

Rethinking the regulation of virtual currency in South Africa

By

Blessing Mukwehwa

Student number 29277095

Submitted in fulfilment of the requirements for the degree

LLM (Banking Law)

In the

FACULTY OF LAW

UNIVERSITY OF PRETORIA

MAY 2019

SUPERVISOR:

PROF C M VAN HEERDEN

Plagiarism Form



UNIVERSITEIT VAN PRETORIA
UNIVERSITY OF PRETORIA
YUNIBESITHI YA PRETORIA
Faculty of Law

Names and Surname: BLESSING MUKWEHWA

Student Number: 29277095

1. I understand what academic dishonesty entails and am aware of University of Pretoria policies in this regard.
2. I declare that this assignment is my own, original work. Where I have used someone else's work, I have indicated this by using the prescribed style of referencing. Every contribution to, and quotation in, this assignment from the work or works of other people has been referenced according to the prescribed style.
3. I have not allowed, and will not allow, anyone to copy my work with the intention of passing it off as his or her own work.
4. I did not make use of another student's work and submit it as my own.

Signature :  Date: 17 June 2019

SUMMARY

The new technologies has proliferated the global economy at a fast pace and proved to be a compelling alternatives to traditional methods of payment. A vital technological development in this process has been the emergence of virtual currencies (VCs). VC schemes are distributed, open-source, math-based peer-to-peer virtual currencies without a central administrating authority, monitoring and oversight authority.

VCs has revolutionised the traditional payment methods. VCs offer many potential benefits, including costs, speed of settlement, global reach, and anonymity of the payer over their traditional payment counterparts.

At the same time, it is these same benefits which pose as a source of risk to the integrity of the financial system. VCs are potential vehicles for money laundering, terrorist financing, tax evasion, fraud and other illicit activities. Risks to financial stability may eventually materialise as the use of VCs become more widespread.

Given their novelty, the developing of effective regulatory responses is still in early stages globally. VCs exists in a heavily regulated environment and as a result regulators have been forced to address these challenges. Responses have included banning VCs totally, issuing warnings to consumers and clarifying the applicability of existing legislation to VCs. South Africa has not been insulated in mining for an effective regulatory responses. .

In South Africa the SARB and National Treasury released position papers that cautions consumers on the risks of VCs. This dissertation considers the possible regulatory approach which may be adopted by the regulators in South Africa. Investigation the right type of regulations suitable in South Africa requires a comparative analysis with other international jurisdictions.

ACKNOWLEDGEMENTS

My sincere gratitude and thanks goes to my mother Ruth Maikano whose support was never ending. You have always been a pillar of strength and source of motivation.

I also would love to thank Faith Kasiyamhuru for the sacrifices you made in order for this dream to be realized. Not to forget my little solider Samantha Ngaakudzwe Mukwehwa who, although too young to remember, sat with me throughout the long nights giving me moral support in your own unforgettable little ways.

To Prof Cornelia van Heerden, words can never express the support, encouragement, scholarly insights which you imparted in me. None of this could have been possible without your selfless support.

Thank you!

CONTENTS

CHAPTER 1: INTRODUCTION.....	1
1.1. Background of study.....	1
1.2. Problem statement	2
1.3. Research questions.....	4
1.4. Hypotheses	5
1.5. Research methodology.....	5
1.6. Delimitation of study	6
1.7. Overview and structure dissertation.	6
CHAPTER 2: VIRTUAL CURRENCIES	8
2.1. Introduction.....	8
2.2. An overview of the virtual currency system	8
2.2.1. Virtual currency categories	9
2.3. Virtual currency system participants.....	10
2.3.1. Inventors	10
2.3.2. VC exchanges.....	11
2.3.3. Administrator/issuer	11
2.3.4. User	11
2.3.5. Miners	11
2.3.6. Wallet providers	12
2.4. Legitimate benefits	12
2.5. Risks and regulatory challenges of VCs.....	13
2.5.1. The anonymity/pseudo-anonymity provided by VCs.....	14
2.5.1.1. <i>Money laundering and terrorism financing</i>	14
2.5.1.2. <i>Tax evasion/avoidance and treatment</i>	15
2.5.2. Avoidance of Exchange Control Regulations.....	16

2.5.3. Consumer risks	16
2.6. Conclusion.....	17
CHAPTER 3: REGULATORY RESPONSE IN SOUTH AFRICA	18
3.1. Introduction.....	18
3.2. Acceptance of virtual currency as currency in South Africa.....	19
3.3. Anti-Money Laundering (AML) and Counter-terrorism financing (CTF)	20
3.4. Consumer Protection.....	21
3.4.1. Application to virtual currency	22
3.5. Securities and investment laws.	23
3.6. Tax regulations.....	23
3.6.1. Application to virtual currency.....	24
3.7. Defence of virtual currency regulation in South Africa.	25
3.7.1. Lessons learnt from the Global Financial Crisis of 2007/8	25
3.7.2. Ensuring financial and systematic stability.....	26
3.7.3. Promoting consumer protection	27
3.7.4. Crime control	28
3.8. Conclusion.....	29
CHAPTER 4: REGULATORY RESPONSES IN THE UNITED STATE OF AMERICA	30
4.1. Introduction.....	30
4.2. Regulation of virtual currency in United States.....	30
4.3. Anti-Money Laundering (AML) and Counter-terrorism financing (CTF)	31
4.3.1. The Bank Secrecy Act (BSA).....	31
4.3.2. Application to Virtual currency.....	32
4.4. Money-Transmission Laws and Consumer Protection	34
4.4.1. Application to virtual currency	35
4.4.1.1. <i>Board of Governors of the Federal Reserve System (Federal Reserve)</i>	35

4.4.1.2.	<i>Federal Deposit Insurance Corporation (FDIC)</i>	35
4.4.1.3.	<i>Consumer Financial Protection Bureau (CFPB)</i>	35
4.4.1.4.	<i>Office of the Comptroller of the Currency (OCC)</i>	36
4.5.	Securities and investment laws	36
4.5.1.	Securities laws	36
4.5.2.	Application to virtual currency	37
4.5.2.1.	<i>Are virtual currencies securities?</i>	37
4.5.2.2.	<i>Securities and Exchange Commission (SEC)</i>	37
4.5.3.	Commodities laws.....	38
4.5.4.	Application to virtual currency	39
4.6.	Tax regulations.....	41
4.7.	Conclusion.....	42
CHAPTER 5: CONCLUSION AND COMMENTS		43
5.1.	Introduction.....	43
5.2.	Overview of dissertation	43
5.3.	Recommendations	45
5.4.	Concluding Remarks	46
Bibliography		47

LIST OF ABBREVIATIONS

AML/CTF	Anti-Money Laundering and Counter-Terrorism Financing
BSA	Bank Secrecy Act
CFPB	Consumer Financial Protection Board
CGT	Capital Gains Tax
E-money	Electronic money
FATF	Financial Action Task Force
FCSA	Financial Sector Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FIC	Financial Intelligence Centre
FIC Act	Financial Intelligence Centre Act
FICA	Financial Intelligence Centre Act 38 of 2001
FinCEN	Financial Crimes Enforcement Network
FinTech	Financial Technology
FMR	Financial Markets Act 19 of 2012
FSR	Financial Sector Regulation
GAO	Government Accountability Office
IFWG	Intergovernmental FinTech Working Group
IMF	International Monetary Fund
IRS	Internal Revenue Services
IRS	Internal Revenue Services
ITA	Income Tax Act 58 of 1962
KYC	Know-your-customer
NPS	National Payment System
NT	South African National Treasury
OCC	Office of the Comptroller of the Currency
OECD	Organisation for Economic Co-operation and Development
PA	Prudential Authority
PER	Potchefstroom Electronic Law Journal
SA Merc LJ	South African Mercantile Law Journal
SARB	South African Reserve Bank
SARB Act	South African Reserve Bank Act 90 of 1989 viii
SARS	South African Revenue Service

SEC	Securities and Exchanges Commission
TAA	Tax Administration Act 28 of 2011
TSAR	Tydskrif vir die Suid-Afrikaanse Reg
US	United States
USA	United States of America
VAT	Value Added Tax
VC	Virtual currency
VCs	Virtual currencies

CHAPTER 1: INTRODUCTION

1.1. Background of study

In recent years, technological advancement have proved to be a major force of transformational changes in the global economy. Virtual Currencies (hereinafter VCs) are hailed as one such innovation which broke into the screens in 2009. The rise of VCs has rocked the international scene to the point that the international community is still attempting to come to grips on how to regulate them. It is too early to tell, “whether virtual currency businesses boom or go bust remains to be seen”.¹ The concept of internet based commerce (for instance e-money or digital money) have existed for decades. For centuries money had always been viewed as either fiat currency (currency that a government has declared to be legal tender);² or digital money/e-money which is the electronic representations of fiat currency.³ The existence of money has undergone some fundamental changes and there has always been a need to improve efficiency and simplicity regarding how money exchange hands. In its staff discussion note, the International Monetary Fund (IMF) contented that “the development of monies and a variety of payments systems throughout history have helped make exchange more efficient and secure.”⁴ The idea of VCs seem to be premised on the ideology of efficiency and security.

De Mink attributes the rapid growth of VC to radical streamlined transfer of value via a “simpler, faster and more efficient process, in which payment and settlement happen simultaneously within a closed system that is highly transparent to both sender and receiver” and free of the “complex process relied upon in the traditional method.”⁵ It is these unique characteristics along with its perceived benefits over traditional

¹ M E Griffiths “Virtual currency businesses: an Analysis of the evolving regulatory landscape” (2015) *Texas Tech Administrative Law Journal* 303.

² D Carlisle “Virtual currencies and financial crime: challenges and opportunities” (2017) *Royal United Services Institute for Defence and Security Studies* (hereinafter referred to as D Carlisle “VCs and financial crime” (2017) 1.

³ D Carlisle “VCs and financial crime” (2017) 1.

⁴ International Monetary Fund “Virtual Currencies and Beyond: Initial Considerations” (2016) available online at https://www.imf.org/~media/Websites/IMF/imported-full-text-df/external/pubs/ft/sdn/2016/_sdn1603.ashx (date accessed 28 March 2018) (hereinafter referred to as IMF “VCs and beyond” (2016)) 6.

⁵ J De Mink “The rise of Bitcoin and other cryptocurrencies” (2017) *De Rebus* 30.

government-backed currency that has catapulted VCs popularity as a method of payment.

Technologies thrive to make human existence easier, efficient and more gratifying, however, they bring new risks and challenges which regulators have to deal with. Currently, there appears to be no general consensus on how VCs should be regulated. Some jurisdictions like China has resorted to total ban or severe restriction of the use of VCs.⁶ Most jurisdictions adopted the “wait and see” approach whilst issuing warnings and waiting to see what other jurisdictions do. A few has gone ahead and decided to take action and regulate VC.⁷

1.2. Problem statement

South African financial markets have not been insulated from the widespread adoption of VCs as a method of purchasing goods or services and performing other activities.⁸ The use of VCs is not banned in South Africa but they are not recognised as legal tender.⁹ In its position paper (Position Paper on VC), the South African Reserve Bank (SARB) released a position paper on virtual currencies in which it stated that virtual currencies are not recognised as legal tender in South Africa and any merchant or beneficiary may refuse VC as a means of payment.¹⁰

The South African National Treasury (NT) also released a “User Alert”, in which the SARB, the South African Revenue Service (SARS) and others warned the public of the risks involved in transacting in VCs.¹¹ The NT confirmed that there are no specific

⁶ A Fu “China” in M S Sackheim & N A Howell (eds) *The virtual currency regulation review* (2018) Chapter 9 96.

⁷ K McConnell “Best practice for bitcoins regulatory, legal and financial approaches to virtual currencies in a hesitant, global environment.” 2014 available online at <https://www.aph.gov.au/DocumentStore.ashx?id=46d34817-cdc7-42a5-97ec-e3ff59bd6634&subId=301945> (date accessed 15 March 2018) 37.

⁸ M Orffer *The inclusion of virtual currencies in the calculation of income tax* (2018) LLM Dissertation (North-West University) 1.

⁹ Section 17 of the South African Reserve Bank Act 90 of 1989 defines a tender as a note of the SARB or an outstanding note of another bank for which the SARB has assumed liability in terms of section 15(3)(c) of the Currency and Banking Act or in terms of any agreement entered into with another bank before or after commencement of this Act.

¹⁰ South African Reserve Bank “Position Paper on Virtual Currencies” 2014, available online at [https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem\(NPS\)/Legal/Documents/Position%20Paper/Virtual%20Currencies%20Position%20Paper%20%20Final_02of2014.pdf](https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Legal/Documents/Position%20Paper/Virtual%20Currencies%20Position%20Paper%20%20Final_02of2014.pdf) [date accessed 13 March 2018] (Hereinafter referred to as SARB “Position Paper” (2014)) 4.

¹¹ National Treasury “User Alert: Monitoring of virtual currencies” 2014, available online at http://www.treasury.gov.za/comm_media/press/2014/2014091801%20-%20User%20Alert%20Virtual%20currencies.pdf [date accessed 13 March 2018] (hereinafter referred to as NT “User Alert” 2014)).

laws or regulations available in South Africa governing the use of VCs. Consequently, no legal protection or recourse is afforded to users of VCs. The NT indicated that relevant authorities will continue to monitor and assess the use of VCs.

