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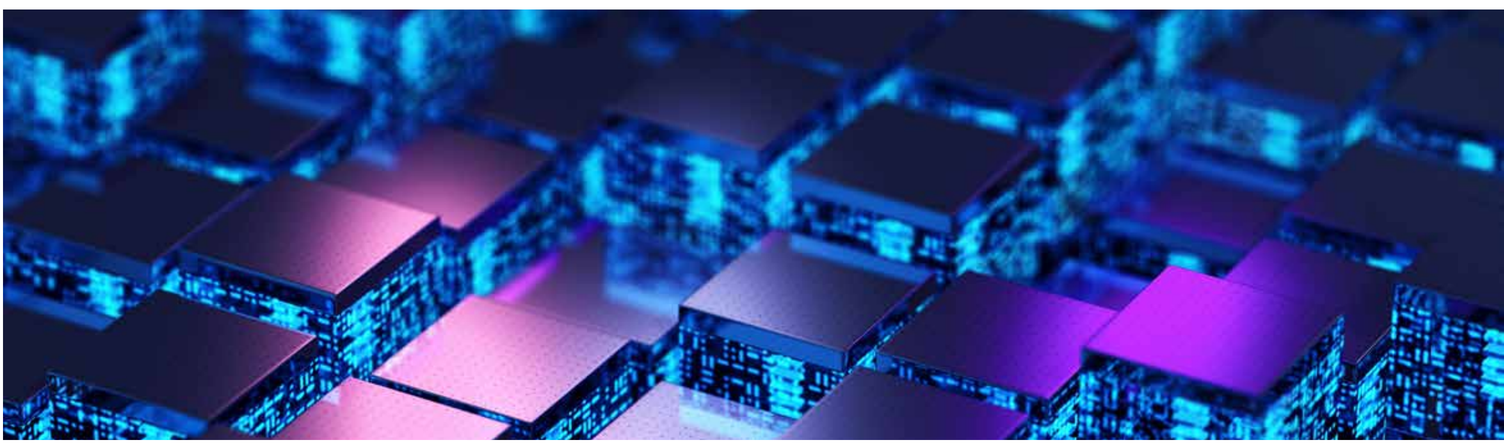
Cryptocurrency & Blockchain: When Do the Benefits Outweigh the Risks?

The collapse of FTX in early November 2022, and subsequent fallout in the cryptocurrency services industry, while disastrous in scope, reflect the growing pains of the industry.



IN RECENT YEARS, REGULATORY AGENCIES around the world have both intensified regulatory enforcement and litigation against bad actors, while at the same time are building regulatory sandboxes in the hopes of nurturing the industry's development.

Multilaw held a webinar in November 2022 with a panel of attorneys from four of its member firms in Germany, Hong Kong, Israel, and the U.S., who have active practices in cryptocurrency issues. The panel, moderated by Jacob Kirkham of Multilaw, featured discussions around regulatory and industry trends in cryptocurrency and other blockchain applications. The following edited excerpts from the webinar (with recent updates) summarize the discussion.

What is the position of the authorities in your jurisdiction in relation to crypto activities? Have they been welcoming or discouraging?

Jill Wong (formerly of Howse Williams): In Hong Kong, the authorities have been welcoming; although in the early days, there was some skepticism about cryptocurrency (or virtual assets, as we now call it). But the concerns have somewhat dissipated since then. Since around 2018, Hong Kong has gradually recognized virtual assets as an alternative asset class and there was investor appetite. Initially Hong Kong authorities allowed asset managers to make limited investments in virtual assets, then the Hong Kong authorities allowed the virtual asset exchanges a framework to opt in to the regulatory regime. Now they are fast moving to regulate through new legislation. In 2023 Hong Kong will have a licensing regime for virtual asset trading platforms or, in other words, exchanges. This is a very positive environment for industry players.

Oded Ofek (M. Firon & Co.): In a way, for years, this has been a pending problem in Israel. Since October 1, 2018, a law regulating services in financial assets, including crypto currency assets, called Supervision of Financial Services (Regulated Financial Services) Law, came into force in Israel. Whoever was a veteran provider in crypto services was issued the right to continue as a veteran until issued a perpetual license for a term. However, until September 2022, no company was actually issued a perpetual license. The Capital Markets, Insurance and Savings Authority in Israel was very diligent before it issued any licenses for virtual currency (aka crypto). The term virtual currency refers to services in these financial assets, including exchange of financial assets, and management of the trading of financial assets; NFTs have still not been tackled, whether said tokens should be regulated under said law or the Securities Law in Israel. The first two licenses were issued in September 2022, one to an aggregator of services and another is a broker; showing that the capital markets authority in Israel is pursuing this agenda.

