; however, if banks are involved with ICOs that have US investors, Swiss banks may fall under SEC scrutiny.

FINMA has already issued separate guidelines to spell out how Swiss AML rules and securities regulations apply to various ICOs. But securities rules are less stringent in Switzerland than in the United States, where the Securities and Exchange Commission has toughened its stance on ICOs. This makes it more risky for banks in Switzerland to be involved with ICO projects which may have raised money from U.S. contributors and could fall under the purview of the SEC.

Id.

tors.”²¹³ The CEO of Sygnum, Manuel Krieger, noted that this is a major move by Switzerland’s regulators as this is the first license of its kind granted.²¹⁴

Most notably, the notion of an SRO has sprouted in Switzerland, and, as of January 2020, before providers may offer services like custody wallet services²¹⁵ and trading platforms, providers must first join an SRO.²¹⁶ According to FINMA, “financial intermediaries operating on a commercial basis must either hold a FINMA license or be a member of a self-regulatory organization . . . recognized by FINMA.”²¹⁷ Notice that FINMA has instituted this requirement to financial intermediaries operating in the commercial sphere and has not directly targeted the cryptocurrency industry. These SROs are regulated and

213. Matthew Allen, *World’s First Crypto Banks Seen as Game Changer for Switzerland*, SWISSINFO (Aug. 27, 2019, 8:45 AM), https://www.swissinfo.ch/eng/licenses-awarded_-world-s-first—crypto-banks—game-changer—for-switzerland/45187400.

214. *Id.*

215. Custodial wallet services are the most commonly used service to store virtual currencies. What comes as a surprise for many traders is that these wallets limit the account holder’s power over their wallets, meaning account holders are not 100 percent in control of their cryptocurrencies.

Custodial cryptocurrency services include most exchanges, brokerage services, and platforms that allow you to buy, sell, and store digital assets. A custodial business is basically a third party that offers to protect your assets within their system. People who store digital assets with a third party need to understand that they are not 100% in control of their cryptocurrencies... Noncustodial wallet services are platforms that allow users to possess their private keys. The application will either give you a file or have you write down a mnemonic phrase that can consist of 12-24 random words. A platform that provides users with the ability to store a cryptocurrency’s private keys gives the user 100% control over the funds. If you possess your private keys, you wholly own bitcoin or any of the other 2,000+ cryptocurrencies in existence.

Jamie Redman, *The Difference Between Custodial and Non-Custodial Cryptocurrency Services*, BITCOIN.COM (Nov. 29, 2018), <https://news.bitcoin.com/the-difference-between-custodial-and-noncustodial-cryptocurrency-services/>.

216. FINMA, *supra* note 197.

217. Lucas Hofer, *More Crypto Businesses Join Self-Regulatory Organizations to Gain Legitimacy*, ICO.LI (Sept. 19, 2019), <https://www.ico.li/cryptoself-regulatory-for-legitimacy/>.

supervised by FINMA; however, they provide flexibility for the industry and avoid a completely centralized authority.²¹⁸ Given the trend of countries to require the issuance of licenses to trade cryptocurrencies, as BaFin²¹⁹ started to require beginning in 2020,²²⁰ the need for a less centralized approach such as Switzerland's forward thinking SRO requirement may be more important than ever.

V. IS THE INTRODUCTION OF A SELF-REGULATORY ORGANIZATION THE ANSWER?

An SRO has the power to create and enforce standards and regulations within a given industry.²²¹ One of the most interesting characteristics of an SRO is that it is a non-governmental authority with powers similar to that of government.²²² Within the financial context, an SRO's number one priority is the protection of the investing public.²²³ The SRO must protect the integrity of the industry and promote "ethics, equality and professionalism."²²⁴ One must keep in mind that despite the power vested within an SRO, the organization is nonetheless subject to governmental regulation and intervention,²²⁵ which may start to deteriorate the true meaning of "self" in SRO.

The ensuing section will focus on one of the most known SROs, the Financial Industry Regulatory Authority (FINRA), and how it has been a driving force within the world of SROs. The subsequent analysis will then address whether FINRA is a "true" SRO and whether a completely non-governmental organization is in reality feasible.

218. *Id.* The SRO is there as a decentralized alternative to licensure and provides the necessary due diligence checks that satisfy Switzerland's AML laws. *Id.*

219. BaFin is Germany's Federal Financial Supervisory Authority. *HomepageFunctions & History*, BAFIN, https://www.bafin.de/EN/DieBaFin/AufgabenGeschichte/aufgabengeschichte_node_en.html (last updated Jan. 29, 2020).