The rise in VC usage seem to be attributed to some of their characteristics. Firstly, the decentralised nature¹² of VC means that there is no intrusion of the middleperson who always seeks an incentive. This in turn leads to great benefits when it comes to cost and efficiency of transmitting payment through the system.¹³ Secondly, VC are not linked to legal tender of a specific government and not subject exchange rates, fluctuating interest rates, and country-to-country transaction fees, this makes VCs transactions faster and cheaper than the traditional money transactions.¹⁴ They also offer a method of payment which is accessible, requiring only an Internet connection to use. Ernie Allen, the president and C.E.O of the International Centre for Missing and Exploited Children, indicated that VCs as a digital economy “...can achieve social good, particularly in bringing about real financial inclusion for the 2.5 billion adults on the planet today without access to banks, credit cards, or the mainstream financial system.”¹⁵

The same benefits provided by VCs also pose risks and challenges to the financial system and regulators.¹⁶ The main concern raised by those who seek to regulate VCs is its anonymity.¹⁷ This anonymity means that VCs may be used as a mechanism for illegal transactions making it hard for law-enforcement agencies to trace activities like money laundering and terrorist financing.¹⁸ Moreover, unregulated VC also pose consumer protection challenges which will be discussed in chapter two of this paper. Thirdly, VCs may lead to financial instability if left unregulated as their

¹² Decentralised VCs are peer-to-peer VCs that have no central administrating authority, and no central monitoring or oversight. See paragraph 2.2.1 below for further explanation.

¹³ R Grinberg, “Bitcoin: An Innovative Alternative Digital Currency” (2011) 4 *Hastings Science & Technology Law Journal* 159 – 208 165.

¹⁴ J De Mink “The rise of Bitcoin and other cryptocurrencies” (2017) *De Rebus* 32.

¹⁵ B P Eha “Why Regulate Bitcoin?” *The New Yorker* 2013 available online at <http://www.newyorker.com/business/currency/why-regulate-bitcoin> (date accessed 23 April 2018).

¹⁶ Potential risks are discussed in full in Chapter 2 of this dissertation.

¹⁷ VCs are anonymous in that the owners of VCs are not identified by name but rather by a set of letters and numbers representing their public VC address. This make it possible for anyone to create as many VC wallets as they desires without providing any identifying information. See O Marian, “A conceptual framework for the regulation of cryptocurrencies” (2017) 82 *University of Chicago Law Review Online* 53- 68 56.

¹⁸ D Bryans “Bitcoin and Money Laundering: Mining for an Effective Solution” (2014) 89 *Indian Law Journal* 441-472 455.

interaction with the real economy may jeopardise the smooth functioning of payment systems.¹⁹

Since 2014, South African regulators has however displayed renewed interest in regulating VCs. In 2016 the Intergovernmental FinTech Working Group (IFWG) was established with the aim of developing common understanding among regulators and policymakers of financial technology (fintech) developments as well as policy and regulatory implications for the financial sector and economy. In January 2019, the IFWG issued a consultation paper calling for public comment on the need to develop a policy and regulatory response to VC activities in South Africa.²⁰ The consultation paper reiterated the risks involved if VC remains unregulated. The South African financial system and all the participants in the system operates in a highly regulated sphere so as to ensure a sound and safe financial system. Given the high level of regulations imposed on the financial market in which VCs exist, it makes perfect sense that they too should be subjected to the same level of regulation.

The main objective on this research paper is to evaluate the regulatory framework of decentralised VC in South Africa. A further aim of this study is to determine how current regulations on VCs can be improved by examining regulatory responses of other jurisdictions.

1.3. Research questions

Pursuant to the above, the central research question this dissertation seeks to answer is: What regulatory measures needs to be adopted in order to mitigate the risks associated with VCs in South Africa? This will be achieved by considering the following research questions:

- a) What are VCs and what benefit and risks they pose?
- b) To what extend are VCs regulated in South Africa?
- c) Is it the time for South Africa to adopt a more interventionist approach in regulating VCs?
- d) To what extend does the United States of America regulate VCs?

¹⁹ SARB “Position Paper” (2014) 12.

²⁰ Intergovernmental FinTech Working Group “Consultation paper on policy proposals for crypto assets” 2019, available online at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9037/CAR%20WG%20Consultation%20paper%20on%20crypto%20assets_final.pdf (date accessed 03 February 2019) (hereinafter referred to as IFWG “Consultation Paper” (2019)).

- e) What lessons should South African regulators learn from the current regulatory attempts by the US?

1.4. Hypotheses

The dissertation will depart from the following hypothesis:

- South African law does not prohibit the use of VCs although it is not recognised as a method of payment.
- VCs tend to be inherently unstable given the floating exchange rate which is used to determine their value. The exchange rate for VCs is floating, which means that it is determined by market supply and demand for the VC.²¹ It is difficult to manage the fluctuation of the value of the fiat equivalence of VCs.
- The unregulated stance of VCs pose risks to the public as indicated by the NT and SARB.²²
- Anonymity presented by VCs could present a challenge for regulators and legislators as VCs can be used by unscrupulous individuals to execute illegal activities.

1.5. Research methodology

The approach taken in this dissertation will be a desktop comparative literature study comprising of an exploration of domestic and foreign legislation, case law and domestic and international academic articles. These sources were consulted with the aim of determining the South African position on VCs and the extent to which current legislation can be used in the VCs ecosystem. The paucity of primary sources regulating VCs in South Africa necessitates an exhaustive foreign law investigation. Considering the uniformity of regulatory challenges among jurisdictions, a brief comparison was drawn between South Africa and the United States (US). While it is worth noting that the USA currently does not have a coherent direction on VC regulation, it has made a number of regulatory advances in the context of VCs and taxation, combating money laundering and funding of terrorism.²³

²¹ The Financial Action Task Force “Guidance for a risk-based approach: virtual currencies” 2015, available online at <https://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-RBA-Virtual-Currencies.pdf> (date accessed 17 September 2018) (hereinafter referred to as FATF “Guidance” (2015”)) 27.

²²NT “User Alert” (2014).

²³ The regulatory efforts in South Africa are explained in detail in chapter 2 and 4 of this dissertation.

1.6. Delimitation of study

As of 2016, it was estimated that over 600 cryptocurrencies or VCs were in existence.²⁴ The focus of this dissertation is not to identify each and every one of the VC in existence. The research will be limited to an analysis of decentralised convertible (bi-directional) VCs with Bitcoin as the case study given their interaction with the real economy.²⁵ It is also not the purpose of this research to give a detailed explanation of the operation of VCs. The research will be directed towards a legal analysis of the concept of VCs.

1.7. Overview and structure dissertation.

Chapter 1 is the introductory chapter acquainting the reader to the concept of VC regulation in South Africa. It consists of the research problem, research questions, motivation of the selection of the comparative jurisdiction, methodology, delimitation and chapter outlay. This chapter conceptualises aspects of the research problem necessary for development of the dissertation in later chapters.

Chapter 2 presents and analyses the meaning of VC. The benefits which attracts users to VC will be examined. At the same time, the common challenges and risks associated with VCs *inter alia* money laundering and terrorism funding will also be discussed.

Chapter 3 will provide an analysis of the current regulatory framework of VC in South Africa so far. The chapter will discuss how the risks which were identified in chapter 2 are being addressed in South Africa. In the final analysis, an argument on why South Africa should take adopt an interventionist approach will be put forward.

Chapter 4 focuses on the regulation of VC by the United States authorities. The US, like South Africa, do not prohibit the use of VCs. However, unlike South Africa it has adopted an active approach when it comes to VC regulation. Most of the regulatory measures adopted by the US involve an adaptation of existing legislation. This chapter will provide an analysis on how the US is mitigating the risks posed by VCs.

Chapter 5 is the concluding chapter and it provides an overview on the preceding chapters. The findings to the main research question and secondary questions will be

²⁴ M Orffer *The inclusion of virtual currencies in the calculation of income tax* (2018) LLM Dissertation (North-West University) 11.

²⁵ See paragraphs 2.2 and 2.3 of chapter 2 for a detailed explanation of different types of VCs and the meaning of decentralised bi-directional VCs.

discussed. Finally recommendations will be made on possible areas of regulating VCs.

CHAPTER 2: VIRTUAL CURRENCIES

2.1. Introduction

Virtual currency (VC) schemes have become relevant in several areas that traditionally fall within the scope of the financial system and especially so in relation to the tasks of central banks.²⁶ Consequently, it seems appropriate to consider the benefits, risks and regulatory challenges they present.

There is no consensus among jurisdictions on whether and if so, how, VCs should be regulated. Amidst the confusion, three regulatory patterns can be noticed. The first approach is a ban or severe restriction of the usage of VCs like Bitcoin. China for one adopted this approach of banning the use of VCs.²⁷ The second approach is to “wait and see” what other jurisdictions are doing with regard to regulating VCs while issuing warnings and alerts in the meantime. The third approach is to actively regulate VCs. The third approach entails either enacting new legislation which is tailored for VC or extend current and existing legislation to include VCs as well.²⁸

This chapter, therefore, explores the definition of "virtual currency" as well as their application. The chapter will also discuss the legitimate benefits of VCs and the challenges which they pose.

2.2. An overview of the virtual currency system

VCs are financial innovations that have received increased acceptance and popularity in recent years. As of 2017, it was estimated that the total global VC market capitalization is approximately \$170 billion.²⁹ Yet despite their growing use, their definition is still controversial and there is no universally accepted definition of VCs.

²⁶ European Central Bank “Virtual currency Scheme” 2012, available online at <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf> (date accessed 22 April 2018) (hereinafter referred to as ECB “Virtual currency scheme” (2012)) 33.

²⁷ A Fu “China” in In M S Sackheim & N A Howell (eds) *The virtual currency regulation review* (2018) Chapter 9 96.

²⁸ K McConnell “Best practice for bitcoins regulatory, legal and financial approaches to virtual currencies in a hesitant, global environment.” 2014, available online at <https://www.aph.gov.au/DocumentStore.ashx?id=46d34817-cdc7-42a5-97ec-e3ff59bd6634&subId=301945> (date accessed 15 March 2018) 37.

²⁹ S D Hughes “cryptocurrency regulations and enforcement in the U.S.” (2017) *Western State Law Review* 3.

The National Treasury (NT) in its User Alert of 2014 defined “virtual currency” as “a unit of account that is created and stored electronically and digitally”³⁰ In its Position Paper on VCs of 2014, the South African Reserve Bank (SARB) defined VCs as “a digital representation of value that can be digitally traded and functions as a medium of exchange, a unit of account and/or a store of value, but does not have legal tender status.”³¹ The European Central Bank (ECB) also defined VCs as a “digital representation of value, not issued by a central bank, credit institution or e-money institution, which, in some circumstances, can be used as an alternative to money”.³² What appears to be a common thread in most definitions is that VCs are (i) a digital representation of a value, (ii) a medium of exchange, (iii) a unit of account, and (iv) a store of value.³³ However, although they function as representation of value and as a medium of exchange, which are features shared with traditional money, the main difference between VCs and traditional money is that VCs are not issued or controlled by central banks hence they are not regarded as legal tenders.³⁴

2.2.1. Virtual currency categories

The ECB identified three groups of VC schemes.³⁵ The first category is closed VC schemes, which has almost no link to the real economy. These are referred by the Financial Action Task Force (FATF) as non-convertible (or closed) VCs. Non-convertible (or closed) VCs are not open to the public but are used by a closed virtual group.³⁶

The second category is VC schemes with unidirectional flows. These are also non-convertible VCs because once a user has purchased them he can only utilise them to buy virtual goods and services, exceptionally also to buy real goods and

³⁰ NT “User Alert” (2014).

³¹ SARB “Position Paper” (2014) 2.

³² European Central Bank “Virtual Currency Schemes – A Further Analysis” (2015), available at <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemesen.pdf> (date accessed 27 April 2018) (hereinafter referred to as ECB “Virtual Currency Schemes – A Further Analysis” (2015)) 4.

³³ G A Acuña & A S Pullas “The digital currency challenge for the regulatory regime” (2016) 5 *Revista Chilena De Derecho Y Tecnología* 173-209 176.

³⁴ The Financial Action Task Force “Virtual Currencies Key Definitions and Potential AML/CFT Risks” 2014 *FATF Report*, available online at <https://www.fatf-gafi.org/media/fatf/documents/reports/Virtual-currency-key-definitions-and-potential-aml-cft-risks.pdf> (date accessed 10 February 2018) (referred hereinafter as FATF “Virtual currencies key definitions and potential AML/CFT risks” (2014) 4).

³⁵ ECB “Virtual Currency Schemes – A Further Analysis” (2015) 6.