[UPDATE – On December 2022, a third company has been issued said license, an Israeli service provider of the Altshuler Shaham investment house.]

Matthias Geurts (Schalast): Germany is one of the key drivers in the European market for virtual currencies. Germany introduced a law in 2021 which allows security tokens in the form of a fixed income type token. Such regulation generally transforms the old world of securities into the world of electronic means by using the same legal concepts. Germany is also driving EU regulation, the so-called MiCA (Markets in Crypto-Assets) which may come to force soon; this regulation should close the gap to financial instruments regulated under MIFID. Virtual or digital assets are considered as an alternative asset class, and consequently requires regulatory regulation and guidance but also with respect to its taxation. From a market perspective we see lots of projects in that field of products in Germany intended to create a new alternative investment market. With respect to the custodian services there is a specific license requirement in Germany, but specific regulation for marketplaces and trading do not exist so that the general requirements for trading financial instruments and products apply.

> Due to a lack of international regulation in some jurisdictions, cryptocurrencies will be considered as authorized money, as e-money or as security. This makes such instruments so complex.
>
> *Matthias Geurts*

Stephen Rutenberg (Polsinelli): United States regulators, at least initially, took a relatively practical view regarding the regulation of cryptocurrency and related activities. Examples of this include: the IRS (Internal Revenue) issuing guidance as far back as 2014; treating Bitcoin as property; and most state regulators treating cryptocurrency as a money, meaning that in most of the 50 states a money transmission license is required for a non-bank or trust company to operate a crypto-related business. Bitcoin and other crypto currencies are regulated by the CFTC as a commodity. Even the SEC (the federal Securities and Exchange Commission), set up a FinHub and requested industry feedback, though their interpretation of fairly old securities law precedent rarely worked to allow for the issuance of payment or in-network tokens in the United States. More recently, with the combination of the fallout from the FTX debacle and the SEC appearing to have a vendetta against anything blockchain/crypto related, there are dark regulatory and enforcement clouds hanging over this entire space.

Geurts: You just pointed out correctly that different terms have different understandings: in some jurisdictions cryptocurrencies will be considered as authorized money, as e-money or as security. Different regulations require different wording and have different consequences. This is one of the key aspects to consider on a global level, that terms used in one jurisdiction may have different meaning in another jurisdiction. Due to the complexity in the U.S. and Canada, often, we have to exclude these jurisdictions, even though the US is the biggest market; it is just because we don't know whether the virtual currency is qualified as a security or not.

Rutenberg: Trying to be optimistic, there is a chance that XRP will win against SEC in whether its token sales violated securities laws. However, there are many ways that the XRP case can be decided which won't provide any clear permissive guidance for the sale of digital assets. The real reason that I am optimistic about crypto-related business having a future in the United States is that we remain the top financial hub in the world, with a combination of funding, talent, and where people want to start companies. As such in the long term a regulatory balance will be reached.

Ofek: We have a kind of "Twin Peaks" regime in Israel, which is that the Israeli Securities Authority regulates whether this is a security, while the Capital

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>
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Markets Insurance and Savings Authority regulates crypto as services in financial assets.

Wong: It's quite an interesting issue: whether it's a utility token or security token. Recently, we've seen court decisions that recognize virtual assets as property. In the past, there were a lot of people interested in issuing a coin, saying it's a utility token and would not be considered as a security and therefore not caught by the regulatory regime. Over time, it became clear that the category of coins that can be considered utility tokens is actually quite narrow from a regulatory standpoint. The industry as a whole has been like a teenager, still growing, though it's time for it to become an adult.

How has the technology behind cryptocurrencies helped or hindered initiatives in your jurisdiction?