220. Hofer, *supra* note 217.

221. Adam Hayes, *Self-Regulatory Organization*, INVESTOPEDIA (July 19, 2020), <https://www.investopedia.com/terms/s/sro.asp>.

222. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

A. FINRA and How it has Served as a “SRO” for the Securities Market in the U.S.

FINRA²²⁶ was created on July 26, 2007 when the regulatory responsibilities of the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) merged to create FINRA as the sole regulatory body overseeing the securities market.²²⁷ At its inception, then CEO of FINRA, Mary L. Schapiro, said that “[t]he creation of FINRA is the most significant modernization of the self-regulatory regime in decades.”²²⁸ With the United States being one of the leading countries in cryptocurrency innovation, it is only appropriate to focus on how it has self-regulated its other industries, primarily the securities market.

Notably, FINRA is categorized and known throughout the industry as an SRO, but the line between governmental authority and “true” SRO becomes murky in the context of evaluating FINRA.²²⁹ By definition, the industry should have a majority control of the SRO, but FINRA is comprised of twenty-four governing officers, only ten of which are industry officers.²³⁰ FINRA acting as the sole regulatory body with a majority of public governors on the board can seemingly classify FINRA as a “quasi” governmental body. In response, FINRA, aware of this discrepancy, has initiated its program known as “FINRA 360” to maximize FINRA’s efficiency and create a fair and just

226. FINRA is the self-regulatory organization for the stock exchange in the United States; it should not be confused with FINMA, Switzerland’s governmental financial authority, as discussed in the prior section.

227. *NASD and NYSE Member Regulation Combine to Form the Financial Industry Regulatory Authority—FINRA*, FINRA (July 30, 2007), <https://web.archive.org/web/20190719173942/http://www.finra.org/newsroom/2007/nasd-and-nyse-member-regulation-combine-form-financial-industry-regulatory-authority>.

228. *Id.*

229. For more information about where exactly FINRA falls on the spectrum, see generally Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J. L. BUS. & FIN. 151 (2008).

230. David Burton, *Reforming FINRA*, HERITAGE FOUNDATION (Feb. 1, 2017), <https://www.heritage.org/markets-and-finance/report/reforming-finra>; see also *FINRA Board of Governors*, FINRA, <http://www.finra.org/about/finra-board-governors>. (last visited Jan. 21, 2020).

regulatory body to protect the interests of investors nationwide.²³¹

1. Is FINRA a True SRO or More like a Government Authority?

There are many advantages to having an industry regulate itself internally. One overwhelming reason is the idea that misbehavior from a few firms can have consequences affecting the whole industry, and the “benefits” of that misbehavior only favor the wrongdoers.²³² This incentivizes the other firms within the industry to police those misbehaving firms and bring equilibrium back into the industry.²³³ This works efficiently so long as the misbehaving few do not control the industry.²³⁴ Further, industry representatives have a greater understanding of how the market works and possess a greater expertise than governmental regulators.²³⁵ Industry representatives can react quickly to market changes and respond appropriately, whereas governmental responses can be slower and disproportionate.²³⁶

Among many industries with some form of SRO, FINRA is particularly unique because it is situated in a grey area between SRO and governmental authority. First, FINRA is not a governmental authority, yet it is the key regulator of the securities market within the United States, maintaining a budget that exceeds more than two-thirds the size of the SEC’s budget and has a staff that is almost as large as the SEC.²³⁷ Further, as mentioned above, FINRA is not solely controlled by the industry, although it has industry representation on its board.²³⁸ Finally, although it is classified as an SRO, FINRA has coercive power within the industry²³⁹ and serves a governmental function, yet it is not “subject to any of the normal transparency, regulatory review, or due-process protections normally as-

231. *FINRA 360*, FINRA, <http://www.finra.org/about/finra360> (last visited Jan. 21, 2020); *FINRA 360 and its implications will be discussed in further detail later in this section. See also infra* Part V.A.2.

232. William A. Birdthistle & M. Todd Henderson, *Becoming a Fifth Branch*, 99 CORNELL L. REV. 1, 8–10 (2013).

233. *Id.*

234. *Id.*

235. Burton, *supra* note 230, at 2.

236. *Id.*

237. *See* Burton, *supra* note 230.