³⁶ ECB “Virtual Currency Schemes – A Further Analysis” (2015) 5.

services. Unidirectional flow VCs can be purchased using fiat currency at a specific exchange rate but cannot be exchanged back to fiat currency.³⁷

The first and second categories of VCs have limited or no interaction with real fiat currency hence they do not pose much risks to the financial environment. It is not the purpose of this research to delve deeper into the operation of these two categories given their lack or limited direct impact on the economy at large.³⁸

The third category is VC schemes with bi-directional flows, in which units can be bought and sold according to (floating) exchange rates.³⁹ These are convertible (open) VCs. The FATF further divided convertible VCs into centralised and decentralised VCs. Centralised VCs has a single administrating authority (administrator). The administrator is a neutral third party that controls the system. The administrator is the one who issues the currency; establishes the rules for its use; maintains a central payment ledger; and has authority to redeem the currency. The exchange rate for a convertible CV may either be floating (determined by market supply and demand for the VC) or pegged (fixed by the administrator at a set value measured in fiat currency or another real-world store of value, such as gold or a basket of currencies.) Examples of convertible centralised VCs are Linden dollars; PerfectMoney and WebMoney.⁴⁰

Decentralised VCs are distributed, open-source, math-based peer-to-peer currency that has no central administrating authority, and no central monitoring or oversight. Examples of decentralised VCs are Bitcoin; LiteCoin; and Ripple.⁴¹

2.3. Virtual currency system participants

A variety of new entities operate within the VC space which differ from those involved in traditional payment environment. Without attempting to be exhaustive, this section briefly discuss some of the main participants in a VC ecosystem which might be of relevance to this dissertation.

2.3.1. Inventors

An inventor is a person or entity who or which is the creator of the “coins” used in a specific VC system. In some cases inventors are known, whereas in other cases their

³⁷ ECB “Virtual currency scheme” (2012), 14.

³⁸ ECB “Virtual currency schemes – A Further Analysis” 2015 26.

³⁹ ECB “Virtual currency schemes – A Further Analysis” 2015 26.

⁴⁰ FATF “Virtual currencies key definitions and potential AML/CFT risks” (2014) 5.

⁴¹ SARB “Position Paper” (2014) 2.

identity remains unknown (e.g. for Bitcoin). Once the VC scheme has been launched, some inventors may remain involved in maintaining and improving the technical characteristics of the VC. The VCs with unknown inventors normally regulate themselves.⁴²

2.3.2. VC exchanges

VC exchanges are persons or entities who offer exchange services to VC users, usually against payment of a fee. Exchanges act as platforms on which VC users sell their coins for fiat currency or buy new coins with fiat currency. Examples of well-known VC exchanges includes Bitfinex and Coinbase. Exchangers are important as individuals use them to deposit and withdraw money from virtual currency accounts.⁴³

2.3.3. Administrator/issuer

This is a person or entity engaged in the business of issuing (thus putting into circulation) a centralised VC, establishing the rules for its use; maintaining a central payment ledger; and who has the authority to redeem (withdraw from circulation) the virtual currency.⁴⁴

2.3.4. User

Users are natural persons or legal entities who obtain VCs for the following use: (i) to purchase real or virtual goods or services, (ii) to make peer to peer payments, or (iii) to hold them for investment purposes.⁴⁵ VC users can obtain VCs in several ways, *inter alia*, by purchasing VCs using fiat money from an exchanger or obtaining VCs as initial offering of coins (ICOs); or obtaining them as self-generated units by the process of "mining" or receiving VCs as payment for goods and services.⁴⁶

2.3.5. Miners

A miner is an individual or entity that participates in a decentralised VC network by validating transactions on the block chain. They solve complex algorithms in a

⁴² R Houben & A Snyers "Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion" 2018 *Policy Department for Economic, Scientific and Quality of Life Policies*, available online at <http://www.europarl.europa.eu/cmsdata/150761/TAX3%20Study%20on%20cryptocurrencies%20and%20blockchain.pdf> (date accessed 15 June 2015) 28.

⁴³ R Houben & A Snyers "Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion" 2018 *Policy Department for Economic, Scientific and Quality of Life Policies* 26.

⁴⁴ FATF, "Virtual currencies – Key definitions and potential AML/CFT risks" (2014) 7.

⁴⁵ FATF, "Virtual currencies – Key definitions and potential AML/CFT risks" (2014) 7.

⁴⁶ R Houben & A Snyers "Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion" 2018 *Policy Department for Economic, Scientific and Quality of Life Policies* 25.

distributed proof-of-work or other distributed proof system used to validate transactions in the VC system.⁴⁷ Apart from the validation of transactions, miner may also be users if they self-generate a convertible VC solely for their own purposes.⁴⁸

2.3.6. Wallet providers

Wallet providers provide VC users with digital wallets (e-wallets) used for holding, storing and transferring coins.⁴⁹ Wallet providers simplify participation in a VC system by allowing users, exchangers, and merchants to store their VC. Wallet providers maintain the customer's VC balance and also provide storage and transaction security. Nevertheless, users can also set up and maintain a wallet themselves without making use of a wallet provider.⁵⁰

2.4. Legitimate benefits

The anonymity or pseudo-anonymity provided by VCs can be viewed as an advantage towards protecting personal data. With traditional banking institutions, a user's true identity is revealed when transactions are processed between bank accounts. In contrast, VCs protect social details and the true identity of parties to a certain extent. VCs provide anonymity or pseudo-anonymity to its users. In this light crimes like scams and identity theft are greatly minimised.⁵¹

Another benefit afforded by VCs is the low transaction fees and real time settlement.⁵² The decentralised nature of VCs means that when payments are processed, there is minimal or no transaction costs involved.⁵³ The services of traditional third parties, like banks that charge transactional fees to all customer transactions, are no longer needed. Some VC schemes like Bitcoin do not charge transactional fees but customers may add optional transaction fees to ensure that their transactions are quickly processed.⁵⁴ Others like BitPesa provide affordable

⁴⁷ FATF "Virtual currencies key definitions and potential AML/CFT risks" (2014) 7.

⁴⁸ FATF "Virtual currencies key definitions and potential AML/CFT risks" (2014) 7.

⁴⁹ FATF "Virtual currencies key definitions and potential AML/CFT risks" (2014) 27.

⁵⁰ FATF "Virtual currencies key definitions and potential AML/CFT risks" (2014) 8.

⁵¹ Kiel Institute for the World Economy "Virtual currencies: monetary dialogue July 2018" (2018) European Union, available online at http://www.europarl.europa.eu/cmsdata/149902/KIEL_FINAL%20publication.pdf (date accessed 25 June 2018) 10.

⁵² J Brito & A Castillo "Bitcoin: a primer for policymakers" (2013) *Mercatus Centre at George Mason University* 10 (hereinafter referred to as J Brito *et al* "Bitcoin: a primer for policymakers" (2013)).

⁵³ R Grinberg, "Bitcoin: An Innovative Alternative Digital Currency" (2011) 4 *Hastings Science & Technology Law Journal* 159 – 208 165.

⁵⁴ R Grinberg, "Bitcoin: An Innovative Alternative Digital Currency" (2011) 4 *Hastings Science & Technology Law Journal* 159 – 208 165.

access when making transactions thereby assisting people who cannot afford traditional banking fees when making an international payment. This may ultimately lead to banking institutions reducing their banking and transaction fees.⁵⁵

VCs provide for the real time settlement of financial transactions.⁵⁶ Compared to other traditional means of financial transactions, VCs offer near-real time transaction settlements.

VCs also have the potential to improve the quality of life for the un-bankable.⁵⁷ Financial inclusion is about ensuring that all people has access to financial services. Because of their nature and lack of central authority financial inclusion is promoted by VCs.

2.5. Risks and regulatory challenges of VCs.

Much support for VCs tend to focus on the benefits provided by VCs. VCs have been hailed for their anonymity, efficiency and operational immediacy both on the domestic and international platform. In turn, it is these characteristics which are 'attractive to both legitimate and illicit individuals and groups'.⁵⁸ The benefits of VCs are undeniable, however, it is similarly significant that the risks posed are properly managed. There is a need for targeted regulation to mitigate potential risks that flow from VCs.⁵⁹

Traditional financial systems has stood the test of time mainly because of the way they are regulated. The financial sector is regulated more than other sectors.⁶⁰ The object of regulation is mainly to achieve a high degree of economic efficiency and consumer protection in the economy.⁶¹ Regulations are effective when a regulator is tasked with the responsibility of developing rules and monitoring compliance within the system.

⁵⁵ C van der Westhuizen *Future digital money: the legal status and regulation of bitcoin in Australia* (2017) LLM Thesis University of Pretoria 58.

⁵⁶ J Everette, "Risks and vulnerabilities of virtual currency cryptocurrency as a payment method" (2017) *Public-Private Analytic Exchange Program* 24.

⁵⁷ J Brito *et al* "Bitcoin: a primer for policymakers" (2013) 14.

⁵⁸ J De Mink "Dangers inherent in Bitcoin and other cryptocurrencies" (2018) *De Rebus* 33-35 33.

⁵⁹ J W Lim "A facilitative model for cryptocurrency regulation in Singapore" in Lee Kuo Chuen (ed) *Handbook of digital currency: Bitcoin, Innovation, financial instructions and bid data* (2015) London Chapter 18, 366.

⁶⁰ The Warwick Commission "The Warwick Commission on International Financial Reform: In praise of unlevel playing fields" 2009 *The University of Warwick*, available online at <https://warwick.ac.uk/research/warwickcommission/financialreform/report/> (date accessed 15 June 2018) 9.

⁶¹ H Falkena, R Bamber, D Llewellyn & T Store, T *Financial Regulation in South Africa* (2nd ed 2001) 2.

Most of the benefits discussed are also a source of risks to the effective regulation of VCs.

2.5.1. The anonymity/pseudo-anonymity provided by VCs

The first characteristic which may pose risk to effective VC regulation is the anonymity which they present. VCs afford users a degree of anonymity that is greater than many traditional payment methods. This anonymity adds a level of complexity for regulators seeking to address concerns of compacting illegal activity. Anonymity/pseudo-anonymity poses risks in the following areas: anti-money laundering/combating the financing of terrorism (AML/CFT)), consumer protection, tax evasion, and the regulation of capital movements.

2.5.1.1. Money laundering and terrorism financing

Money laundering is the process of taking money earned by illicit or illegal activities, and making the money appear “clean” or legitimate.⁶² The anonymous, near-untraceable and cross-border nature of VCs raise genuine concerns from a financial integrity standpoint. VCs can be used to conceal or disguise the illicit origin or sanctioned destination of funds, thus facilitating the money laundering (ML), terrorist financing (TF), and the evasion of sanctions. These traits of VCs have also garnered the interest of criminals in cyber-related criminal activity.⁶³

Money laundering pose a serious global concern with devastating economic impact. It undermines the integrity and stability of financial institutions and the economic stability of a country.⁶⁴ VCs like Bitcoin can be transferred between parties without the intervention of any third-party.⁶⁵ The lack of a third party greatly undermines the traditional approach to thwarting money laundering and terrorism financing. Third parties are instrumental in guarding against money laundering as they are responsible for reporting suspicious activity and “limiting the ability of criminals to transfer value without scrutiny.”⁶⁶

⁶² N. J. Ajello “Fitting a square peg in a round hole: bitcoin, money laundering, and the Fifth Amendment privilege against self- incrimination,” (2015) 80 *Brooklyn Law Review* 435 – 461 435 (hereinafter referred as N J Ajello “Fitting a square peg in a round hole” (2015)).

⁶³ N J Ajello “Fitting a square peg in a round hole” (2015) 435.

⁶⁴ S. Mabunda “Cryptocurrency: The new face of cyber money laundering” (2018), available at <http://dx.doi.org/10.1109//ICABCD.2018.8465467> (date accessed 17 July 2018) 2.

⁶⁵ N J Ajello “Fitting a square peg in a round hole” (2015) 446.

⁶⁶ N J Ajello “Fitting a square peg in a round hole” (2015) 447.

The anonymity or pseudo-anonymity which comes with VCs is in direct confrontation with AML/CTF regulations like the “Know Your Customer” principle which is at the heart of the global AML/CTF regime.⁶⁷ The Know Your Customer principle obliges financial institution to verify and identify their customers, and to monitor any suspicious transactions.⁶⁸ This obligation on financial institution will not be discharged in anonymous transactions. The near real-time, cross-border settlement and low costs of VCs exacerbate the fracturing of AML/CTF regulations.⁶⁹

2.5.1.2. ***Tax evasion/avoidance and treatment***

In most jurisdictions tax evasion is criminalised. The key challenges which almost all these jurisdictions face is effective policing and enforcement of anti-tax evasion laws.⁷⁰ Transacting in a taxable VC transactions without paying taxes is tax evasion.⁷¹ However, effective policing and enforcement of tax compliance is difficult to attain when tax authorities does not know the identity of the person who enters into the taxable transaction.

Unscrupulous individuals find the anonymity provided by VCs a very attractive means for tax evasion. Since VC transactions happen in an anonymous or pseudonymous environment, there is a very high risk that the users of VCs can easily evade taxes.⁷²

Another challenge posed by VCs is the intrinsically cross-border nature they present. The cross-border nature of VCs probably mean that rules will only be adequate when they are taken at a sufficiently international level. This requires uniformity of regulatory rules and cooperation by different jurisdictions.

⁶⁷ D Carlisle “VCs and financial crime” (2017) 9.

⁶⁸ Van der Westhuizen C, *Future digital money: the legal status and regulation of bitcoin in Australia* (2017) LLM Thesis University of Pretoria 77.

⁶⁹ N J Ajello “Fitting a square peg in a round hole” (2015) 446.

