

Crypto Set To Drive Demand For Traditional Services: Part 1

By **Collin Starkweather and Izzy Nelken** (April 23, 2018, 12:12 PM EDT)

Virtual currencies (also commonly referred to as cryptocurrencies or digital currencies) such as bitcoin continue to evoke the character of the Wild West and are often idealized as technology that thrives free of the shackles of regulation, oversight and institutional influence. While that character may both appeal to many market participants and serve as a deterrent to others, one doesn't have to look far to know that tracks are being laid and the civilizing influence of the railroad is coming to town, at least for the more prominent products and platforms.

The legal and regulatory environment for virtual currencies changes on almost a daily basis as legislators, financial regulators and tax authorities grapple with the issues that the unique characteristics of these assets bring to the market.

As virtual currencies such as bitcoin and related technologies see more widespread adoption and are increasingly regulated, individuals with expertise in traditional knowledge capital fields, such as legal, accounting, information technology and systems (IT and IS), and financial services, will be in demand.

In this article, we discuss a number of areas in which we anticipate virtual currencies will drive traditional knowledge industry services, including regulation and compliance, taxation and other legal services as well as related accounting and financial services.

In a companion article, we will discuss similar dynamics that we anticipate will arise as a result of blockchain and smart contracts. Though these technologies are closely associated with virtual currencies, they have the potential to develop and diffuse outside the context of virtual currencies, which in turn would inform the demand for knowledge capital and associated services.

Regulation and Compliance

Both in the U.S. and abroad, bitcoin and other virtual currencies are under increasing scrutiny by regulators including the U.S. Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission.[1]



Collin
Starkweather



Izzy Nelken

In the U.S., virtual currencies are classified as a commodity under the Commodity Exchange Act, and thus fall within the jurisdiction of the CFTC.

Manipulation of the markets for virtual currencies has become an increasing concern,[2] bolstered by explicit warnings issued by U.S. regulators about the potential for “fraud and manipulation”[3] and a widely cited academic analysis of trading activities in bitcoin markets.[4] Those concerns have even extended to the prospect that some of the exchanges themselves may be engaging in or associated with behaviors such as front running, insider trading or price manipulation.[5] In response, some exchanges have been actively developing and implementing monitoring technologies.[6]

The CFTC has initiated numerous actions against traders for alleged spoofing, banging the close, and other allegedly manipulative trading practices related to traditional commodities and futures products. To the extent the CFTC pursues similar actions against traders or even the exchanges in virtual currencies or derivative products, it would drive demand for sophisticated legal representation capable of understanding nuanced regulation that has been criticized as vague or ambiguous[7] as well as financial experts to scrutinize trading activity and the technical merits of various allegations.

Additionally, increased demand is likely to come from exchanges, providers of trading platforms, proprietary trading entities and others to develop and implement monitoring and compliance programs as well as conduct internal oversight and investigation, and this demand will require highly skilled legal and financial services as well as IT and IS professionals.

In addition to oversight by the CFTC, the SEC maintains jurisdiction over issuance of securities and has offered guidance in which it has indicated that initial coin offerings, or ICOs,[8] “based on specific facts, may be securities offerings, and fall under the SEC’s jurisdiction of enforcing federal securities laws,”[9] and that “those who offer and sell securities in the U.S. are required to comply with federal securities laws, regardless of whether those securities are purchased with virtual currencies or distributed with blockchain technology.”[10]

In September, the SEC began initiating enforcement actions against ICO issuers.[11] In response to potential regulatory scrutiny, many issuers are now marketing “utility tokens,” which give investors future access to a company’s product or service and, the issuers would contend, exempt them from federal securities laws. Whether “utility tokens” exempt issuers remains a subject of debate. The SEC enforcement actions are ongoing, with “dozens” of probes into virtual currencies, which seems to be having an impact on the volume of ICOs coming to market.[12] As the understanding of what constitutes securities offerings is further refined, both existing and future market participants who are potentially impacted will need access to experienced legal service providers to ensure compliance with relevant securities laws.