238. *Id.*

239. *Id.* FINRA has the ability to completely bar firms and individuals from the industry and administer fines and penalties. *Id.*

sociated with government.”²⁴⁰ FINRA can only be subject to these requirements if it is deemed to be a state actor, but in 2015 the Court of Appeals for the Second Circuit held that FINRA is not a state actor.²⁴¹ Unsurprisingly, at their convenience, courts have held that FINRA is a governmental actor in the context of immunity from private lawsuits.²⁴² With the SEC and the courts showing continued deference towards FINRA, the “self” in self-regulatory seems to be drifting further away as FINRA has grown to look more like a “deputy SEC,” and less like an entity subject to SEC scrutiny.²⁴³

2. FINRA 360, Making FINRA as Efficient as Possible

In 2017, President and CEO of FINRA, Robert W. Cook, initiated the FINRA 360 program.²⁴⁴ Also known as the listening tour, FINRA 360 aims at receiving as much feedback as possible from the brokerages and registered representatives that FINRA regulates, including others such as investor advocates

240. *Id.* at 2–3. For example, FINRA is not subject to the notice-and-comment provisions of the Administrative Procedure Act, the Freedom of Information Act, and others. *Id.* In addition, FINRA’s arbitration hearings are not open to the public, nor are the arbitrators required to provide reasons for their opinions. *Id.*

241. *Id.* at 3; see Santos-Buch v. Fin. Indus. Regulatory Auth., Inc., 591 F. Appx. 32 (2d Cir. 2015).

242. Given the scope of FINRA’s power, FINRA seemingly does not appear susceptible to governmental regulation, but rather gives off the appearance of being an arm of the government and immune from certain liabilities.

[W]hen dealing with FINRA, the many protections afforded to the public when dealing with government are unavailable, and the recourse that one would normally have when dealing with a private party—both access to the courts and the ability to decline to do business—is also unavailable. Like Schrödinger’s cat, simultaneously dead and alive, FINRA is, under current rulings, both a state actor (for purposes of barring liability and for tax purposes and, generally, not a state actor (for purposes of absolving it of due process and other requirements and for liability purposes).

Id.

243. *Id.* at 4.

244. Mark Schoeff Jr., *One Year Later, is FINRA 360 Working?*, INVESTMENT NEWS (Apr. 28, 2018, 6:00 AM), <https://web.archive.org/web/20190701095904/https://www.investmentnews.com/article/20180428/FREE/180429927/one-year-later-is-finra-360-working>.

and industry trade groups.²⁴⁵ Many representatives from the industry, including SEC Commissioner Hester Peirce, have praised Cook's efforts and given FINRA the chance to amend on its own before SEC intervention.²⁴⁶ Peirce stressed that it is one thing to start listening to the industry, but "the harder road lies ahead."²⁴⁷

FINRA can be much more transparent with the way it budgets and allocates fines within that budget. Instead of an annual report of financials,²⁴⁸ FINRA should supply quarterly reports, which would ensure a more consistent monitoring system for eyes on the outside of FINRA's walls. In addition, smaller firms are less enthusiastic about FINRA 360, claiming that they are still underrepresented given that much of FINRA's regulations can be devastatingly costly for smaller firms and only beneficial for larger ones.²⁴⁹ In a progress report released by FINRA in April 2018, FINRA announced that larger firms may be examined annually, whereas smaller, low-risk firms will be examined every four years; as Cook said, "figuring out an exam structure is the biggest thing to come."²⁵⁰ FINRA 360 is proving to be a real attempt at reform and it sparks hope that large SROs are capable of improvement.

B. The Crypto Market in the United States: Attempts to Form SROs and Create Internal Guidelines

Attempts to form SROs are becoming more popular, as seen in Switzerland; however, the US is not among the countries trying to completely centralize the cryptocurrency marketplace. In fact, with the US still undecided as to its approach, it is important to see what the financial industry is doing about a self-regulatory scheme within the cryptocurrency marketplace in conjunction with the US's strict AML compliance regulations.

245. *Id.*

246. *Id.*

247. *Id.*

248. *Id.*

249. *Id.*

250. *Id.*; see also *FINRA Progress Report on FINRA 360 Highlights Significant Changes*, FINRA (Apr. 24, 2018), <http://www.finra.org/newsroom/2018/finra-progress-report-finra360-highlights-significant-changes>.

