BOXERMAN ON BITCOIN - PART II: BLOCKCHAIN AND LEGAL ISSUES THAT CAN ARISE WITH VIRTUAL CURRENCY

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In my previous blog post, I provided a very basic overview of Bitcoin, the most prominent of the virtual currencies that have developed over the past few years. This post picks up where that post left off.

To my mind, the most interesting and exciting aspect to Bitcoin is its use of the blockchain, and this blockchain technology has applications and potential applications that go beyond virtual currencies. The blockchain, as discussed in Part 1, consists of a publicly-available and verifiable list of each and every transfer of bitcoins since the cryptocurrency's inception. Most importantly, the blockchain cannot be changed or altered. It can only be added to, as new transactions are recorded.

Blockchain technology can potentially be used to establish and trade ownership interests as to any type of asset, such as tickets to events or subscriptions to publications. Some have suggested that blockchain technology can help facilitate transactions in works protected by copyright law. In December, 2015, it was announced that the Securities and Exchange Commission had approved an application from Overstock.com to issue company stock over the internet using the blockchain (although, to my knowledge, the company has yet to issue stock this way). Blockchain technology has given rise to a new term, "smart contracts", to describe, among other things, legal agreements that can be created, verified and/or enforced, in whole or in part, through computer protocols. And this past June, the Department of Homeland Security awarded a $199,000 grant to a blockchain startup, Factom Inc., to look into how blockchain technology might be used to ensure the security of cameras used to monitor U.S. borders.

The "Dark" Side of Bitcoin

Despite the growth of Bitcoin since 2009, and despite the promise and potential of blockchain technology, some people view Bitcoin as mysterious and even sinister. This suspicion is likely attributable, in large part, to Bitcoin's association with the Silk Road, which one court described as "an online criminal marketplace" operated on a segment of the internet designed to promote anonymity. Shut down by the FBI in 2013, the Silk Road provided a venue over which illicit products, primarily drugs, were bought and sold. The Silk Road required its users to utilize only bitcoins when conducting transactions on the site.

When not used over the so-called "darknet", or specifically as a vehicle for disguising illegal transactions, Bitcoin and other virtual currencies are perfectly legal. Within the past few years, virtual currencies have become subject to regulation at both the federal and state levels. In 2014, for example, the Internal Revenue Service issued guidance as to the proper tax treatment of transactions conducted in virtual currency. In the view of the IRS, virtual currency constitutes a form of property and is taxed that way. In 2016, the Commodity Futures Trading Commission, through the bringing of charges against a bitcoin-exchange, signaled that, under certain circumstances, virtual currency will be regulated as a commodity.

The FinCEN Approach

In 2013 FinCEN issued guidance in which it explained how its regulations would apply in the virtual currency context. FinCEN divides the virtual currency world into users, exchangers and administrators. In FinCEN's view, those who simply obtain virtual currency to buy goods or services constitute users not subject to the agency's regulations. In contrast, those who buy or sell virtual currency in exchange for "real" currency, and those who are engaged in the business of issuing or redeeming virtual currency, constitute "money transmitters," subject to FinCEN regulation. These regulations include requirements to register with FinCEN; to establish and maintain effective Anti-Money Laundering programs; to report to the government suspicious transactions; and to obtain and, in some instances, forward to certain financial institutions, information about anyone who transmits funds (including virtual currency) worth $3,000 or more. These regulations treat virtual currency more like money, in contrast to the approaches taken by the IRS or Commodity Futures Trading Commission.

Violations of FinCEN's regulations carry civil and criminal penalties. In the past few years the Government has convicted and sent to prison individuals for failing to register their money transmitting business, although, to put these prosecutions in context, the individuals prosecuted have been those connected to the Silk Road website.

In 2015, FinCEN and the United States Attorney's Office in San Francisco entered into an agreement with Ripple Labs Inc. and one of its subsidiaries pursuant to which the companies acknowledged operating as a money services business, failing to properly register, and failing to put in place and maintain the required anti-money laundering program. The company agreed to pay $700,000 in civil penalties.

The State Approach

State government has also gotten into the act. New York, for instance, in 2015 put in place a licensing requirement that many view as overly restrictive and unfriendly to innovation. Within the past few weeks, in North Carolina, the governor signed into law a revision of that state's Money Transmitter Act which covers activities related to bitcoin and other virtual currencies. The North Carolina statute received generally favorable reviews from those in the industry, although some had some criticisms and suggested modifications.

Earlier this week a state court judge in Florida dismissed criminal charges accusing the defendant of illegally transmitting and laundering $1,500 worth of bitcoins. In so doing, the judge agreed with the defendant that Bitcoins should not be considered "money" under Florida law.

In addition, those getting involved in the virtual currency world at any level need to be on the lookout for the possible application of federal and state securities laws. Many contractual relationships and investment projects – which to the uninitiated may appear to have nothing to do with what most people think of when they hear the word "securities" – do in fact constitute securities under federal and/or state law.

Someone who promotes such investments can find himself or herself in the unpleasant position of having, in the eyes of regulators, issued a "security" without having followed a myriad of regulatory requirements, such as registration. Substantial civil penalties, and in some cases, criminal prosecution, can be the unanticipated result.

Potential regulatory issues notwithstanding, there is no need to be afraid of Bitcoin or the other virtual currencies. New types of monetary transactions always require examination to make sure that those who engage in those transactions don't run afoul of applicable rules and regulations. Similarly, new technologies require similar examination. When new types of monetary transactions are combined with new types of technology, the results can be exciting, so long as proper care is taken to comply with the law.