



Blockchain & Cryptocurrency Regulation

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The regulation of blockchain technology

Joseph F. Borg & Tessa Schembri
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Introduction

There is no denying that blockchain and cryptocurrencies have taken the world by storm. Whether or not these innovative technologies will live up to the revolution which they are predicted to create in various economic sectors, it cannot be refuted that the blockchain phenomenon is a reality which will not be disappearing any time soon. But can blockchain technology be regulated? Can we consider blockchain technology without the involvement of cryptocurrencies? These are two fundamental questions that are often brought up when discussing blockchain and cryptocurrency regulation.

The concept of regulating a disruptive technology, is in itself unrealistic and unattainable as a result of the principle of “technological neutrality”. Technology changes exponentially, but social, economic and legal systems change incrementally. Therefore, technology will always render regulation outdated, almost immediately. On the other hand, it is the very tendency of technology to evolve that is crucial in justifying legal and regulatory change. The objective of regulation should never be to slow down or delimit technology, as this inevitably leads to stifling innovation. The focus should always be on creating standards as well as ethical and good governance principles as these are essentially the tools required for a new industry to mature, grow and flourish. Without such standards in place, we would not be able to connect one device produced by Company A with another one produced by Company B. Without ethical principles, vulnerable people would continuously be abused and exploited. Without good governance principles, business ventures would not develop into structured, stable and trustworthy entities.

Building a case for regulation

Thus, we must ask ourselves, is there a good case for regulation? In our opinion, yes! Regulation is necessary, but avoiding over-regulation is crucial. The risks for over-regulation are huge, especially when we take look back at the recent history of regulation. Even today, Europe is notorious when it comes to over-regulation. While it is undeniable that these regulations are backed by good intentions, the reality is that many recent European Union directives and regulations are bad for business: they cripple start-ups and limit innovation. It is important to strike the right balance and maintain the focus on the regulatory objectives. The latter should always constitute the basis of any regulation. Therefore, we deduce that the regulatory objectives at the basis of any form of blockchain

regulation should be:

1. the creation of standards that allow interoperability and protect end users;
2. ensuring the protection of vulnerable people and protecting them from criminals; and
3. ensuring good governance to protect investors as well as end users from fraud, mismanagement and gross negligence.

The open source nature of most blockchain projects is in itself achieving the goal of interoperability. However, the key term among the above regulatory objectives is “protection”. There is a fine line for governments and regulators between protecting, and taking on a “Big Brother” approach whereby adults are not allowed to take their own informed decisions. From our angle, the best solution for protection is by ensuring transparency and providing the necessary information for an adult to be able to make his/her own decision.

Financial freedom through blockchain

As readers may have guessed, we are liberals at heart and firm believers in freedom. Blockchain technology is an expression of liberalism and it provides mankind with both freedom and self-sufficiency. If you try to distort this through regulation, blockchain can be dangerous. This technology was applied for the first time, by a revolutionary person or group of persons to create the world’s first cryptocurrency – Bitcoin. The aim behind this project was to create a revolution to dethrone the big intermediaries of the financial world, such as banks and other financial institutions. If regulators attempt to decouple blockchain from its intended purpose, blockchain fundamentalists will retaliate by further developing blockchain to satisfy their objective of replacing the financial system as we know it.

As liberals, we sympathise with blockchain fundamentalists, while remaining mindful that liberal fundamentalism is equally as dangerous as authoritarianism. Therefore, a balance needs to be struck. If the financial system is destroyed, civil wars across the globe will follow suit. This should not be something that we want. Blockchain should serve as a tool to reshape what is outdated and does not function properly in the current financial system. As Don Tapscott¹ correctly points out, big financial intermediaries have done a decent job but instead of creating prosperity, they have also created a lot of wealth for themselves. The time has now come for these intermediaries to be controlled, to avoid another financial crisis like the one we experienced in 2008 and to generate prosperity amongst people from all walks of life and from across the globe. Adequate and proportionate regulation over blockchain technology could be the key.

Cryptocurrencies unchained?

Can blockchain exist without cryptocurrencies? The answer very much depends on the type of blockchain which we are considering. A distinction must be made between a public or permission-less blockchain and a private or permissioned blockchain. Bitcoin is the first example of a public, permission-less blockchain. It is a type of Distributed Ledger Technology that is not controlled by a central entity but which relies on the community that is made up of miners, nodes and users. A public blockchain cannot exist without a cryptocurrency or crypto asset, because miners have to get rewarded in cryptocurrencies or crypto assets, and users have to trade in cryptocurrencies or crypto assets to make use of the network.