Rutenberg: Bitcoin, the first of the ccryptocurrencies, came out of a dream of many years, where people wanted the ability to have a currency without government involvement, or without some other centralized authority involved. However, such theoretical currencies always came up against what is called the double spend problem, which is that, unless there's a centralized authority, I can give the same check to you and to somebody else. In many ways the internet today, almost in its entirely, is limited by a form of this double spend problem. For example, if I sell a song to one person and send them a copy; nothing technically stops me from selling the same song to three other people thus providing limited means of ensuring any value in any sale. What the bitcoin protocol did was a genius idea of getting around the double spend problem through a complicated combination of several different technologies. Based on this protocol one could design a payment system to work in an automated fashion with no central party controlling it, thus opening up the dream of decentralization, which has in turn lead to a huge rush of innovation, and creative ideas about property, which we're still trying to "grow up with" as Jill said today. At this same time, we are also trying to figure out what aspects of our society and economy we want decentralized and when a centralized authority is more fair, efficient, or secure. For example, do we want a legal system that's fully efficient, or do we want one that gives courts room to slow a process down, maybe to let a bankrupt company restructure? Such an option is unlikely to be feasible on a fully decentralized protocol. What's particularly fascinating in this industry is you have these growing pains that are forcing us to think through these big ideas rather quickly.

Geurts: The European regulation is relatively open-minded with respect to the technology being used. They don't have specific requirements in particular with respect to the protocol. So, there is sufficient flexibility for technologic development. Another key driver is

that the EU government realizes the opportunity for the overall digitalization in particular when government becomes more flexible, efficient, and transparent to everybody. Initially under the perspective of ESG, in the parliamentary process of the MICA regulation, the so-called proof of stake concept has been considered as consuming too much e-power. Finally, they stopped discussing ESG as this would have an impact on the respective type of technology.

Wong: On the ESG question, the thinking in Hong Kong is developing. I don't think the authorities here have made up their minds on how exactly to address that problem. But, certainly, in terms of the technology behind crypto, one example I can give you is with regard to distribution ledger technology (DLT).

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The Hong Kong government, together with the central banks of Thailand, the UAE, and the PRC, have been using DLT to study whether central banks can use DLT more efficiently for cross-border payments under Project mBridge. The project intends to ultimately develop the mBridge platform into a production-ready system. NFTs and gaming are seen as more tools for entertainment, not really as alternative asset classes in the same way as an established cryptocurrency such as bitcoin.

Geurts: This is one of the use cases. As Jill mentioned, the authorities are thinking that in cross-border scenarios, currency exchange transactions or cash flows can be eliminated. That is what companies are very keen on—reducing currency fluctuations costs. By the way, this was one of the drivers for the introduction of the euro which may apply to cryptocurrencies too. With cryptocurrency, they could have a real view of what their cash position is. So, in the European market they are saying this is one of the goals to go for because this would make their treasury activities more efficient.

Ofek: As for ESG, we see it developing side by side with the technology. In Israel, the regulators are probing the players in the industry, whether they would take ESG in consideration as an aspect of investment. Or whether that would jeopardize deals with investors. As for blockchain technology, that should move things forward with crypto; they will each push each other forward in developing the technology. Israel has developed a unique startup hub, with a regulatory sandbox, giving financial technology startups an easier environment to set up their company and experiment with their products and services. Companies that meet the initial requirements can develop their products and services and engage with the government authorities in real time.

How is the crypto industry expected to develop in your jurisdiction, regulatory or otherwise?

Wong: We are going to have new legislation, probably in Q2 2023 which would allow securities regulators in Hong Kong to grant licenses to virtual asset exchanges. This would be a welcome development in Hong Kong; exchanges are a very important part of the cryptocurrency ecosystem. It will be interesting to see if these exchanges will be allowed to offer products to only sophisticated investors only or whether or not the retail investors will be able to trade as well. *[Update: Hong Kong's Securities and Futures Commission is considering a proposal to allow all types of investors, including retail investors, to access trading services provided by licensed virtual asset trading platform operators, provided that the platforms comply with a range of investor protection measures. They are currently consulting market participants and interested parties on this.]* The law is not being introduced as part of the existing securities laws, but as an amendment to the anti-money laundering laws. This evolution in regulatory thinking means that, for the right industry players, Hong Kong is the place to be.

