Bitcoin: The Path to Regulation

coinfloor

In March 2017, Bitcoin, the controversial yet potentially revolutionary cryptocurrency that was created in 2009, hit a record high value of $1,290 compared to a low of $200 in 2015. The growth of Bitcoin and its ever-increasing popularity has led to a recent focus on the regulation of cryptocurrencies (also known as virtual currencies); in particular, the inclusion of Virtual Currency Exchange Platforms (VCEPs) and Custodial Wallet Providers (CWPs) in the Fifth EU Money Laundering Directive (5AMLD). It has also fostered a significant interest in the technology behind Bitcoin — blockchain, the secure distributed ledger of digital events — for broader applications within the financial services industry, with many companies actively engaging in blockchain initiatives.

In this paper, Protiviti collaborated with Coinfloor to discuss the evolution of Bitcoin and recent impacts on the cryptocurrency industry from events all over the world. This paper explores the future of Bitcoin and other cryptocurrencies and the aim of balancing privacy and anonymity with regulatory compliance.

Introduction to Bitcoin

Bitcoin is a virtual currency which is “mined” or created after solving complex mathematical problems. Anyone with enough computing power can mine bitcoins, however, the Bitcoin protocol — the rules that govern the Bitcoin network — allow for only 21 million bitcoins ever to be created.

Bitcoins are not printed or minted like traditional currencies, but are stored electronically. The most distinguishing characteristic of Bitcoin is that it is decentralised i.e., it is not backed by an underlying asset and is not controlled by a single institution.

As mainstream adoption has increased, the need for an intermediary between the cryptocurrency world and the traditional currency world has developed. In response, to this Bitcoin exchanges have been created to enable customers to buy or sell bitcoins using different currencies.

History of Significant Compliance-related Events

2008	October: Bitcoin created by Satoshi Nakamoto[1]
2009	January: • The first block is mined • The first Bitcoin transaction occurs
2010	February: The first Bitcoin exchange is set up October: Financial Action Task Force (FATF) publishes Money Laundering Using New Payment Methods to warn about the use of virtual currencies to finance terrorist groups
2011	February: Silk Road, an online black market, opens on the "darknet" with Bitcoin as its payment method
2013	May: The first Bitcoin Automated Teller Machine (ATM) opens in Vancouver, Canada October: Silk Road is shut down due to alleged criminal activity and the owner is arrested; successor sites are developed November: Bitcoin breaks $1,000 in value and surpasses Western Union in transaction volume
2014	February: Mt Gox, based in Tokyo, Japan and at the time the largest Bitcoin exchange, shuts down after 744,408 bitcoins are stolen (worth $350 million at the time; now worth over $925 million) April: Bitcoin value drops to $363, after hitting a record price of over $1200 in November 2013
2015	August: • 160,000 merchants in the USA accept Bitcoin • The BitLicense comes into effect in New York state October: The EU recognises Bitcoin as a currency and transactions are exempt from VAT[2]
2016	February: Prompted by terrorist attacks in November 2015, the European Commission published an Action Plan to strengthen the fight against the financing of terrorism, including reopening aspects of the Money Laundering Directive such as the anonymity associated with virtual currencies July: A judge in Miami, USA ruled that Bitcoin is not captured under the Florida statute that defines "monetary instruments" i.e., Bitcoin is not actually money[3]
2017	March: • The value of one bitcoin surpasses the value of an ounce of gold for the first time • The Winklevoss Bitcoin Trust Exchange Traded Fund (ETF) was rejected by the United States Securities and Exchange Commission due to the lack of regulation in the Bitcoin space

Use Case for Bitcoin

At its inception, Bitcoin flourished among parties that wanted to remain anonymous, as personally identifiable information is not required to create a Bitcoin address or account, and thus transact using bitcoins. These parties included both libertarians wishing to be free of a centralised authority, as well as counterparties in underground marketplaces, such as Silk Road, using bitcoins to trade contraband items without the risk of being identified. The latter led to the association of Bitcoin with illegal activities in the early days.

However, this stigma is now a perception of the past. A recent study analysing patterns in Bitcoin transactions from 2009 to 2015 found that, while the initial growth stage consisted largely of transactions

1 Satoshi Nakamoto is believed to be an alias; the individual's identity and nationality are unknown.

2 "The exchange of traditional currencies for units of the 'bitcoin' virtual currency is exempt from VAT," Court of Justice of the European Union, October 2015: http://curia.europa.eu/jcms/upload/docs/application/pdf/2015-10/cp150128en.pdf.

3 "Bitcoin not money, Miami judge rules in dismissing laundering charges," *Miami Herald*, July 25, 2016: www.miamiherald.com/news/local/crime/article91785802.ece/BINARY/Read%20the%20ruling%20%28.PDF%29.

for "sin" enterprises, the system matured into largely legitimate transactions by the end of 2013.[4] Obi Nwosu, Managing Director of Coinfloor, says that its clients, who all undergo know-your-customer (KYC) compliance checks, are using bitcoins for currency hedging, investment, trading, payment processing and many other legitimate activities. Demand for legitimate Bitcoin services is growing. As of April 2017, there are approximately 200,000-350,000 global Bitcoin transactions per day, making it by far the most dominant cryptocurrency in the world.[5]

Regulation of Cryptocurrencies

Virtual Currency Exchange Providers (VCEPs) and Custodial Wallet Providers (CWPs) are presently not regulated in the European Union and, therefore, are under no obligation to identify suspicious activity.[6] This could allow the misuse of Bitcoin and other cryptocurrency networks to go undetected and, the use of bitcoins to integrate dirty money into the financial system or to fund terrorist activity to remain unnoticed.