⁷⁰ IMF Staff Discussion Note, “Virtual Currencies and Beyond: Initial Considerations” (2016) available online at <https://www.imf.org/external/pubs/ft/sdn/2016/sdn1603.pdf> (date accessed 15 June 2018) 30.

⁷¹ R Houben & A Snyers “Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion” 2018 *Policy Department for Economic, Scientific and Quality of Life Policies* 53.

⁷² J Everette “Risks and vulnerabilities of virtual currency cryptocurrency as a payment method” (2017) *Public-Private Analytic Exchange Program* 18.

2.5.2. Avoidance of Exchange Control Regulations

VCs usage may lead to circumvention of the Exchange Control Regulations.⁷³ These Regulations allows South African residents a foreign capital allowance of R10 million per calendar year.⁷⁴ If the funds are below the threshold they may be transferred abroad and invested without prior approval of Financial Surveillance Department of the Bank (FinSurv), as long as a tax clearance certificate is obtained. In the event of non-regulation of VCs it will be impossible to enforce this and it will lead to exchange control circumvention.⁷⁵

2.5.3. Consumer risks

The regulatory uncertainty and lack of transparency surrounding VCs create significant consumer protection vulnerabilities. The SARB identified several risks to consumers which include the following: (a) loss and theft due to a breach of security; (b) a user error or a technological failure of the wallet; (c) fraud or unauthorised use; (d) processing errors in the transaction; (e) absence of insurance to users; and (f) lack of obligations on wallet operators to make certain disclosures.⁷⁶

The decentralised nature of VCs thus means that there is lack of effective central control. The SARB contended that one of the greatest risks for end-users trading in these currencies is the potential to incur sizeable financial losses. Since the prices of these currencies` are controlled by demand and supply, if unregulated, this may result in price volatility where prices may fluctuate wildly leading to loss by user investors.⁷⁷

Another risk to consumers triggered by the lack of central authority is that transaction processing in error, for instance, payment misdirection and incorrect amount transfers are not reversible. Thus, the error is not correctible, and the consumer has no recourse against the wallet, exchange, or processor.⁷⁸ In the case of Bitcoin this is referred as the block chain's "immutability" – which means that once a transaction is confirmed it cannot be reversed or terminated in the manner that a credit card company or banks can reverse transactions. User purchasers are not

⁷³ Exchange Control Regulations of 1961.

⁷⁴ SARB "Position Paper" (2014) 11.

⁷⁵ SARB "Position Paper" (2014) 10.

⁷⁶ SARB "Position Paper" (2014) 5.

⁷⁷ SARB "Position Paper" (2014) 9.

⁷⁸ SARB "Position Paper" (2014) 10.

always protected against failure to deliver goods, or if they receive counterfeit or faulty goods.⁷⁹

2.6. Conclusion

Due to their design, VCs offers a number of advantages when compared to traditional payment methods. VCs has the potential to improve human welfare and potentially improve developments to the traditional payments, communications, and business systems.⁸⁰ However, due to their interaction with the real economy and currency, VCs also poses risks if they remain unregulated. The financial markets are heavily regulated, so leaving VCs unregulated is not an option. It is evident after analysing the regulatory challenges mentioned in this chapter that lawmakers and regulators are faced with a huge task. The regulatory steps which has been proposed or adopted by South Africa and United States of America will be analysed in the following chapters.

⁷⁹ D Carlisle “VCs and financial crime” (2017) 19.

⁸⁰ J Brito *et al* “Bitcoin: a primer for policymakers” (2013) 41.

CHAPTER 3: REGULATORY RESPONSE IN SOUTH AFRICA

3.1. Introduction

The rise of VCs in recent years have presented regulators globally with a mammoth challenge. Regulators has been walking a thin tightrope trying to strike a delicate balance between regulating this embryonic phenomenon of decentralised currency, while avoiding stifling technological innovation with overenthusiastic regulations. The boom experienced in the adoption of VCs has also reached the South African markets thereby giving South African legislators and regulators something to worry about. In response to the rise of VCs, South Africa initially adopted a ‘wait and see’ approach. To some extent this approach is understandable. Crafting the right, first-stage regulation of any new technology is a formidable task especially in an ever changing environment.

The first official communication by the South African regulators regarding VCs was in 2014. The initial public statement on VCs was issued by National Treasury as the “*User Alert: Monitoring of virtual currencies*” warning the public of risks associated with the use of VCs either as a payment method or as an investment tool.⁸¹ This was followed by the SARB ‘*Position Paper on Virtual Currencies, 2014*’⁸² which clarified the position of VCs as non-legal tender in the Republic of South Africa (RSA).

In January 2019, after a long observation period, the Intergovernmental FinTech Working Group (IFWG) released its Consultation Paper on VCs which was open for public comments until 15 February 2015.⁸³ The Consultation Paper proposes a number of intervention measures to be adopted in order for VCs to be aligned to current regulation in the financial industry.

This chapter discusses the regulatory approach adopted by South Africa to VCs. Given the regulatory culture of South African financial markets, the regulatory attempts adopted by South Africa to mitigate the risks posed by VC will be discussed.

⁸¹ NT “User Alert” (2014) 1.

⁸² SARB “Position Paper” (2014).

⁸³ G Steyn “Crypto shake-up: SARB publishes regulation views on cryptocurrency” 15 January 2019 *Business Report*, available online at <https://www.iol.co.za/business-report/economy/crypto-shake-up-sarb-publishes-regulation-views-on-cryptocurrency-18840077> (date accessed 28 January 2019).

Finally, an argument on why South African regulators need to do more than what is already done will be presented.

3.2. Acceptance of virtual currency as currency in South Africa

None of the existing legislation consider VC as a legal tender or currency in the Republic. The South African Reserve Bank Act 90 of 1989 (SARB Act) which govern the management of currency in the Republic entrusts the sole mandate to issue currency to the SARB. Section 14 of the SARB Act provides that the SARB has the sole right to issue or cause to be issued banknotes and coins in RSA. Section 17 of the SARB Act defines a legal tender as:

- “(1) A tender, including a tender by the Bank itself, of a note of the Bank or of an outstanding note of another bank for which the Bank has assumed liability in terms of section 15(3) (c) of the Currency and Banking Act or in terms of any agreement entered into with another bank before or after the commencement of this Act, shall be a legal tender of payment of an amount equal to the amount specified on the note.
- (2) A tender, including a tender by the Bank itself, of an undefaced and un mutilated coin which is lawfully in circulation in the Republic....”

Given the decentralised nature of VC and lack of SARB involvement in the issuance of such, it is clear that VC is not covered by the definition of legal tender as per section 17 of the SARB Act. This was confirmed by the SARB in its 2014 Position paper.⁸⁴

As to whether VC can be regarded as E-money, the National Payment System (NPS) Department defined E-money as “money which is stored electronically and issued on receipt of funds which is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account on demand.”⁸⁵ The NPS Position Paper further declares the issuance of E-money as the “business of a bank” as defined in the Banks Act 94 of 1990 (the Banks Act). The Position Paper further states that only South African registered banks may issue e-money.⁸⁶ Therefore, seen in this light, there is a clear distinction between VC and E-money. VCs may also not be treated like E-money.

⁸⁴ SARB “Position Paper” 2014 4.

⁸⁵ National Payment System Department “Position Paper on Electronic Money” 2009, available online at [https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem\(NPS\)/Legal/Documents/Position%20Paper/PP2009_01.pdf](https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Legal/Documents/Position%20Paper/PP2009_01.pdf) (date accessed 15 June 2018) 3 (hereinafter referred to as National Payment System Department “Position Paper on Electronic Money” 2009).

⁸⁶ National Payment System Department “Position Paper on Electronic Money” 2009 7.

The lack of a regulatory framework was also echoed by the SARB in its position paper of 2014 in which that paper stated that VCs are not legal tenders. Furthermore, the South African National Treasury warned members of the public of the risks associated with the use of VCs for either transactions or investments.⁸⁷

3.3. Anti-Money Laundering (AML) and Counter-terrorism financing (CTF)

The Financial Intelligence Centre Act⁸⁸ has been the key regulatory tool to protect the integrity of the South African financial system against abuse for illicit purposes like money laundering; the proceeds of crime and the financing of terrorism.⁸⁹ The FIC Act was recently amended by the Financial Intelligence Centre Amendment Act.⁹⁰

The FIC Act defines “money laundering” or “money laundering activity” as an “activity which has or is likely to have the effect of concealing or disguising the nature, source, location, disposition or movement of the proceeds of unlawful activities or any interest which anyone has in such proceeds [...]”.⁹¹ The FIC Act also defines “accountable institutions” to include banks and money remitters.⁹² The FIC Act casts a wide net on those who have the duty to report suspicious or unusual transactions.⁹³ Section 29 imposes a duty on any person who carries on a business, or is in charge of, or manages a business, or who is employed by a business, who knows or suspects that: (a) the business has received or is about to receive the proceeds of unlawful activities (b) a transaction to which the business is a party involve proceeds of unlawful activity or property relating to the financing of terrorist activities, (c) the business has been used, or is about to be used for money-laundering purposes, or the financing of terrorism, to report such to the FIC.

Based on the aforementioned provision of the FIC Act, it can be argued that these provisions could be interpreted to apply to VCs. However, the FIC Act has not

⁸⁷ NT “User Alert” 1.

⁸⁸ Financial Intelligence Centre Act 31 of 2001 (hereafter referred to as the “FIC Act”).

⁸⁹ Financial Intelligence Centre “A new approach to combat money laundering and terrorist financing 13 June 2017”, available online at [https://www.fic.gov.za/Documents/A%20NEW%20APPROACH%20TO%20COMBAT%20MONEY%20LAUNDERING%20AND%20TERRORIST%20FINANCING%20\(2\).pdf](https://www.fic.gov.za/Documents/A%20NEW%20APPROACH%20TO%20COMBAT%20MONEY%20LAUNDERING%20AND%20TERRORIST%20FINANCING%20(2).pdf) (date accessed 15 June 2018)

1.

⁹⁰ Financial Intelligence Centre Amendment Act 1 of 2017 (hereinafter referred to as the FIC Amendment Act).

⁹¹ Section 1 of the FIC Act.

⁹² Section 1 of the FIC Act.

⁹³ Section 29 of FIC Act.

made such a pronouncement nor have they taken any enforcement action against persons or entities dealing in VCs.⁹⁴

With the release of the Consultation Paper of 2019, the IFWG proposed changes to the current FIC's non-regulatory approach to VC. The IFWG proposed the adoption of Financial Action Task Force (FATF) Recommendations on VCs.⁹⁵ IFWG proposed that the FIC must include VC service providers as an accountable institution and, as such, the accountable institutions will be under a legal obligation to comply with AML/CFT requirements in the FIC Act.⁹⁶

3.4. Consumer Protection.

In the past decade, consumer protection has been one of the main focus areas of legislators and regulators. Consumer protection aims to address the imbalance of power between an individual consumer and a financial service provider. This balance of power mainly flows from information asymmetries that are particularly pronounced in the financial services sector, where products tend to be complex, information can be difficult and costly to obtain, and often the performance of underlying assets can only be judged over time.⁹⁷

Given the complicated nature of the South African financial landscape, consumer protection has been substantially enhanced over the past few years. Legislatures has enacted new laws or amended the existing laws to improve consumer protection. Notably, the Financial Advisory and Intermediaries Services Act, 2002 (FAIS), the Financial Services Ombuds Schemes Act, 2004, the National Credit Act, 2005 (NCA) and, the Consumer Protection Act 28 of 2008 (CPA) are all examples of legislation which was created with the aim of increasing customer

⁹⁴ A Itzikowitz, I Meiring & E Gunning "South Africa" in J Dewey (ed) *Blockchain & Cryptocurrency Regulation* (1st ed 2019) London: Global Legal Group Ltd 432 – 437 434.

⁹⁵ FATF "Regulation of virtual assets", available online at <http://www.fatf-gafi.org/publications/fatfrecommendations/documents/regulation-virtual-assets.html> (Date accessed 15 November 2018). The FATF Recommendations indicates that jurisdictions, including South Africa, have to ensure that CVs service providers are subject to FATF requirements that are aimed at combatting money laundering and terrorist financing, for example, conducting customer due diligence, including ongoing monitoring, record-keeping and reporting of suspicious transactions.

⁹⁶ IFWG "Consultation paper" (2019) 22.