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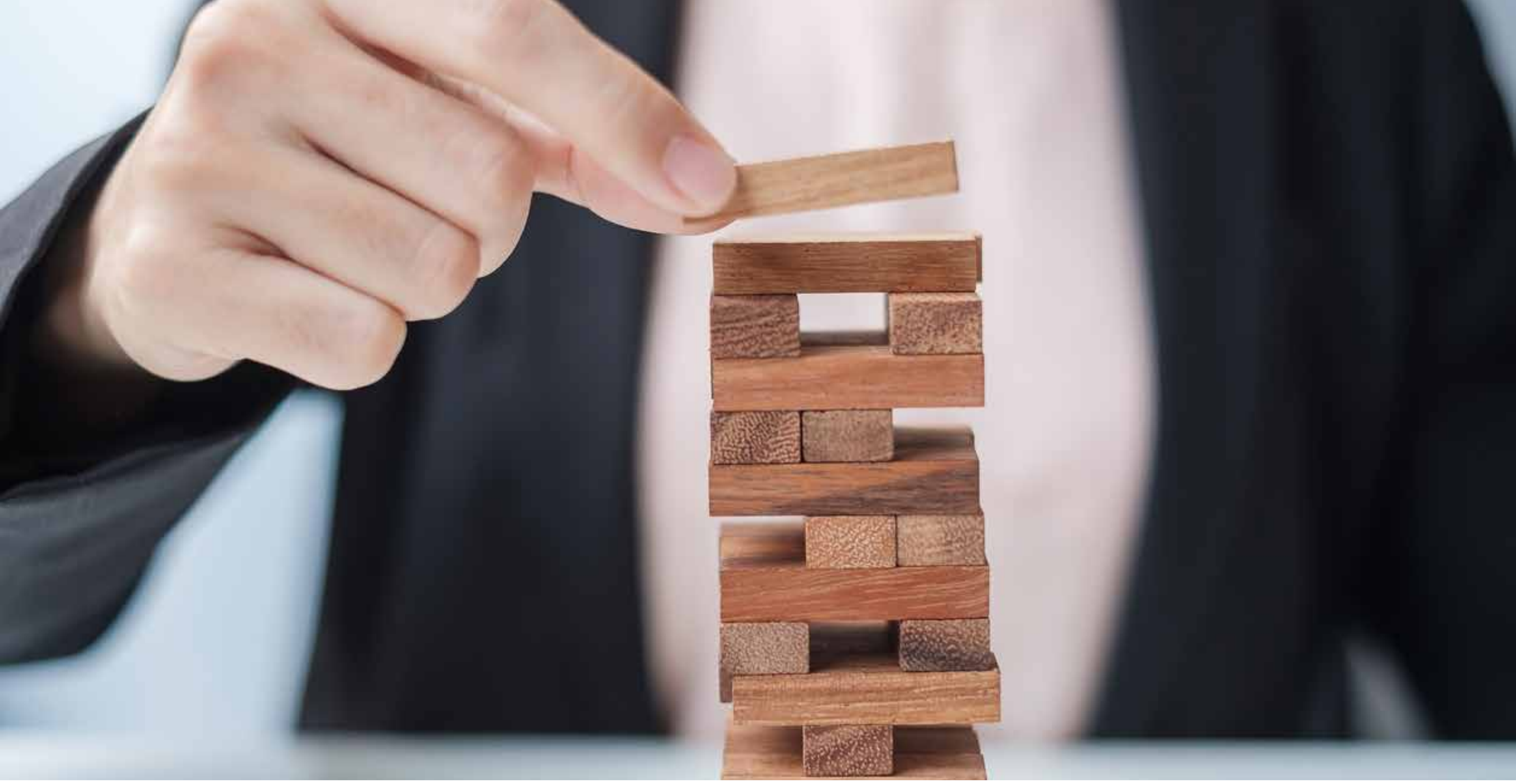
Rutenberg: Since its establishment in the 1930's the U.S. Federal securities regulation has been principally concerned with protecting investors, and in particular retail investors, perhaps more so than in other countries. In some ways this explains the SEC enforcement actions focused on the sale and promotion to the public of what it considers to be a security without hesitation or pursuant to an exemption. However, in bringing actions against issuers of the LBRY or XRP tokens, among others, without providing a legal framework for regulation that would allow the underlying protocols to build their network, is to many a dereliction of the regulators' duty. Recent SEC statements and actions, including those related to insider trading allegations, could be seen as an attempt to shut down anything crypto-related that is not a registered or exempt security. We are now in a situation where the industry cannot reasonably expect significant