1. The Virtual Commodities Association

In August 2018, the Virtual Commodities Association (VCA) was launched with support from four participating cryptocurrency companies with a plan to discuss, in the near future, guidelines for membership, dispute resolution, record keeping, and the creation of a board of directors.²⁵¹ The mission of the VCA “is to establish an industry-sponsored, self-regulatory organization . . . designation for U.S. cryptocurrency marketplaces to oversee virtual commodity marketplaces.”²⁵² The VCA is governed by a board of directors consisting of a president and secretary, includes a required number of independent directors, and has adopted “sound practices” that members must follow.²⁵³ These practices include adherence to BSA protocols like KYC and AML, current best practices for cryptocurrency custody, and enforcement of the regulatory framework established by the VCA.²⁵⁴ During 2019, the VCA launched six committees, appointed two special advisors and other board leadership appointments to initiate these sound practices and take essential steps towards self-regulating the marketplace.²⁵⁵

2. Association for Digital Asset Markets

In November 2018, ten virtual currency industry leaders formed the Association for Digital Asset Markets (ADAM).²⁵⁶ ADAM aims to establish a code of conduct for the cryptocurrency market, as well as a comprehensive standard for industry

251. *The Virtual Commodity Association Working Group Has Formed and is Planning Inaugural Meeting*, BUS. WIRE (Aug. 20, 2018), <https://www.businesswire.com/news/home/20180820005066/en/Virtual-Commodity-Association-Working-Group-Formed-Planning> (the four participating companies are Bitstamp, Inc., bitFlyer USA, Inc., Bittrex, Inc., and Gemini Trust Company, LLC).

252. *Our Mission*, VIRTUAL COMMODITY ASSOCIATION, <https://virtualcommodities.org/#OurMission> (last visited Jan. 21, 2020).

253. *Id.*

254. *Id.*

255. *Id.*

256. Gabriel Machado, *10 Crypto Companies Form Association for Digital Asset Markets (ADAM) as a Code of Conduct Guide* (Nov. 27, 2018), <https://bitcoinexchangeguide.com/10-crypto-companies-form-association-for-digital-asset-markets-adam-as-a-code-of-conduct-guide/>; see also *Leading Financial Firms to Create Code of Conduct for Digital Asset Markets*, BUS. WIRE (Nov. 18, 2018), <https://www.businesswire.com/news/home/20181127005261/en/Leading-Financial-Firms-Create-Code-Conduct-Digital>.

participants.²⁵⁷ These ten companies intend to gain the trust of legislators and create a guideline that Congress can use when creating rules and regulations for the industry.²⁵⁸ Former CEO of the NYSE and current board member of ADAM, Duncan Neiderauer, has said that ADAM is important for the development of the ever-growing cryptocurrency industry given the need for structure and oversight of such an anonymous and decentralized marketplace without infringing on the liberties of the marketplace itself through cumbersome regulations.²⁵⁹ Neiderauer compared ADAM to the regulatory group within the NYSE where industry leaders banded together to create a set of guidelines for the stock market that remained in effect until FINRA was created in 2007.²⁶⁰ Almost one year later, ADAM's inception of the code of conduct was released on November 12, 2019.²⁶¹ The goal of the Code of Conduct is to promote "integrity, fairness, and efficiency in digital asset markets" and all current members of ADAM were required to sign the Code as of early 2020.²⁶²

C. An SRO and a Diligent Watchful Eye

With governments around the world racing to develop the next best regulatory platform, many regulators are not considering initiating an SRO, though they should be. This may be the case given the volatility of the market and the fact that there is still so much unknown about the industry and where it is headed. Nonetheless, the advantages that come with an industry regulating itself are enough to push the needle towards self-regulation, such as the greater expertise of leaders in the industry compared to government officials, as well as the abil-

257. Machado, *supra* note 256.

258. *Id.*

259. *Id.*

260. *Id.*

261. *Association for Digital Asset Markets Releases Code of Conduct*, BUS. WIRE (Nov. 12, 2019), <https://www.businesswire.com/news/home/20191112005165/en/Association-Digital-Asset-Markets-Releases-Code-Conduct>.