⁹⁷ Financial Regulation Reform Steering "Committee implementing a twin peak model of financial regulation in South Africa" 2013 available online at http://www.treasury.gov.za/comm_media/press/2013/2013020102.pdf (date accessed 7 September 2018) 47.

protection.⁹⁸ Recently, the Financial Sector Regulation Act⁹⁹ was enacted which introduced the South African Twin Peaks model. In terms of the FSRA, the regulation of prudential and market conduct risk are separated under the supervision of two distinct regulatory bodies. The Prudential Authority (PA) is contained within the South African Reserve Bank (SARB) which is responsible for protecting, maintaining and enhancing financial stability.¹⁰⁰ Protection of consumers and public confidence in the South African financial system is tasked to the Financial Sector Conduct Authority (FSCA) which is established in terms of section 56 of FSRA.¹⁰¹

3.4.1. Application to virtual currency

In 2014, the NT in its User Alert¹⁰² and the SARB in its position paper further indicated that VCs are not regarded as currency in South Africa nor are they securities. As indicated, in 2016 the IFWG was established by members from NT, the SARB, FSCA and FIC. The overall objective of IFWG is to foster financial technology (fintech) innovation while ensuring the continued efficient functioning of financial markets, financial stability and protecting the rights and interests of customers and investors.¹⁰³

In January 2019, the IFWG issued a consultation paper calling for public comment on the need to develop a policy and regulatory response to VC activities in South Africa. The consultation paper reiterated the risks involved if VCs remains unregulated. The South African financial system and all the participants in the system operate in a highly regulated sphere so as to ensure a sound and safe financial system. Accepting VC in such a highly regulated system without similar safety mechanisms will expose the system to potential financial and consumer risks.¹⁰⁴ The purpose of the Consultation Paper is to (a) provide an overview of the perceived risks

⁹⁸ National Treasury Policy Document “A safer financial sector to serve South Africa better” (2011) available online at <http://www.treasury.gov.za/twinpeaks/20131211%20-%20Item%202%20A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf> (date accessed 7 September 2019) (referred hereinafter as NT “A safer financial section to serve SA better” (2011) 41).

⁹⁹ Financial Sector Regulation Act 9 of 2017 (hereafter referred to as the FSRA).

¹⁰⁰ Section 32 of the FSRA.

¹⁰¹ EY “Financial Sector Regulation Act: Implementing Twin Peaks and the impact on the industry” [http://www.ey.com/Publication/vwLUAssets/ey-financial-sector-regulation-act-twin-peaks/\\$FILE/ey-financial-sector-regulation-act-implementing-twin-peaks-and-the-impact-on-the-industry.pdf](http://www.ey.com/Publication/vwLUAssets/ey-financial-sector-regulation-act-twin-peaks/$FILE/ey-financial-sector-regulation-act-implementing-twin-peaks-and-the-impact-on-the-industry.pdf) [Date accessed 3 May 2018] 4.

¹⁰² NT “User Alert” (2014).

¹⁰³ The Intergovernmental Fintech Working Group “Pre-workshop note – Intergovernmental Fintech Working Group Workshop 19–20 April 2018” available online at <https://www.genesis-analytics.com/uploads/Note-%E2%80%93-Intergovernmental-Fintech-Working-Group-Workshop.pdf> (date accessed 12 November 2018) 2.

¹⁰⁴ IFWG “Consultation paper” (2019) 6.

and benefits associated with VC; (b) discuss the available regulatory approaches; and (c) present policy proposals to industry participants and stakeholders.¹⁰⁵

The financial regulators has remained aloof when it comes to regulating VC and has for the most part remained as mere observers. Besides the user alerts and position papers discussed above, nothing tangible has been done. The Consultation Paper is therefore a major leap towards a more hands-on approach to VC regulation to date. The IFWG propose that regulatory action should not be delayed further “[...] but to rather act and amend as innovation evolves’.¹⁰⁶

3.5. Securities and investment laws.

The Financial Markets Act 19 of 2012 (FMA) forms the cornerstone of securities regulation in South Africa. Section 1 of the FMA has a long definition of “securities” which includes listed and unlisted shares; depository receipts; debentures, bonds; and derivative instruments. The definition of securities does not make any reference to VC and the Registrar of Securities Services has not prescribed VC to be instruments similar to any of the securities listed in the FMA.¹⁰⁷

In view of the lack of pronouncement by the Registrar or other regulators, VC are not currently included in the definition of FMA.

3.6. Tax regulations

South African’s income tax regime is principally set out under the Income Tax Act¹⁰⁸) and the Tax Administration Act.¹⁰⁹ The South African Revenue Service (SARS) is the tax regulator of the South Africa.

Section 1 of the ITA defines “gross income” as, the case of a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or in the case of a non-resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic. Income tax liability for the taxable income is imposed on both natural persons and companies.¹¹⁰ A taxpayer must submit income tax returns annually so

¹⁰⁵ IFWG “Consultation paper” (2019) 7.

¹⁰⁶ IFWG “Consultation paper” (2019) 29.

¹⁰⁷ A Itzikowitz, I Meiring & E Gunning “South Africa” in J Dewey (ed) *Blockchain & Cryptocurrency Regulation* (1st ed 2019) London: Global Legal Group Ltd 432 – 437 433.

¹⁰⁸ Income Tax Act 58 of 1962 (hereinafter referred to as ITA).

¹⁰⁹ Tax Administration Act 28 of 2011 (hereinafter referred as TAA).

¹¹⁰ Section 5(1)(c) and (d) of the Income Tax Act 58 of 1962.

that SARS will determine taxable income.¹¹¹ Omitting to declare income, can lead to a penalty in terms of chapter 15 or 16 of the TAA¹¹² and falsifying an entry in a return is a criminal offence.¹¹³

3.6.1. Application to virtual currency

One of the risks posed by VC on tax laws is tax evasion. Tax evasion is not a new phenomenon, however, the decentralised and anonymous nature of VCs exacerbate this challenge. During the 2019 budget speech, the NT announced that tax revenue in the 2018/19 financial year had been revised downwards with a revenue shortfall of R42.8bn being expected. One of the reason for such shortfall is tax evasion.¹¹⁴

In April 2018 SARS, through a media release, indicated its standpoint on the treatment of VC within the current tax laws.¹¹⁵ SARS emphasised that the word “currency” is not defined in the ITA and as such, VCs are not regarded by SARS as a currency for income tax purposes or Capital Gains Tax (CGT). However, SARS provided that VCs are regarded as assets of an intangible nature to which normal income tax rules apply.¹¹⁶ Like the ITA, SARS places the onus on the taxpayers to declare all VC-related taxable income in the tax year in which it is received or accrued. VC can be valued to ascertain an amount received or accrued as envisaged in the definition of “gross income”. Failure to declare such income could result in interest and penalties.

In January 2019 the Taxation Laws Amendment Act¹¹⁷ came into effect and it brought various amendments to the ITA and the Value Added Tax Act.¹¹⁸ The Tax Amendment Act amend section 2 of the VAT Act to include in the description of “financial services”, the issue, acquisition, collection, buying or selling or transfer of ownership of any cryptocurrency. The Tax Amendment Act also inserted

¹¹¹ Section 66(13) of the ITA and section 25 of the TAA.

¹¹² Section 210 of the TAA.

¹¹³ Section 235 of the TAA.

¹¹⁴ J Cronje “SARS is being fixed, says Mboweni, as Treasury again faces shortfall” 20 February 2019 *fin24* available online at <https://www.fin24.com/Budget/sars-is-being-fixed-says-mboweni-as-treasury-again-faces-shortfall-20190220> (date accessed 26 February 2019).

¹¹⁵ SARS “SARS’s stance on the tax treatment of cryptocurrencies” 6 April 2018 *Media Release* available online at <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> (date accessed 12 November 2018).

¹¹⁶ SARS “SARS’s stance on the tax treatment of cryptocurrencies” 6 April 2018 *Media Release*, available at <http://www.sars.gov.za/Media/MediaReleases/Pages/6-April-2018---SARS-stance-on-the-tax-treatment-of-cryptocurrencies-.aspx> (date accessed 15 November 2018).

¹¹⁷ Taxation Laws Amendment Act No. 23 of 2018 (referred to as Tax Amendment Act).

¹¹⁸ Value Added Tax Act 89 of 1991 (hereinafter referred to as VAT).

cryptocurrency in the definition of “financial instrument”. Section 20A of the ITA was also amended to include the acquisition or disposal of any cryptocurrency under the ring-fencing of assessed loss provisions.

3.7. Defence of virtual currency regulation in South Africa.

The financial sector is regulated more than other sectors because unlike other industries, “it exhibits market failures that could have devastating results on the economy”.¹¹⁹ A well-regulated and stable financial services industry enables economic growth, job creation and sustainable development of any country.¹²⁰ Regulating financial markets and products is of particular relevance when securing systematic stability in the economy, ensuring institutional safety and soundness and promoting consumer protection.¹²¹

3.7.1. Lessons learnt from the Global Financial Crisis of 2007/8

Hesitation in regulating VC appears to be centred mainly on uncertainties and the unknown effects which they pose to the financial system as a whole. Hence most jurisdictions, South Africa included, initially decided to adopt a light touch regulatory stance. The idea that the financial sector can successfully regulate itself proved to be a misguided one with the occurrence of the 2007/9 Global Financial Crisis (GFC).¹²² Before the GFC regulators generally held the idea that it may be easier to manage a crisis if and when it comes rather than try to prick a bubble whose dimensions were uncertain.¹²³ The GFC highlighted the need for proper financial regulation to be better coordinated with monetary, fiscal and other economic policies and to take into account systemic risks.¹²⁴

Post GFC, like in most jurisdictions, a paradigm shift in the regulatory approach occurred in South Africa. In 2011 the NT drafted a policy document in response to the GFC titled “A safer financial sector to serve South Africa better”. The proposed financial regulatory reform agenda was aimed at introducing a Twin Peaks model of

¹¹⁹ The Warwick Commission “The Warwick Commission on International Financial Reform: In praise of unlevel playing fields” 2009 *The University of Warwick* 9.

¹²⁰ NT “A safer financial section to serve SA better” (2011) 1.

¹²¹ H Falkena, R Bamber, D Llewellyn & Tim Store *Financial Regulation in South Africa* (2nd ed) 2001 SA Financial Sector Forum 3.

¹²² S Kayondo *Aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience* 2016 LLM University of Pretoria 31.

¹²³ The Warwick Commission “The Warwick Commission on International Financial Reform: In praise of unlevel playing fields” (2009) *The University of Warwick* 9.

¹²⁴ NT “A safer financial section to serve SA better” (2011) 5.

financial regulation in South Africa and specifically to address the following four policy objectives: (i) financial stability (ii) consumer protection and market conduct (iii) expanding access through financial inclusion and (iv) combating financial crime.¹²⁵ According to the NT Policy document, financial stability was to be obtained by committing to, *inter alia*, the establishment of a stronger regulatory framework, effective supervision and crisis resolution and addressing systemic institutions ensuring that system events are contained effectively.¹²⁶ The Policy document propose to achieve consumer protection by implementation of the comprehensive Treating Customers Fairly initiative, with clear principles for market conduct backed up by rules.¹²⁷

The paradigm shift was championed by the Financial Sector Regulation Act 9 of 2017 (FSRA) which introduced the Twin Peaks approach to financial regulation in South Africa. The FSRA seeks to achieve a stable financial system that works in the interests of financial customers and that supports economic growth by establishing regulatory and supervisory framework that promotes (a) financial stability; (b) the safety and soundness of financial institutions; (c) the fair treatment and protection of financial customers; (d) the efficiency and integrity of the financial system; (e) the prevention of financial crime.¹²⁸ With this in mind, it becomes necessary to discuss the risks which are posed by VC to financial stability, consumer protection and the monitoring of systemic events.¹²⁹

3.7.2. Ensuring financial and systematic stability

Financial stability refer to a condition in which the financial system is capable of withstanding shocks, thereby mitigating the likelihood of disruptions in the financial intermediation processes.¹³⁰ The SARB is tasked with monitoring the financial system for potential systemic events. Also, if a systemic event has occurred or is imminent, the SARB is tasked with restoring and maintaining financial stability. Section 221(1) of the Constitution of the Republic of South Africa, 1996 and section 3 of the SARB Act clearly states the primary goals of the SARB as the protection of the value of the currency in the interest of balanced and sustainable economic growth in the Republic.

¹²⁵ NT "A safer financial section to serve SA better" (2011 4.

¹²⁶ NT "A safer financial section to serve SA better" (2011 4.

¹²⁷ NT "A safer financial section to serve SA better" (2011 6.

¹²⁸ Section 7 of the FSRA.

¹²⁹ Section 1 of the FSRA is defined as an event that may reasonably be expected to have a substantial adverse effect on the financial system or on economic activity in the Republic.

¹³⁰ ECB "Virtual currency Scheme" (2012), 37.

Financial stability as an additional express SARB mandate was recently introduced by section 11(1) of the Financial Sector Regulation Act 9 of 2017 (FSRA). Furthermore, the SARB in seeking to maintain financial stability, must monitoring the financial system for systemic events. If a systemic event has occurred or is imminent the SARB must take steps to prevent such systemic events from occurring or if a systemic event has occurred or is imminent SARB must take mitigating steps without delay in managing the systemic event and its effects.¹³¹

The GFC highlighted the need for financial regulation to be better coordinated with monetary, fiscal and other economic policies and to take into account systemic risks. The South African financial services industry operates in a globalised environment where a crisis in one economy can easily spread to another, with devastating speed and impact. This interconnectedness also increased financial stability risks and the need for enhanced supervision of the financial sector.¹³²

Whether VC has any effect on the financial system is still largely speculative. It can be argued that, VC could jeopardise financial stability given their unstable nature. In October 2012 Bitcoin was trading at around USD 12. Bitcoin's exchange rate peaked first in April 2013 at USD 266 and reached its all-time high at USD 1240 (€914) in early December 2013. In April 2014 the exchange rate dropped briefly to approximately €245 or USD 339. Having recovered to €490 in June 2014, the exchange rate has gradually fallen below €200 in February 2015. As of September 2018 it was trading at USD 6611.¹³³

The ECB is of the opinion that VC may pose a risk to financial stability if: (i) they become more widely used in regular payments; (ii) greater links to the real economy develop, including through the presence of financial institutions participating in VC; and (iii) no structural developments are envisaged that would make VCS inherently more stable.¹³⁴ South Africa would thus be wise not to ignore these remarks by the ECB.