> **We see companies having a complex and risky business model, in particular by leveraging inappropriately, which gives rise to concerns due to the massive impact on consumers when such risks occur. Authorities may react to this kind of behavior in such a manner that it stops the business overall.**
>
> *Matthias Geurts*

regulatory relief as there is an immense lack of trust on the part of regulators for any company connected to this space. Any regulation is going to be limiting and stifle the availability of the technology. It's hard to predict what the future will bring. Our goal should be to work for a new form of regulation that can protect the markets while also unleashing the technical and societal power of blockchain technology. For this to be a possibility, we need all the smart and thoughtful people on both the government and industry side to get together to save the industry, hyperbolic as that may sound.

Geurts: Jill and Stephen pointed it out correctly, AML and consumer protection are two elements governments will react to with regulation. But the truth is, this market just exists and grows because the retail market considers the crypto world as unregulated, virtual, and more like a world of gambling and speculation. That's where we have to balance the diverging interests. If one looks deeper into the collapse or insolvency of FTX, they will realize that this is not the consequence of the technology, it is just the consequence of an inappropriate business model. Do we just let it play out? Or do the authorities start with regulations which generate trust in the crypto world and its products? If the philosophy of cryptocurrencies is to be decentralized, de-controlled and transparent, we haven't seen such behavior. The reality is different, we see companies doing really complex transactions and leveraging themselves inappropriately; we will see how the authorities react because it can cost consumers billions. If the authorities react with strong regulation, will that stop the business overall?

Ofek: Is regulation taking us forward or actually hindering crypto services as a whole? Israel does have regulation and a license regime, but licenses are issued only if the license applicant satisfies the preconditions and requirements of the Capital Markets Insurance and Savings Authority. On the other hand, they did not yet come to the institutional world, where you have custodianship rules, rules to safeguard the assets and assets in transit. This is where the Israeli regulators are trying to mandate now two directives. One of them is on safeguarding crypto assets; however, I think the regulator is taking it to the other edge. Mandating that an institution would be liable to a consumer/client of crypto services, this is something no financial institution in Israel could comply with. There needs to be an equilibrium so you can actually move the industry forward as well as safeguard the assets. You can take the regulation of the traditional industries, from brokers, banks, custodians and apply them to this new world.

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>
> *Stephen Rutenberg*

What is the current status of expected future trends in the tokenization of assets in your respective jurisdictions?

Rutenberg: By tokenization of assets, I am discussing taking real world assets and using a blockchain in some capacity to increase the durability, liquidity, and efficiency of their transferability and recordkeeping. Since, unlike cryptocurrencies, these tokenized assets generally can function under the confines of the securities laws, the U.S. laws are for the most part open to them. They do fall under the securities laws and can only be sold pursuant to registration of an exemption. Even in the current environment we are seeing projects related to tokenization of real estate and NFTs as well as other types of assets including debt. Tokenization of assets is increasing but slowly. In my view what is holding up asset tokenization, are mostly business-side issues such as cost and efficiency rather and legal constraints. This is in comparison to other types of digital assets such as cryptocurrency and in-game tokens, where the law in the United States does not currently provide a workable solution.

Wong: I agree with Stephen, that tokenized assets are treated as securities in Hong Kong; it is a financial product. What is interesting in Hong Kong is that we have a stricter regime for investment products that are considered to be complex, as this goes to investor protection. One would have thought that tokenized securities may be considered to be complex, but actually, no: simply because it's issued or traded on a blockchain doesn't mean it's necessarily complex, what will actually be looked at are the features of the product themselves. Some may be available to retail investors if they can be considered as non-complex products.

Geurts: We will see two different things: on the one hand financial products, and on the other hand products like music or real estate, which are in a way illiquid. However, they have a sound and continuous cash flow. Therefore, where there is an illiquid asset, but which provides for strong cash flows, this will be a product for the next generation because currently securities as an instrument to make them liquid and markable is too cost intensive. If the technology is quicker and cheaper, this might give the opportunity for more of these kinds of products which would lead to more trading, more of a market, more transparency and more efficiency. For example, for people who don't want to own the real estate itself, but rather the stable income from the real estate, or want to invest into returns from music licenses, the digital assets can provide solutions; this is where Germany' s product developers are going to.