Following the terrorist attacks in France in November 2015, it was discovered that cryptocurrencies were used as a form of income to fund terrorists' ongoing operations and that a single Bitcoin address was found to contain $3 million worth of bitcoins.[7] In response, the European Commission published an action plan to strengthen the fight against terrorist financing in February 2016, which included provisions around cryptocurrencies due to their inherent anonymity.[8]

In July 2016, the European Commission published its proposal to amend the Fourth EU Anti-Money Laundering Directive. These amendments form a separate directive, the 5AMLD, which may be enacted as soon as mid-2017. Once enacted, organisations will have a defined period to implement measures to satisfy the directive.

The 5AMLD will better define virtual currencies and bring VCEPs and CWPs into scope under the list of obliged entities required to perform customer due diligence, including:

- Performing KYC activities on all new customers
- Carrying out transaction monitoring to identify suspicious activity
- Reporting suspicious activity to the relevant governing authorities.

The Balance of Privacy and Compliance

The attraction to the cryptocurrency world varies across the customer base. While some users desire anonymity for legitimate privacy or economic reasons, others welcome regulation as a perceived sign of stability and security. Although these are not mutually exclusive, care must be taken not to emphasize one at the expense of the other.

Coinfloor says that it considers strong compliance as an efficient means of attracting the right type of customers. The company is vocal about prohibiting customers that wish to engage in illegal activities including those that wish to transact on the darkweb and states that it is committed to providing its users with a compliant Bitcoin exchange to capture the unfulfilled demand for legitimate Bitcoin services.

Bitcoin blockchain customers stress the importance of maintaining their privacy, which makes focusing on pre-emptive compliance a difficult balancing act.

"Cryptocurrency exchanges are best positioned to manage the balance between user privacy and regulatory compliance," says Coinfloor's Nwosu. "Cryptocurrency exchanges can provide the desired privacy between on-exchange counterparties and help improve "on-Bitcoin blockchain" privacy while recording sufficient information to help minimise money laundering and terrorist financing."

[4] "The Evolution of the Bitcoin Economy: Extracting and Analyzing the Network of Payment Relationships,"by Paolo Tasca, Shaowen Liu, and Adam S. Hayes, July 2016: www.the-blockchain.com/docs/The%20Evolution%20of%20the%20Bitcoin%20Economy%20-%20Extracting%20and%20Analyzing%20the%20Network%20of%20Payment%20Relationships.pdf.

[5] Confirmed Transactions Per Day: https://blockchain.info/charts/n-transactions.

[6] "A report on the proposal for a directive of the European Parliament and of the Council amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing and amending Directive 2009/101/EC," *European Parliament*: www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+REPORT+A8-2017-0056+0+DOC+PDF+V0//EN.

[7] "ISIL Militants Linked to France Terrorist Attacks had a Bitcoin Address with 3 Million Dollars," *NewsBTC*: www.newsbtc.com/2015/11/14/isil-militants-linked-to-france-terrorist-attacks-had-a-bitcoin-address-with-3-million-dollars/.

[8] "Action plan to strengthen the fight against terrorist financing," *European Commission*, February 2016: http://ec.europa.eu/justice/criminal/files/aml-factsheet_en.pdf.

Global Perspectives

Several recent global events have caused Bitcoin to once again make headlines. The uncertainty following the US election, Brexit and demonetisation in India and Venezuela have caused traditional currencies (such as GBP, EUR, USD, and CNY) to fluctuate, creating a surge in Bitcoin trading. This level of adoption of Bitcoin has accelerated the global push to bring virtual currencies under regulation.

The 5AMLD is not the only attempt to regulate the virtual currency space. In May 2016, Japan passed a regulation requiring virtual currency operators to register with the Japanese financial services regulatory body, the Financial Services Agency. The regulation follows two years of discussion after the collapse of the Japanese Bitcoin exchange Mt. Gox and includes provisions for AML compliance.

In January 2017, the People's Bank of China also announced that it was looking into Bitcoin exchanges to ensure they had implemented AML controls. This resulted in the major exchanges partially suspending their operations for a number of months while they reviewed their AML practices.

In the United States, New York's "Bit License" was introduced in August 2015 and Bitcoin companies have started to become compliant. In March 2017, the Winklevoss Bitcoin Trust ETF was rejected by the United States Securities and Exchange Commission (SEC) due to the lack of regulation in the Bitcoin space. However, the SEC's explanation for the rejection has provided clear guidelines to achieve approval in the future.[9]

Conclusion

It is important to understand the changing view of Bitcoin in the public's perception in order to appreciate the ongoing transformation of it and other cryptocurrencies into legitimate financial instruments. Bitcoin has decidedly moved away from early darknet associations, and moved towards regulatory compliant use cases — as much as 80% of Bitcoin trading is now carried out by professionals mimicking Wall Street strategies.[10]

However, as the adoption of Bitcoin grows, the pressure for regulation also grows due to the increasing risk of money laundering, terrorist financing, and other misuse. The 5AMLD in 2017 could mean that VCEPs and CWPs will need to become compliant with applicable law or face termination.

Technology is revolutionising the financial world and it is impossible to ignore the growing demand presented by increasingly sophisticated consumers. As is ever the case, regulation will follow innovation. However, the rapid pace of adoption of cryptocurrencies is proving the need for financial institutions, regulators and the consumer to be agile and responsive to change. Bitcoin and the blockchain are leading a revolution with an uncertain yet promising future, and the world will need to stay tuned.

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9 www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf.

10 "High-Speed Traders Are Taking Over Bitcoin," *Bloomberg*, January 2017: www.bloomberg.com/news/articles/2017-01-16/high-speed-traders-are-taking-over-bitcoin-as-easy-money-beckons.