3.7.3. Promoting consumer protection

One of the most highlighted cause of the GFC is the lack of adequate consumer protection. In reaction, the FSRA created a dedicated market conduct and consumer

¹³¹ Section 15(1) of the Financial Sector Regulation Act 9 of 2017.

¹³² National Treasury Policy Document "A safer financial sector to serve South Africa better" 2011 5.

¹³³ Coindesk <https://www.coindesk.com/price/> (date accessed 20 September 2018).

¹³⁴ ECB "Virtual currency schemes – a further analysis" (2015) 26.

protection regulator, the Financial Sector Conduct Authority (FSCA). The market conduct regulator's objective is to protect consumers of financial services and promote confidence in the South African financial system.¹³⁵ The FSCA will enhance consumer protection through the promotion of fair treatment of financial services customers and promoting financial awareness and financial literacy amongst South Africans.¹³⁶

Consumer protection is greatly undermined by the unregulated use of VC. Currently VC, does not provide mechanisms for consumer protection. When left unregulated, consumer involved in VC activities are always faced with a number of risks. One of the risks of unregulated VC is that consumers are not protected if the activities of key actors is discontinued.¹³⁷ Moreover, the fact that VC is not recognised as a currency in South Africa means, as pointed out by the ECB, that acceptance of these 'currencies' by retailers is based on their free decision and can cease at any moment, again leaving users with valueless units.¹³⁸

Against this backdrop, Mothokoa remarks that there are rarely mechanisms available to the consumer to measure liquidity of exchanges and associated risks, such as bankruptcy, fraudulent misappropriation of funds and vulnerability to hacks. This lack of quantifying mechanisms suggests a lack of transparency in the cryptocurrency ecosystem.¹³⁹ Furthermore, the lack of the SARB or any regulatory intervention entails that the object of the FSRA are not extended to protect consumers of VC. Seen in this light, there is need to regulate VC in South Africa in order promote consumer protection an environment where the legislators has gone to strengths to promote consumers.

3.7.4. Crime control

The primary features of VC, specifically Bitcoin, that prove beneficial and attractive to its survival, seem to be the most harmful to effective crime control. This is because the inability to tie an identifiable user to a single VC transaction makes it attractive to nefarious users. As discussed above money laundering and terrorism are some of the

¹³⁵ See section 57 of the FSRA.

¹³⁶ Section 57(b) of the FSRA. See also Financial Regulation Reform Steering Committee "Implementing a twin peak model of financial regulation in South Africa" 2013 47.

¹³⁷ ECB "Virtual currency schemes – a further analysis" 2015 22.

¹³⁸ ECB "Virtual currency schemes – a further analysis" 2015 25.

¹³⁹ Mothokoa K *Regulating crypto-currencies in South Africa: The need for an effective legal framework to mitigate the associated risks* LLM Dissertation University of Pretoria 2017 43.

crimes which require immediate intervention by the state. If left unregulated, VCs can become a vehicle through which crimes are perpetrated.

3.8. Conclusion

VCs are indeed becoming popular payment methods and investment commodities. With their increased use comes their novel challenges that place pressure on established legal and regulatory frameworks that were not developed to respond to VCs.¹⁴⁰ In the meantime, some of the challenges posed by VCs may potentially be managed within the existing South African legal and regulatory framework.

As indicated in this chapter, South Africa has not promulgated any legislation pertaining specifically to VCs. It is however submitted that an assessment of the potential applicability of all current legislation and regulations relevant to VCs needs to be done.¹⁴¹ The time for South Africa to adopt an interventionist approach is now.

¹⁴⁰ A Nieman “A few South African cents' worth on bitcoin” (2015) 18 *PER* 1979 – 2011 1999.

¹⁴¹ A Nieman “A few South African cents' worth on bitcoin” (2015) 18 *PER* 1979 – 2011 1999.

CHAPTER 4: REGULATORY RESPONSES IN THE UNITED STATE OF AMERICA

4.1. Introduction

On the onset, VCs operated entirely outside of the traditional financial system with only a few users. It was justified at that stage that both regulators and legislators needed not pay much attention to it. However, as their popularity grew so did the pressure on regulatory bodies to assess the potential risks of an increasingly mainstream decentralized currency. Federal and state laws in the US currently do not provide for consolidated, comprehensive oversight of VC markets by a single regulator. Multiple agencies are however increasingly joining forces to provide a “multifaceted, multi-regulatory” approach to VC markets.¹⁴²

Currently, most US federal and state agencies have resorted to publishing risk warnings to investors and, in some cases, have brought civil enforcement actions against VC trading platforms, brokers and operators of collective investment funds. Others agencies have issued interpretative guidances making the existing laws applicable to VC transactions.¹⁴³

This chapter deals with regulatory approach adopted by US at the federal level when dealing with VC transactions. This analysis is aimed at shedding light at regulatory steps which can be adopted by South African regulators.

4.2. Regulation of virtual currency in United States

In the USA, regulatory bodies and legislators at both the federal and state levels have resorted to adopt steps to clarify the applicability of current legislation to VCs. Before 2013, neither the federal government nor the states had any issued regulatory guidance over VCs, their issuers, or the exchanges that facilitate their transfer. It was only in 2013 that some regulations began to emerge. Holistically, regulation in the United States has been mainly focused on establishing how VCs will be treated under existing law.¹⁴⁴ While federal and state financial laws and regulations

¹⁴² S Brown-Hruska & T Wagener, “Recent trends in virtual currency regulation, enforcement, and litigation” 2018 *NERA Economic Consulting* 5.

¹⁴³S Austin LLP “United States” (2018) 330.

were not enacted with VCs in mind, regulators began analysing existing legislation and rules to determine whether they are sufficiently broad to capture commercial transactions in VCs.¹⁴⁵

4.3. Anti-Money Laundering (AML) and Counter-terrorism financing (CTF)

Money laundering is the process of making money or proceeds which are earned through illegal activities and making such money appear to have been sourced legally or legitimately.¹⁴⁶ Anti-Money Laundering laws (AML) are the legislative attempts to curtail such illegal activity. Terrorist financing is the process where money (even clean money) is used for illegal activities specifically supporting terroristic acts. Bryans points out that counter terrorism financing (CTF) is often considered under the same umbrella as money laundering.¹⁴⁷ This section will discuss the regulatory attempts adopted by the US to combat money laundering and terrorism financing.

4.3.1. The Bank Secrecy Act (BSA)

The Bank Secrecy Act (BSA)¹⁴⁸ is the principal federal legislation which offers a comprehensive set of regulations which are aimed at preventing money laundering and the financing of terrorist or other illegal activity.¹⁴⁹ Accordingly when the BSA was enacted, the US Congress wanted the traditional financial service providers to create a paper trail to inform law enforcement agencies of potentially suspicious activity with the hope of using such paper trail as a weapon to prosecute money launderers.¹⁵⁰ The BSA generally requires that financial institutions: (1) report suspicious transactions to law enforcement, (2) maintain records of large and/or suspicious

¹⁴⁴ Hunton & Williams, "Recent development in the regulation of bitcoin under state and federal securities law" 2014 *Client Alert*, available online at <https://www.huntonak.com/images/content/2/9/v3/2926/Developments-in-the-Regulation-of-Bitcoin-under-Securities-Laws.pdf> (date accessed 27 September 2018) 2.

¹⁴⁵ R Arnfield "Regulation of virtual currencies: A global overview" *Network Media Group* 2015, 7.

¹⁴⁶ N J Ajello "Fitting a square peg in a round hole" (2015) 435.

¹⁴⁷ D Bryans "Bitcoin and money laundering: mining for an effective solution" (2014) 89 *Indiana law journal* 441-472 442.

¹⁴⁸ Bank Secrecy Act of 1970 as amended by the USA Patriotic Act 31 U.S.C.

¹⁴⁹ S Austin LLP "United States" (2018) 351.

¹⁵⁰ K V. Tu & M W. Meredith "Rethinking virtual currency regulation in the bitcoin age" (2015) 90 *Washington Law Review* 271-347 322 (hereinafter referred to as K V Tu *et al* "Rethinking virtual currency regulation" (2015).

transactions, (3) submit to compliance reviews of their anti-money laundering efforts, and (4) develop methods of identifying potentially dangerous customers.¹⁵¹

In 2001, there was an addition to the BSA's anti-money laundering regulatory framework enacted as Title III of the Patriot Act.¹⁵² This addition introduced a number of regulatory requirements for financial institutions. The most germane Title III amendment being the "know your customer" (KYC) or "customer due diligence" provisions. The KYC requirements impose a regulatory burden on regulated financial institutions of identifying potentially illegal activity via gathering of customer information and monitoring of customer transactions. This means that regulated financial institutions have a duty to actively identify and report potentially illegal transactions, which ultimately promotes the policy goals of helping with the identification and prevention of criminal activity.¹⁵³ The regulated financial institutions are tasked to collect information to identify their customers and then verify that information using a customer's passport or other documents.¹⁵⁴

4.3.2. Application to Virtual currency

The pseudonymity which comes with VCs threatens the effectiveness of the KYC principle which is at the heart of the global AML/CTF regime.¹⁵⁵ When it comes to VCs, one can merely access the network and create a potentially infinite number of pseudonymous 'identities' when transacting with other users.¹⁵⁶ Needless to say, the US has made some progress in attempting to regulate the effect of VCs on AML/CTF measures.

The US Financial Crime Enforcement Network (FinCEN), is the agent which is mandated with the mission of safeguarding the US financial system from illicit use, counter terrorism financing and combating money laundering. FinCEN has the power to issue regulations in undertaking its mandate. Their regulations set forth requirements for money services businesses, which include financial institutions and other entities engaged in money transmission.¹⁵⁷

¹⁵¹ K V Tu *et al* "Rethinking virtual currency regulation" (2015) 322.

¹⁵² International Money Laundering Abatement and Financial Anti-Terrorist Financing Act of 2001.

¹⁵³ K V Tu *et al* "Rethinking virtual currency regulation" (2015) 326.

¹⁵⁴ K V Tu *et al* "Rethinking virtual currency regulation" (2015) 325.

¹⁵⁵ D Carlisle "VCs and financial crime" (2017) 9.

¹⁵⁶ D Carlisle "VCs and financial crime" (2017) 10.

¹⁵⁷ United States Government Accountability Office "Virtual currencies emerging regulatory, law enforcement, and consumer protection challenges" (2014) *Report to the Committee on Homeland*

In March 2013, FinCEN issued its first key federal guidance clarifying how FinCEN will apply the Bank Secrecy Act (“BSA”) and other anti-money laundering laws to VCs.¹⁵⁸ The FinCEN 2013 Guidance clarified the applicability of BSA regulations to certain participants in VCs transactions. The FinCEN 2013 Guidance is applicable to activities involving convertible VCs. Convertible VC is defined as a VC that ‘has either an equivalent value in real currency, or acts as a substitute for real currency’.¹⁵⁹

The FinCEN 2013 Guidance defines three participants in VC arrangements. Firstly it defines a *user* as a person who obtains VC to purchase goods or services. Secondly, an *exchanger* is defined as a person engaged as a business in the exchange of VC for real currency, funds, or other VC.¹⁶⁰ Thirdly, an *administrator* is defined as a person engaged as a business in issuing VC, and who has the authority to redeem such VC.¹⁶¹

The Guidance further distinguishes between centralised and decentralised convertible VCs. In relations to centralised convertible VCs (with a centralised repository) the Guidance provides that the administrator of the centralised repository is a money transmitter to the extent it allows transfers of value between persons or from one location to another, regardless of whether the transferred value is a real or convertible VC. Moreover, an exchanger that uses its access to VC services provided by the administrator to accept and transmit convertible VCs on behalf of others is also a money transmitter.¹⁶²

In connection to decentralised VCs, the Guidance provides that a person who merely creates units of convertible VC and uses those units to purchase real or virtual goods and services is a user and is not a money transmitter under the BSA Regulations. A person is an exchanger, and a money transmitter under the BSA

Security and Governmental Affairs, U.S. Senate available online at

<https://www.gao.gov/assets/670/663678.pdf> (date accessed 18 January 2019) 13.

¹⁵⁸ Financial Crimes Enforcement Network, “Application of FinCEN’s regulations to persons administering, exchanging, or using virtual currencies” (2013), Guidance FIN-2013-G001, available at <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf> [date accessed 17 January 2019] (hereafter referred to as FinCEN Guidance (2013)).

¹⁵⁹ FinCEN Guidance (2013) 1.

¹⁶⁰ FinCEN Guidance (2013) 2.

¹⁶¹ FinCEN Guidance (2013) 2.

¹⁶² FinCEN Guidance (2013) 3.