Ofek: I agree with what others have said with respect to ICOs (initial coin offerings); we don't see a big wave of ICOs in Israel. But as for tokenization as a whole, it's becoming more institutionalized going forward. The Bank of Israel has appointed a steering committee to study potential issues of the digital shekel, and the Tel Aviv Stock Exchange has already announced it will be venturing into virtual currencies with the introduction of a platform for trading of digital assets in Israel. The Tel Aviv Stock Exchange in conjunction with the Israeli Ministry of Finance has announced they will conduct testing of blockchain-backed platform for trading of digital bonds issued by the Ministry of Finance. I do see tokenization in Israel moving forward and moving the industry forward.

Please give one example of where you think crypto is helping, and where it's hindering.

Wong: I think crypto is helpful as an alternative asset class, and there is investor appetite for it, so it provides choices for investors. What is hindering development is that the industry is still young, it's still a teenager that is learning to behave in an adult world. And so there is misconduct, whether it's intentional or not intentional. Going back to what Stephen said, [the day FTX collapsed] was a very bad, terrible day for the industry, and we can do without scandals like this one, but unfortunately this is not the end of scandals for this industry. So that's hindering the industry's development—these incidents do not build trust. Matthias mentioned this concept of building trust. But overall things are moving in the right direction, albeit with some hiccups along the way.

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Geurts: We see all the positive aspects of crypto, but one thing we need to think about is cybercrime. It is important to build trust in this kind of new ecosystem.

Ofek: Crypto is essential, it's inevitable, you see the new generation pushing out the old generation. You need regulation to stop misleading the public and protections from this going AWOL, but crypto is needed in the industry in the new world, to bring new opportunities, and it's inevitable that it will move forward. It needs regulation that won't pin it down and stop the industry from moving forward.

Rutenberg: On the positive side, as mentioned above, one of the most powerful things about crypto is how it's making people rethink basic social constructs, particularly with regard to assets and ownership. What does it mean to own property? What is the ideal role of regulators? The negative side, history littered with the attempts by well-meaning people to develop a better system that is fairer with often disastrous results as these systems get used nefariously. This risk of misuse is particularly acute related to blockchain and privacy, as a blockchain keeps an almost indestructible ledger of any assets and transaction on it. In this way GDPR and blockchain at their core functions, contradict each other. As such it could easily be used as a tool for tyranny. For example, we often talk about central banks adopting digital currencies, and helping the unbanked but does that really mean that the shoe shiner is going to be taxed on their tip? Do you really want the government to know every one of our transactions? We need to move cautiously and not assume the industry will regulate itself.

Has the collapse of the crypto exchange FTX had any concrete impacts, to date, on the cryptocurrency market or regulation in your jurisdiction?

Wong: The FTX collapse underscores the need for a robust regulatory regime. Hong Kong is ready; on 1 June 2023, a new licensing regime for virtual asset service providers will come into effect in Hong Kong. All centralised VA trading platforms carrying on businesses in Hong Kong, or actively marketing their services to Hong Kong investors, will need to be licensed and regulated by the Securities and Futures Commission (SFC).

The proposed guidelines for virtual asset trading platform operators are based on existing requirements, with modifications. This includes requirements regarding the safe custody of assets, Know Your Customer, conflicts

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of interest, cybersecurity, accounting and auditing, risk management, Anti-Money Laundering/counter-financing of terrorism, and prevention of market misconduct.

There is currently an ongoing public consultation on the proposal, including whether retail investors should be allowed access to licensed virtual asset trading platforms.

In its consultation paper on the proposed regulatory requirements for licensed virtual asset platform operators, regulators including the SFC and the Hong Kong Monetary Authority have specifically cited turmoil in the virtual asset market, including the collapse of FTX amidst the ongoing "crypto winter", to underscore the importance of effective regulation and oversight of the virtual asset industry.

Ofek: The collapse of crypto exchange FTX did not have any concrete impacts on the Israeli market, but it intensified and emphasized the need to process the new directives concerning custodianship of financial assets and mainly crypto assets, and drawing down on capital where a service provider is a custodian of financial assets, and mainly crypto assets. Following said event, the Israeli inter-committee in the ministry of finance published its final report concerning crypto-assets, and the Israeli Securities Authority published a new memorandum to amend different securities laws in Israeli regulating services in crypto-assets of mutual funds, investment advice, and portfolio management and in trading platforms.

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