262. *Id.* ("The ADAM code is divided into principles [] in the following areas: Compliance and Risk Management, Market Ethics, Conflicts of Interest, Transparency and Fairness, Market Integrity, Custody, Information Security and Business Continuity, and Anti-Money Laundering and Countering the finance of Terrorism.").

ity of SROs to proportionately present effective regulation.²⁶³ In addition, SROs present a way out of political gridlocks when certain regulations are difficult to pass because of a lack of bipartisan support or other political tie-up.²⁶⁴ With the creation of developments such as ADAM and the VCA, US industry leaders have taken major steps towards creating such a platform and bringing this idea to fruition. These organizations are even backed by the United States regulatory community, including the Commodity Futures Trading Commission (CFTC).²⁶⁵ The CFTC Commissioner, Brian Quintez, has openly advocated for the VCA, arguing that a “virtual commodity SRO that has the most independence from its membership, the most diversity of views, and the strongest ability to discover, reveal, and punish wrongdoing will add the most integrity to these markets.”²⁶⁶

Nonetheless, one must consider the risks associated with an SRO and the need for a consistent and responsive watchful eye, particularly with an industry such as cryptocurrency and the reputation it has for risks of fraud, money laundering, terrorism, and other criminal activities.²⁶⁷ As this Note has demonstrated, many of the criticisms that plague the SRO world stem from FINRA and its purported lack of accountability, its reputation for sidestepping regulatory input,²⁶⁸ and the deference afforded to FINRA by the SEC. SROs can be categorized as being as volatile as the industry it is regulating, especially with regards to cryptocurrency markets and the anti-authoritarian decentralized culture that it comes with.²⁶⁹

In order for an SRO to work efficiently within the US cryptocurrency market, there needs to be governmental backing from the SEC and the CFTC, comprehensive KYC initiatives, and the power to enforce penalties and fines when necessary. These

263. Ryan Clements, *Can a Cryptocurrency Self-Regulating Organization Work?*, FINREG BLOG (June 21, 2018), <https://sites.duke.edu/thefinregblog/2018/06/21/can-a-cryptocurrency-self-regulatory-organization-work-assessing-its-promise-and-likely-challenges/>.

264. *Id.*

265. Annaliese Milano, *CFTC Official Backs Winklevoss Crypto Self-Regulation Bid*, COINDESK (Mar. 13, 2018, 6:40 PM), <https://www.coindesk.com/cftc-official-backs-winklevoss-brothers-crypto-self-regulation-bid>.

266. *Id.*

267. *See generally* Luu, *supra* note 6.

268. Clements, *supra* note 263; *see also* Burton, *supra* note 230, at 2.

269. Clements, *supra* note 263.

protocols focus on the need for accountability and transparency, elements FINRA has lacked but are a necessity for any working SRO. The solution includes trust in the industry and its leaders to regulate honestly and properly. To build this trust, there is a need for a determined watchful eye that can keep track of the industry and maintain its police powers over the SRO.

The benefits of incorporating an SRO into the cryptocurrency marketplace are immense. An SRO limits the heavy regulation that unknowledgeable legislators and regulators may impose given their lack of expertise in the field, and, most importantly, a significant level of uncertainty is removed when the market is regulated by a self-governing agency managed by the industry.²⁷⁰ Further, an SRO can more easily tap into the global regulatory sphere given that they have a greater opportunity to collaborate with one another to build a uniform front.²⁷¹ Lastly, and arguably most importantly, the costs of implementation and enforcement fall on the industry, which reduces the stress that governments may endure if the burden were to fall on them.²⁷²

CONCLUSION

This Note detailed the history of the cryptocurrency exchange and how three particular countries have approached regulatory action. With China enforcing an all-out ban on ICOs and the trading of cryptocurrencies, Switzerland with its “safe-haven” approach, and the United States with its undetermined status, much is still unknown as to effective regulation of the industry, and if there even is a “right” answer. This Note is meant to shine light on several problems within states’ regulatory strategies and pinpoint where these countries may have gone wrong. While solutions to these problems exceed the scope of this Note, looking to what other agencies outside of the cryptocurrency marketplace have done to successfully regulate—FINRA being one of the major SROs with a history of success—is an important first step.

270. Alexander Larsen, *Here’s How Self-Regulation Could Reinvigorate The Cryptocurrency Boom*, LAW. MONTHLY (May 9, 2018), <https://www.lawyer-monthly.com/2018/05/heres-how-self-regulation-could-reinvigorate-the-cryptocurrency-boom/>.

271. *Id.*

272. *Id.*

When all is said and done, there is no perfect system that would work with complete transparency, authenticity, integrity, and fluency; however, there is always a system that can work more efficiently than others. When used appropriately, the SRO regime in the cryptocurrency context can be the start of what many hope will bring about the institution of a “true” SRO—where the industry has a majority hold on the enforcement mechanisms and the public sector is there as a silent watchful eye, or contingency plan in the event that integrity is lost.

*Rani Shulman**

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