Some financial products are being introduced that allow investors to invest in these virtual assets while remaining within the walled garden of traditional financial assets. Bitcoin futures were introduced onto both the Chicago Mercantile Exchange, or CME,[13] under the symbol BTC and the Chicago Board Options Exchange, or CBOE, under the symbol XBT last December.[14] Four virtual currency exchange-traded funds were introduced in January,[15] and in March, the virtual currency exchange Coinbase introduced a virtual currency index fund.[16]

Concerns have been raised regarding potential manipulation of these products,[17] and as is clear with the recent termination of and class action litigation surrounding the XIV,[18] even within the walled garden, new financial products can suffer from teething pains. Should those teething pains translate to

litigation, it would drive the demand for legal and financial professionals with expertise applicable to those asset classes.

Taxation and Accounting

The Internal Revenue Service has ruled that virtual currencies are considered property for the purposes of taxation and accounting.[19] That means that either any virtual currency accepted as payment must be exchanged for fiat immediately (at least before its fair market value changes) or a cost basis in terms of fair market value has to be recorded for each transaction, then gains or losses must be recorded upon redeeming the virtual currency for fiat.

Businesses without access to sophisticated internal resources may find the processing and accounting for virtual currency transactions prohibitively burdensome. Fortunately, for such firms interested in accepting virtual currencies as payment, service providers known as bitcoin merchant service providers, or BMSPs, have arisen to provide services to businesses that accept bitcoin or other virtual currencies.[20] Merchants who make use of BMSPs receive regular settlements in fiat and do not handle the virtual currency themselves, thus divorcing themselves from the record-keeping obligations associated with virtual currency transactions.

As a result of the accounting treatments, large firms may need to devote significant accounting and IT resources to tax planning for the adoption of virtual currency products and services and to properly process and account for transactions involving virtual currencies, while smaller firms that take advantage of BMSPs will similarly need to devote accounting and IT resources to integrate with BMSP payment systems.

Retail investors who transact virtual currencies must also be aware of and accommodate the tax consequences. When exchanging the virtual currency for fiat, investors must report cost bases and gains or losses for each transaction. If an exchange is made for another virtual currency, however, investors must keep track of the basis of each of the currencies and will be required to pay taxes on such exchanges beginning in 2018.[21] Despite the tax treatment, many exchanges do not provide tools that facilitate the reporting of transactions, leaving users the task of maintaining their own records.

The IRS, believing that too few investors have been paying taxes on their sales, has recently begun to clamp down, requesting customer records from virtual currency platforms. The federal judiciary has thus far agreed that the IRS may have the right to obtain these records, which may result in tax consequences for large numbers of individual taxpayers. For example, a federal judge recently ordered Coinbase to turn over records on about 13,000 accounts that transacted virtual currencies between 2013 and 2015.[22] These consequences may give rise to the need for criminal tax lawyers and tax accounting professionals, as well as indirectly drive demand for tax accounting services and software.

Conclusion

We believe the overall trend toward increasing oversight and regulation will continue, which in turn will drive demand in traditional knowledge capital industries. Moreover, due to the complexity and ongoing evolution of enforcement,[23] those who have cut their teeth on similar claims related to more traditional financial products will be well-positioned to address the issues surrounding these types of claims.

Dr. Collin Starkweather is a principal at Charles River Associates, where he is an economist specializing in securities regulatory and compliance, valuation and competition issues.

Dr. Izzy Nelken is a member of the CBOE product development committee, where he was involved in bringing the CBOE's bitcoin futures offering to market, and is the founder of Super Computer Consulting. He was an instructor in the University of Chicago's financial mathematics program for 18 years.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] Other regulatory entities, such as the Financial Industry Regulatory Authority and the U.S. Department of the Treasury's Financial Crimes Enforcement Network, will likely also play important roles in the development of these markets. For example, virtual currency exchanges have already been under scrutiny for several years by FinCEN, which has engaged in a number of actions targeting these exchanges and related parties. (John Reed Stark and David Fontaine, "3 Critical Events For Cryptocurrency Exchanges: Part 2," Law360, March 13, 2018, available at <https://www.law360.com/articles/1021064>.)

[2] Jonathan Berr, "Cryptocurrencies: Market manipulation a rising fear," CBS Moneywatch, Jan. 18, 2018, available at <https://www.cbsnews.com/news/bitcoin-cryptocurrencies-fear-of-market-manipulation/>.