Regulations, if that person accepts such convertible VCs from one person and transmits it to another person.¹⁶³

Acting as a mere user of VC does not qualify one as a money transmitter, therefore, users are not money services business (MSB) hence they are exempted from AML regulations.¹⁶⁴ Administrator accepts and transmits a convertible VC or is involved in the buying and/or selling convertible VC. The Guidance regards administrators as money transmitters under FinCEN's regulations, unless if certain exemptions applies to them. In this case, the administrators must comply with BSA regulation.¹⁶⁵ In addition a person is an exchanger and a money transmitter under the BSA Regulations, if that person accepts decentralised convertible VC from one person and transmits it to another person as part of the acceptance and transfer of currency.¹⁶⁶

4.4. Money-Transmission Laws and Consumer Protection

A business that transmits funds from one person to another is regarded as a money transmitter.¹⁶⁷ While the BSA is aimed at preventing money laundering, the main objective of state money transmitter laws is to protect consumers from suffering financial loss as a result of the non-performance or failure of a regulated money transmitter.¹⁶⁸ Regulated money transmitters generally include businesses that transmits funds from one person to another.¹⁶⁹ While money transmission requirements differ from state to state, the universal chain that link this laws together is the requirement that money transmitters are required to obtain a license from the appropriate state regulatory body.¹⁷⁰

The importance of the role played by money transmitters can never be overemphasised. As stated by Brito and Castillo, given that money transmitters are typically not covered by the Federal Deposit Insurance Corporation (FDIC), consumers are at the risk of being “[...] left holding the bag if a money transmitter

¹⁶³ FinCEN Guidance (2013) 3.

¹⁶⁴ See R Arnfield “Regulation of Virtual Currencies: A Global Overview” 2015, 7. See also S Austin LLP “United States” (2018) 353.

¹⁶⁵ Financial Crimes Enforcement Network, “Application of fincen’s regulations to persons administering, exchanging, or using virtual currencies” (2013), *Guidance FIN-2013-G001* 3.

¹⁶⁶ Financial Crimes Enforcement Network, “Application of fincen’s regulations to persons administering, exchanging, or using virtual currencies” (2013), *Guidance FIN-2013-G001* 5.

¹⁶⁷ J Brito *et al* “Bitcoin: a primer for policymakers” (2013) 29.

¹⁶⁸ K V Tu *et al* “Rethinking virtual currency regulation” (2015) 331.

¹⁶⁹ K V Tu *et al* “Rethinking virtual currency regulation” (2015) 331.

¹⁷⁰ K V Tu *et al* “Rethinking virtual currency regulation” (2015) 331.

does not forward the funds to the intended recipient.” Licensing requirements were intended to minimize the risk posed to consumers, when they rely on a money transmitter to efficiently deliver their funds.¹⁷¹

Consumer protection is the mandate of the US federal prudential banking regulators. This includes the Board of Governors of the Federal Reserve System (Federal Reserve), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Consumer Financial Protection Bureau (CFPB) and Securities and Exchange Commission (SEC).¹⁷² Below is an overview of how these agencies has done so far in regulating VCs.

4.4.1. Application to virtual currency

4.4.1.1. Board of Governors of the Federal Reserve System (Federal Reserve)

The Federal Reserve has not taken positive steps in attempting to bring VCs to existing money transmission laws. Former Chair of the Federal Reserve, Janet Yellen confirmed, in a press conference in 2017, that the Federal Reserve does not have any direct role in regulating VCs.¹⁷³ Federal Reserve current governors have publicly commented that VCs currently do not pose risk given their limited use. They pose risk in the event of wider use and integration with the banking system.¹⁷⁴

4.4.1.2. Federal Deposit Insurance Corporation (FDIC)

The US FDIC has largely adopted the wait and see approach. While it has publically stated that it is actively studying the potential effects of VCs on the banking system it is presently monitoring the development of VCs.¹⁷⁵

4.4.1.3. Consumer Financial Protection Bureau (CFPB)

The CFPB has consumer protection supervisory authority over institutions that offer consumer financial products and services.¹⁷⁶ The CFPB has authority to adopt regulations that implement money transmission laws in the protection of financial

¹⁷¹ J Brito *et al* “Bitcoin: a primer for policymakers” (2013) 29.

¹⁷² S Austin LLP “United States” (2018) 342.

¹⁷³ Chair Yellen’s Press Conference “Transcript of Chair Yellen’s Press Conference December 13, 2017” (2017), available at <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20171213.pdf>. (date accessed 15 October 2018).

¹⁷⁴ S Austin LLP “United States” (2018) 343.

¹⁷⁵ S Austin LLP “United States” (2018) 344.

¹⁷⁶ M E Griffiths “Virtual currency businesses: An analysis of the evolving regulatory landscape” (2015) 16 *Texas Tech Administrative Law Journal* 303-331 328.

consumers.¹⁷⁷ In 2014 the CFPB issued an advisory warning consumers of the risks of transacting and investing in VCs. It has also developed a process of taking complaints relating to VC activity. To date, there have been no public enforcement action by CFPB relating to VCs.¹⁷⁸

4.4.1.4. Office of the Comptroller of the Currency (OCC)

Equally, the OCC has published little guidance on the role of national banks in VC system. On 31 July 2018, the OCC announced its intention to make available a special-purpose national bank charter, generally known as a FinTech charter that may be owned by certain non-bank financial services companies. This FinTech charter will allow a company to operate under the supervision of OCC. The license under this charter will be held under the same standards as banking institutions. However, this proposal has not been finalised.¹⁷⁹

4.5. Securities and investment laws

4.5.1. Securities laws

The Wall Street Crash of 1929 highlighted the dangers of very little regulation of securities.¹⁸⁰ The Wall Street crash led to the adoption of the Securities Act of 1933 (SA) and the Securities Exchange Act of 1934 (SEA). The main objective of the SA is to protect investors by requiring relevant financial and other significant information regarding securities being offered for public sale to be furnished to investors. This is to be achieved by prohibiting deceit, misrepresentations, and other fraud in the sale of securities.¹⁸¹ The SEA created the Securities and Exchange Commission (SEC), a statutory body which was endowed with broad authority to regulate, and oversee brokerage firms, transfer agents, and clearing agencies as well as the nation's securities self-regulatory organizations. Both these statutes require any security that is issued also to be registered with the SEC. The registration requirement enables investors to make informed decision when deciding to purchase a security. As such, securities law ensures the disclosure of material information such that investors are not misled and can make informed investment decisions.

¹⁷⁷ United States Government Accountability Office "Virtual currencies emerging regulatory, law enforcement, and consumer protection challenges" 2014 *Report to the Committee on Homeland Security and Governmental Affairs, U.S. Senate* 16.

¹⁷⁸ S Austin LLP "United States" (2018) 344.

¹⁷⁹ S Austin LLP "United States" (2018) 344.

¹⁸⁰ K V Tu *et al* "Rethinking virtual currency regulation" (2015) 337.

¹⁸¹ K V Tu *et al* "Rethinking virtual currency regulation" (2015) 337.

4.5.2. Application to virtual currency

4.5.2.1. Are virtual currencies securities?

VC is not only conceived as medium of payment for goods and services, but has increasingly been seen as a means of investing money. It is evident that determining whether VCs can be regarded as a “security” is paramount. Section 2(a)(1) of the SA defines “security” to include “any note, stock, [...] transferable share, [or] investment contract,” and many other things.¹⁸² Section 3(a)(10) of the SEA is substantially identical to the definition given by the SA.

In *Securities and Exchange Commission v. Shavers*¹⁸³ the question whether VC, specifically Bitcoin, was a security was determined. In *casu* SEC charged Shavers and his company with an offence of offering and selling investments in violation of the anti-fraud and registration provisions of securities law, specifically section 5(a), 5(c) and 17(a) of the SA and section 10(b) of the SEA. Shavers` defence that his transactions were all Bitcoin transactions and no money exchanged hands was unsuccessful. The Eastern District of Texas found the definition of securities which included an investment contract as provided in SE and SEA to be broad enough to include Bitcoin.

4.5.2.2. Securities and Exchange Commission (SEC)

The SEC's mission is "to protect investors, maintain fair, orderly, and efficient markets, as well as the facilitation of capital formation". In carrying out their mandate, the SEC issued several alerts informing investors of the potential risks of investing in Bitcoin and other VCs. The SEC`s perspective that VCs are securities was reflected in its 2017 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (“DAO Report”).¹⁸⁴ The SEC investigated whether the DAO, a token created by Slock.it, German corporation, could be classified as security in terms of SEA. The DAO was used as an initial coin offerings (ICOs) where the holders of DAO tokens stood to share in the anticipated earnings from the ICO as a return on

¹⁸² M E Griffiths “Virtual currency businesses: An analysis of the evolving regulatory landscape” (2015) 16 *Texas Tech Administrative Law Journal* 303-331 327.

¹⁸³ *Security Exchange Commission v Trendon T Shavers and Bitcoin Savings and Trust* Case No. 4:13-CV-416.

¹⁸⁴ Securities and Exchange Commission “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207” 2017, available at <https://www.sec.gov/litigation/investreport/34-81207.pdf> (date accessed 25 November 2018) (hereinafter referred to as SEC “The Dao Report” (2017)).

their investment in DAO tokens. After DAO tokens were sold, but before the DAO was able to commence funding projects, one-third of the DAO's assets were stolen. Slock.it co-founders offered DAO token holders an option to have their investment returned to them. SEC investigated the application of the US federal securities laws to the offer and sale of DAO Tokens, specifically the question whether DAO Tokens are securities. SEC ruled that DAO tokens are indeed securities under the SA and SEA.¹⁸⁵

SEC reasoned that DAO tokens are securities because investors in DAO Tokens (i) entered into an investment contract (ii) where they invested money by exchanging another VC for DAO Tokens, and (iii) the investors did so with a reasonable expectation of profit derived from the managerial efforts of the team behind the DAO.¹⁸⁶ The SEC concluded that the DAO was an issuer of securities and as such it was obliged to register its offers and sales of securities unless an exemption applied. This conclusion was based on the fact that the online platforms that traded DAO tokens met the definition of an exchange and thus either had to register or operate pursuant to an exemption from registration.¹⁸⁷

The DAO report was followed by an enforcement action in the case of *In the Matter of Munchee Inc.*¹⁸⁸ In this case, Munchee Inc sought to raise capital through the development and issuance of a digital token (MUN token). The issuance of the MUN token purported to address the issues raised by the SEC in the DAO Report.¹⁸⁹ SEC ordered Munchee Inc to cease and desist from committing or causing any violations and any future violations of Sections 5(a) and (c) of the SA.¹⁹⁰

4.5.3. Commodities laws

Like securities, commodities and derivatives are also heavily regulated with the objective of protecting “market participants and the public from fraud, manipulation, abusive practices, and systemic risk related to derivatives - both futures and swaps -

¹⁸⁵ SEC “The Dao Report” (2017) 1.

¹⁸⁶ SEC “The Dao Report” (2017) 11.

¹⁸⁷ SEC “The Dao Report” (2017) 15 -18, see also S Brown-Hruska & T Wagener, “Recent trends in virtual currency regulation, enforcement, and litigation” 2018 *NERA Economic Consulting* 9.

¹⁸⁸ *In the Matter of Munchee Inc*, Release No. 10445, Admin. File No. 3-18304 (Dec. 11, 2017), available at <https://www.sec.gov/litigation/admin/2017/33-10445.pdf> (date accessed 25 November 2018).

¹⁸⁹ *In the Matter of Munchee Inc*, Release No. 10445, Admin. File No. 3-18304 (Dec. 11, 2017) paras 1 – 3. .

¹⁹⁰ *In the Matter of Munchee Inc* para 39.

and to foster transparent, open, competitive, and financially sound markets”.¹⁹¹ The Commodity Exchange Act¹⁹² provides federal regulation of all commodities and futures trading activities and requires all futures and commodity options to be traded on organized exchanges. The CEA is enforced through the Commodity Futures Trading Commission¹⁹³ which is the primary federal derivatives regulator. The CEA tasks the CFTC with regulating financial derivative products and their markets, including commodity futures and options. The CFTC also investigates and prosecutes violations of the Commodity Exchange Act (CEA) and related regulations.¹⁹⁴

4.5.4. Application to virtual currency

The CFTC has confirmed VCs to be commodities and as such it has professed its full jurisdiction over VC derivatives and derivatives markets.¹⁹⁵ CEA defines “commodities” as “wheat, cotton, rice, corn, [...] *and all other goods and articles [...] and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in*”¹⁹⁶ (emphasis added). In the case of *In the Matter of: Coinflip, Inc, d/b/a Derivabit, et al*¹⁹⁷ (*Coinflip*), the CFTC ordered that the definition of commodities as provided by the CEA is wide enough to encompass VCs. The CFTC issued a further statement emphasising its jurisdiction over VC when such VC are used in a derivatives contract, or if there is fraud or manipulation involved.¹⁹⁸

The CFTC has actively been involved in VC enforcement regulation from around 2015. In the case of *Coinflip* the respondent was an unregistered trading facility on which Bitcoin options were traded. The CFTC determined that Bitcoin and all VCs are commodities within the definition of CEA Section 1a(9). The CFTC charged Coinflip Inc. with conducting commodity option transactions that did not comply with the CEA. After being charged with violation of a number of sections in the

¹⁹¹ J Gatto & E. Broeker “Bitcoin and beyond: current and future regulation of virtual currencies” (2015) 9 *The Ohio State Entrepreneurial Business Law Journal* 429 – 469 450.

¹⁹² Commodity Exchange Act of 1936 (hereinafter referred to as CEA).

¹⁹³ Commodity Futures Trading Commission of 1974 (hereinafter referred to as CFTC).