On the other hand, a private or permissioned blockchain generally comprises a ledger/database that is built on a decentralised and possibly distributed infrastructure which is controlled by the same entity or a group of entities. The control of the latter type of blockchain is not distributed among the users of the network but is centralised in that entity or those entities which together control that blockchain. Really and truly, this defeats the whole *raison d'être* of blockchain. While private blockchains may serve as the perfect tools for large entities to collaborate with each other on a project or a number of projects, or for operating entities of one large group to work better together, the reality is that “blockchain” was intended to be an open-source decentralised system.

Horizontal vs. vertical regulation

Ultimately, there really is no other way to help an emerging industry to thrive than by introducing a clear regulatory framework. But how can we regulate a technology designed to be decentralised, through a centralised institution? When considering the concept of “cryptocurrency”, it is useful to view such assets as a type of “application” using blockchain technology. Therefore, the regulation of blockchain could also be horizontally regulated through concentration on the hierarchy of identifiable layers involved in the technical structure of such applications. These layers include the platform level (the blockchain), the application level (the tools that run on the platform such as cryptocurrencies) and the overall blockchain ecosystem (the ledger or ledgers). Thus, horizontal regulation of blockchain technology would seek to regulate the infrastructure and as such, such a form of regulation is typically met with scepticism and criticism.

There is wide agreement that cryptocurrencies could be brought within the sphere of regulation without regulating cryptocurrencies *per se*, through the vertical regulation of the blockchain market itself. Vertical regulation follows a sectoral approach, establishing vertical lines respectively between the different intermediary services in the targeted ecosystem which build interfaces with traditional financial and economic sectors. Such a form of regulation is further justified in view of the reality that a rising number of cryptocurrency transactions are not performed “on-chain”, i.e. directly on the blockchain network, but “offchain” via internal logging systems controlled by centralised cryptocurrency exchanges, wallets and payment companies.

Over the last two years, regulators and policymakers around the world have become increasingly interested in bringing cryptocurrencies and blockchain technology within the scope of regulation. When considering the initiatives which are currently being taken in jurisdictions around the globe, we see that the most widespread approach has been the issuance of warnings in relation to the risks inherent to cryptocurrencies and Initial Coin Offerings. While warnings and public statements are effective forms of pre-regulation of new technologies in the short term, the ever-increasing popularity of blockchain technology merits in-depth regulatory guidance to provide legal certainty to blockchain actors and users.

Existing legislation – fit for purpose?

In some countries (mainly in the EU), existing laws such as those tackling money-laundering, investment services and taxatio have been “recycled” to extend to cryptocurrency-related activities. Other countries such as Lithuania, Gibraltar and Switzerland have introduced new rules applicable to certain cryptocurrency activities such as Initial Coin Offerings. The legislators in these countries have acknowledged that certain “new” services which have

come to fruition as a result of the capabilities of blockchain technology merit *sui generis* regulation.

Following its history of looking towards the future, the Maltese legislator has been touted for acknowledging emerging industries and embracing new technology and innovation. In fact, over the past 10 years, Malta has become the hub for the online gaming companies in Europe, an industry which is now of fundamental importance to the economy of the country. Now, Malta is proving to be the most ambitious country so far within the sphere of blockchain technology. Apart from issuing new rules applicable to Initial Coin Offerings and the provision of intermediary services incorporating cryptocurrencies, laws have also been introduced which cover the blockchain (Distributed Ledger Technology) sector in general. The latter is an example of the horizontal regulation contemplated above.

Going forward with caution

The blockchain ecosystem welcomes comprehensive regulation without which, people would be able to make ill-use of blockchain technology. The crux will be in the ability of legislators to strike a balance between the need for governance and the avoidance of heavy-handed government intervention which would kill this emerging technology. As with any other innovative technology or its application, one must carefully analyse the functional characteristics of various concepts under consideration and their implications and risks (real, not perceived), so that the introduced regulatory regime provides an appropriate and adequate response to regulatory concerns without over-regulation. We strongly believe that regulatory intervention should be functional, technology-neutral and based on regulatory goals and principles.

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