[3] In December 2017, SEC Chairman Jay Clayton issued a statement indicating that "concerns have been raised regarding the cryptocurrency and ICO markets" because "substantially less investor protection than in our traditional securities markets, with correspondingly greater opportunities for fraud and manipulation." (SEC, "Statement on Cryptocurrencies and Initial Coin Offerings," Dec. 11, 2017, available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.) Also in December 2017, the CFTC issued a customer advisory warning of potential fraud and market manipulation. (CFTC, "Customer Advisory: Understand the Risks of Virtual Currency Trading," Dec. 15, 2017, available at https://www.cftc.gov/sites/default/files/idc/groups/public/@customerprotection/documents/file/customeradvisory_urvct121517.pdf.)

[4] Neil Gandal, JT Hamrick, Tyler Moore, Tali Oberman, "Price Manipulation in the Bitcoin Ecosystem," Journal of Monetary Economics (2017), DOI: 10.1016/j.jmoneco.2017.12.004.

[5] For example, the Bitfinex exchange was reportedly recently subpoenaed surrounding claims of manipulation of bitcoin markets using a virtual currency named Tether issued by the exchange. (Nathaniel Popper, "Worries Grow That the Price of Bitcoin Is Being Propped Up," New York Times, Jan. 31, 2018, available at <https://www.nytimes.com/2018/01/31/technology/bitfinex-bitcoin-price.html>.) It has also been alleged that some exchanges may engage in front-running. (Hugo Renaudin, "How exchanges manipulate the price of Bitcoin," Medium, Jan. 21, 2018, available at <https://medium.com/legolas-exchange/how-exchanges-manipulate-the-price-of-bitcoin-6e7e4b99a4a>. Renaudin is the chief product officer at the Legolas Exchange.) The Coinbase exchange also recently announced that it is investigating possible insider trading of bitcoin cash in violation of the exchange's policies. (Aaron Smith, "Coinbase investigates possible insider trading of bitcoin cash," CNN Money, Dec. 20, 2017, available at <http://money.cnn.com/2017/12/20/investing/coinbase-bitcoin-cash/index.html>.)

[6] See, for example, Oscar Williams-Grut, "Cryptocurrency exchange Bitfinex is going to use special tools to crack down on market manipulation," Business Insider, March 14, 2018, available at <http://www.businessinsider.com/bitfinex-irisium-market-surveillance-manipulation-cryptocurrency-scams-crypto-2018-3>. The Seed CX exchange has even characterized compliance and surveillance tools as a part of its "top priority" in ensuring fair and orderly trading, and planned the application of compliance and surveillance tools to its crypto markets from the beginning. (Author communication with Waseem Barazi, chief compliance officer and general counsel at Seed CX.)

[7] For example, the landmark *Coscia v. U.S.* spoofing case currently has a petition outstanding before the U.S. Supreme Court seeking a review on the grounds that the statutes defining spoofing are "hopelessly" vague. (Dunstan Prial, "Jailed Spoofer Coscia Asks High Court To Review Conviction," Law360, Feb. 2, 2018, available at <https://www.law360.com/articles/1008795/jailed-spoofers-coscia-asks-high-court-to-review-conviction>.)

[8] ICOs are crowd-funded offerings of virtual "tokens" often used to capitalize startup ventures in which the "tokens" are marketed to investors in exchange for fiat or virtual currencies such as bitcoin, which can easily be tendered for fiat. If the ICO's funding threshold is met, these "tokens" become exchangeable for a new virtual currency or other products or services. (See, e.g., Benjamin Sherry, "What is an ICO?," Investopedia, Jan. 29, 2018, available at <https://www.investopedia.com/news/what-ico/>.)

[9] SEC, "Initial Coin Offerings (ICOs)," March 7, 2018, available at <https://www.sec.gov/ICO>.

[10] SEC, "Investor Bulletin: Initial Coin Offerings," July 25, 2017, available at https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings. The SEC has further stated that ICO issuers must demonstrate that the product is not a security or be subject to applicable securities laws. (SEC, "Statement on Cryptocurrencies and Initial Coin Offerings," Dec. 11, 2017, available at <https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11>.)

[11] Allen & Overy, "SEC files its first enforcement action against alleged sponsors of initial coin offerings," Oct. 4, 2017, available at <http://www.allenoverly.com/publications/en-gb/Pages/SEC-files-its-first-enforcement-action-against-alleged-sponsors-of-initial-coin-offerings.aspx>.

[12] Andrew Ramonas, "SEC Working on 'Dozens' of Cryptocurrency Probes, Official Says," Bloomberg News, March 15, 2018, available at <https://www.bna.com/sec-working-dozens-n57982089945/>; Paul Vigna and Dave Michaels, "Has the Cryptocurrency Market Met Its Match in the SEC?," Wall Street Journal, March 20, 2018, available at <https://www.wsj.com/articles/hot-cryptocurrency-market-chilled-by-sec-scrutiny-1521557569>. See also John Reed Stark and David Fontaine, "3 Critical Events For Cryptocurrency Exchanges: Part 1," Law360, March 12, 2018, available at <https://www.law360.com/articles/1020929>.

[13] The CME introduced bitcoin futures trading under the ticker BTC on Dec. 17, 2017 that trade on the CME Globex exchange. (Reuters Staff, "Bitcoin futures contracts at CME and Cboe," Reuters, Dec. 15, 2017, available at <https://www.reuters.com/article/uk-bitcoin-futures-contracts/bitcoin-futures-contracts-at-cme-and-cboe-idUSKBN1E92K9>.)

[14] The CBOE introduced bitcoin futures trading under the ticker XBT on Dec. 10, 2017 that trade on the Chicago Futures Exchange. (Reuters Staff, "Bitcoin futures contracts at CME and Cboe," Reuters,

Dec. 15, 2017, available at <https://www.reuters.com/article/uk-bitcoin-futures-contracts/bitcoin-futures-contracts-at-cme-and-cboe-idUSKBN1E92K9>.)

[15] Chris Katje, “4 New Cryptocurrency ETFs To Consider For Your Portfolio,” Seeking Alpha, Feb. 5, 2018, available at <https://seekingalpha.com/article/4143066-4-new-cryptocurrency-etfs-consider-portfolio>.

[16] Gertrude Chavez-Dreyfuss, “Coinbase announces launch of cryptocurrency index fund,” Reuters, March 6, 2018, available at <https://uk.reuters.com/article/us-crypto-currencies-coinbase/coinbase-announces-launch-of-cryptocurrency-index-fund-idUKKCN1GI313>.

[17] Alexander Osipovich, “Bitcoin Futures Manipulation 101: How ‘Banging the Close’ Works,” Wall Street Journal, Dec. 16, 2017, available at <https://www.wsj.com/articles/bitcoin-futures-manipulation-101-how-banging-the-close-works-1513425600>.

[18] The XIV was an exchange-traded note, or ETN, issued by Credit Suisse that was described as an “inverse volatility index” based on the VIX volatility index. Credit Suisse terminated the ETN on Feb. 6, 2018, after its price dropped more than 80 percent in premarket trading. (Gunjan Banerji, “Credit Suisse Announces Effective End of XIV, Popular Short Volatility ETN,” Wall Street Journal, Feb. 6, 2018, available at <https://www.wsj.com/articles/credit-suisse-announces-effective-end-of-xiv-popular-short-volatility-etn-1517929298>.)

[19] Stephen Middlebrook, “Bitcoin for Merchants: Legal Considerations for Businesses Wishing to Accept Bitcoin as a Form of Payment,” Business Law Today (November 2014), available at https://www.americanbar.org/publications/blt/2014/11/02_middlebrook.html. See also IRS, “Internal Revenue Bulletin,” April 14, 2014, available at https://www.irs.gov/irb/2014-16_IRB.

[20] Ibid.

[21] Although the tax treatment is not entirely clear, such virtual currency swaps prior to 2018 may be reportable as nontaxable “like-kind” exchanges. (Laura Saunders, “Do You Own Bitcoin? The IRS Is Coming for You,” Wall Street Journal, March 16, 2018, available at <https://www.wsj.com/articles/do-you-own-bitcoin-the-irs-is-coming-for-you-1521192601>.)

[22] Ibid.

[23] For example, as noted above, the landmark *Coscia v. U.S.* spoofing case currently has a petition outstanding before the U.S. Supreme Court. (Dunstan Prial, “Jailed Spoofer Coscia Asks High Court To Review Conviction,” Law360, Feb. 2, 2018, available at <https://www.law360.com/articles/1008795/jailed-spoofers-coscia-asks-high-court-to-review-conviction>.)