¹⁹⁴ M E Griffiths “Virtual currency businesses: An analysis of the evolving regulatory landscape” (2015) 16 *Texas Tech Administrative Law Journal* 303-331 324.

¹⁹⁵ CFTC “A CFTC Primer on virtual currencies” (2017) available online at https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies10041_7.pdf (date accessed 28 September 2018) (herein after referred to as CFTC “A primer of virtual currencies” (2017)), 11.

¹⁹⁶ Title 7 U.S.C. § 1(a)(9).

¹⁹⁷ CFTC No. 15-29 (Sept. 17, 2015).

¹⁹⁸ CFTC “A CFTC Primer on Virtual Currencies” 2017 11.

CEA, Coinflip consented to the order which requires it to cease and desist the online offering.¹⁹⁹

In 2016 the CFTC entered into another settlement with Bitfinex in the case of *In the Matter of: BFXNA Inc d/b/a Bitfinex*.²⁰⁰ Bitfinex was charged of operating an online platform and trading various VCs in violation of the CEA's retail commodity transactions provision that is intended to protect individual retail customers from abuse involving unregulated speculative commodities investments. In this enforcement action, CFTC concluded once again that VCs are commodities, and that the transactions were illegal, off-exchange commodity futures contracts because they were transacted with retail investors and did not result in actual delivery.²⁰¹ Bitfinex was requested to register with the CFTC as a futures commission merchant because it engaged in soliciting orders for retail commodity transactions and received funds from retail customers in connection with the transactions.²⁰²

In October 2017, the CFTC published a report titled *A CFTC Primer on Virtual Currencies* (the "Primer"). The primer confirmed the Coinflip and Bitfinex rulings which defined Bitcoin and other VCs as commodities. The Primer further confirmed the CFTC's jurisdiction when VCs are used in a derivatives contract, or if there is fraud or manipulation involving a VC traded in interstate commerce.²⁰³

In 2018 CFTC was involved in another enforcement case, namely *CFTC v. McDonnell and CabbageTech Corp (d/b/a Coin Drop Markets)*.²⁰⁴ In *casu* it was confirmed by the court that all VCs are commodities under the CEA definition, and that spot transactions in VCs are subject to the CFTC's anti-fraud and anti-manipulation enforcement authority. Although only Bitcoin futures contracts were traded on CFTC regulated designated contract markets by McDonnell, the court concluded that all VCs are goods that fall within the constraints of the definition of CEA. The court found in favour of the CFTC and the court issued a permanent injunction and assessed civil monetary penalties against the defendants.²⁰⁵

The CFTC has been instrumental in regulating commodities which are traded in VC.

¹⁹⁹ *In the Matter of: Coinflip, Inc, d/b/a Derivabit, et al* CFTC Docket No. 15-29 (Sept. 17, 2015).

²⁰⁰ CFTC No. 16-19 (June 2, 2016).

²⁰¹ *In the Matter of: BFXNA Inc d/b/a Bitfinex*, CFTC No. 16-19 (June 2, 2016).

²⁰² S Austin LLP "United States" (2018) 340.

²⁰³ CFTC "A CFTC Primer on Virtual Currencies" 2017 11.

²⁰⁴ No. 1:18-cv-00361.

²⁰⁵ *CFTC v. McDonnell and CabbageTech Corp (d/b/a Coin Drop Markets)* No. 1:18-cv-00361 para 23.

4.6. Tax regulations

The tax laws in the US impose an obligation on taxpayers to report and pay taxes on all income, regardless of the source from which the income was derived. The rise of virtual economies and currencies resulted in various tax compliance risks.²⁰⁶ The GAO identified five tax compliance risks which are posed by VC, namely: (i) users lack of knowledge regarding tax requirements; (ii) uncertainty regarding the type of income; (iii) uncertainty about calculating tax base; (iv) difficulty with third party reporting and (v) tax evasion.²⁰⁷ To mitigate some of the aforesaid risks, GAO recommended to the US Internal Revenue Service (IRS) to develop low-cost ways to provide information to taxpayers and the development of guidance on the basic tax reporting for transactions involving VC.²⁰⁸

Following the GAO report, the IRS took some steps in regulating VC. The IRS issued its first major contribution on the federal tax implications of convertible VCs transactions in March 2014 in the form of a notice.²⁰⁹ The IRS Notice 2014-21 (IRS notice)²¹⁰ provided that “VC is treated as property for US federal tax purposes.”²¹¹ This means that general tax principles that apply to property transactions apply equally to transactions using VC. The notice highlighted that (i) wages paid to employees using VC are subject to federal income tax withholding, (ii) payments using VCs made to independent contractors and other service providers are taxable and self-employment tax rules generally apply, (iii) a payment made using VC is subject to information reporting to the same extent as any other payment made in property.²¹²

The notice further noted, among other details, that “mining” VC could count as a form of self-employment, and be subject to the self-employment tax.²¹³

²⁰⁶ United States Government Accountability Office (GAO) “Virtual economies and currencies: Additional IRS guidance could reduce tax compliance risks” (2013) available at <https://www.gao.gov/assets/660/654620.pdf> (date accessed 20 September 2018) 12.

²⁰⁷ GAO “Virtual economies and currencies: Additional IRS guidance could reduce tax compliance risks” (2013) 12.

²⁰⁸ GAO “Virtual economies and currencies: Additional IRS guidance could reduce tax compliance risks” (2013) 17.

²⁰⁹ J Gatto & E. Broeker “Bitcoin and beyond: current and future regulation of virtual currencies” (2015) 99 *The Ohio State Entrepreneurial Business Law Journal* 429 – 469 447.

²¹⁰ Internal Revenue Service, “Notice 2014-21,” 2014, available online at <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> (date accessed 29 December 2018) (hereinafter referred to as IRS “Notice” (2014)).

²¹¹ IRS “Notice” (2014) 2.

²¹² IRS “Notice” (2014) 4.

²¹³ IRS “Notice” (2014) 4.

4.7. Conclusion

This chapter has described the efforts to regulate VCs in the US. It reviewed how current legislation has been extended to VCs for purposes such as deterring and detecting money laundering, collecting taxes, regulation of the issuance of securities and of those who trade in them as a business, and regulation of commodities and those who trade in them as a business. It can be noted that the US has made greater strides than most jurisdictions in regulating VCs. While it is conceded that progress has been made, more work still needs to be done, but the progress the US has made thus far can serve as a valuable example for South Africa.

CHAPTER 5: CONCLUSION AND COMMENTS

5.1. Introduction

VCs have the potential to provide substantial benefits to the financial system, market participants, and consumers. They have the potential of augmenting the efficiency of the financial system by enabling transactions to be quicker and cheap than ever before.²¹⁴ VCs also have the potential to deepen financial inclusion by bringing the “unbanked” of many developing countries into the financial system.²¹⁵ At the same time, the risks which VCs pose cannot be ignored. Consequently, it seems appropriate to rethink how to regulate them.

This chapter provides an overview of key findings and recommendations on the regulation of VC in South Africa, drawing on the experience of regulation in United State.

5.2. Overview of dissertation

The purpose of this research paper was to answer the following questions:

- i) What are VCs and what benefit and risks they pose?
- ii) To what extend are VCs regulated in South Africa?
- iii) Is there need actively adopt a more interventionist approach in regulating VCs?
- iv) To what extend has United States of America gone to regulate VCs?
- v) Are there any lessons which can be learnt from US regulatory actions towards VCs?

In addressing the first research question on the meaning of VCs and their benefits and challenges, Chapter 2 provided an overview of VC ecosystems. It is evident that VCs have a number of benefits and that simply banning them will be counterproductive. VCs offer cheaper, greater speed and efficiency in making payments and transfers and ultimately promotes financial inclusion. Inclusive

²¹⁴ R Leckow “Virtual currencies: the regulatory challenges” (2017) 36 *Yale Journal on Regulation: Notice & Comment* 132-142 135.

²¹⁵ R Leckow “Virtual currencies: the regulatory challenges” (2017) 36 *Yale Journal on Regulation: Notice & Comment* 132-142 136.

economic growth and development will be aided by improving access to financial services for the poor, vulnerable and those in rural communities.²¹⁶

At the same time, VCs pose considerable risks which hinder their effective regulation. Chapter 2 also discussed the major risks and regulatory challenges which are presented by VCs. As it stands VCs are potential vehicles for money laundering, terrorist financing, tax evasion and do not afford consumer with proper protection. The benefits provided by VCs impose pressure on regulators to devise regulation which mitigate the risks they impose to the financial system.

Research questions 2 and 3 were discussed in chapter 3 of the research paper. To gain some insights into how South Africa has approached the regulation of VCs, regulatory positions papers, user alert, media releases and proposed actions were discussed.

The National Treasury (NT) issued its “User Alert: Monitoring of virtual currencies” (NT User-Alert notice 2014) alerted the public of the risks associated with the use of VCs for either transactions or investments.²¹⁷ This was followed by the SARB ‘*Position Paper on Virtual Currencies, 2014*’ (SARB Position paper 2014) which clarified that VCs are not recognised as legal tender in the Republic of South Africa (RSA) and any merchant or beneficiary may refuse VC as a means of payment.²¹⁸ These official communications clearly indicated that VCs are currently not regulated in South Africa.

Given the intensive efforts by South African financial regulators to regulate the financial sector, the non-regulatory approach towards VCs proved to be an inappropriate response. Things appear to be changing for the better and although there are no VC specific legislation, different regulators are busy attempting to regulate VCs. SARS has indicated that VCs are taxable and the current taxation laws also apply to VCs. In January 2019, the Intergovernmental FinTech Working Group (IFWG) released its Consultation Paper which proposed a number of changes to be brought to the current AML/CFT measures, consumer protection and other areas to which VCs apply. Chapter 3 also laid an argument why immediate action is needed to regulate VCs. While taking cognisance of the fact that crafting the right, first-stage regulation of any new technology is a formidable task, failure to take any action is

²¹⁶ International Monetary Fund “Virtual Currencies and Beyond: initial considerations” (2016) 5.

²¹⁷ NT “User Alert” (2014) 1.

²¹⁸ SARB “Position Paper” (2014) 4.

equally disastrous even not more. Reminiscing the global financial crisis of 2007, it is evident that failure to regulate or adopting a light approach to regulate financial markets it not a good move.

Chapter 4 of this dissertation discussed the fourth question. The relevant comparative jurisdiction used was the US. The US has adopted some VC laws regarding their use in transactions. Consequently, the US also partook in a number of enforcement actions against certain entities or individuals dealing in VCs. In *SEC v Shavers* the court held that Bitcoin is a form of money and payment system, even though it doesn't have legal tender status.²¹⁹ In response to AML/CFT regulations, the US has amended existing money laundering legislation in order to regulate the misuse of VC transactions for money laundering purposes.

In the case of *Coinflip Inc*²²⁰ the CFTC ordered that the definition of commodities as provided by the CEA is wide enough to encompass VCs. The CFTC issued further statement emphasising its jurisdiction over VC when such VC are used in a derivatives contract, or if there is fraud or manipulation involved.²²¹ In 2018 the CFTC was involved in another enforcement action in the matter of *CFTC v. McDonnell and CabbageTech Corp (d/b/a Coin Drop Markets)*.²²² The case confirmed that all VCs are commodities under the CEA definition, hence they were subject to the CFTC jurisdiction.

5.3. Recommendations

The “wait and see” approach which South Africa currently adopts is a disaster waiting to happen especially in the otherwise heavily regulated environment within which VCs operates in. South Africa needs to do a lot more to ensure that the risks associated with VCs are mitigated. Regulators all over the globe are faced with the same challenges. South Africa has a number of lessons which they can draw from the US. The Consultation Paper of the IFWG is propelling South Africa towards a more interventionist approach which is the direction that should be adopted by South Africa.

Recommendation 1: South Africa must extend VCs to current legislation which affect the financial markets. The US has extended certain financial market

²¹⁹ *Security Exchange Commission v Trendon T Shavers and Bitcoin Savings and Trust* Case No. 4:13-CV-416, 3

²²⁰ CFTC No. 15-29 (Sept. 17, 2015).

²²¹ CFTC “A primer of virtual currencies” (2017) 11.

²²² No. 1:18-cv-00361.

legislation and regulations to include VCs. This will provide a good launch pad for VC specific legislation.

Recommendation 2: South Africa must impose registration requirements to all VC service providers. The actors which must be required to register includes: VC asset trading platforms; those providing intermediary services for the buying and selling crypto assets; those trading and exchanging VCs to fiat currency; and digital wallet providers. This will provide some level of protection to consumers especially when it comes to scamming.

Recommendation 3: All VC service providers must be required to comply with AML/CFT provisions. These provisions would require VC service providers to conduct customer due diligence, monitor and keep transactions which they are involved in.

5.4. Concluding Remarks

This dissertation has described what VCs are, the benefits and regulatory challenges they pose and efforts adopted in South Africa and the US to regulate them so far. As different VCs schemes and their use thereof continue to develop, new legal and regulatory challenges will continue to arise with such development. The need for an effective legal and regulatory framework that protects consumers, business, and the financial system will drive governments and regulatory authorities to develop innovative VC regulations.

VCs is a technological force which should be harnessed to better the financial system. VC has been accepted in South Africa as an alternative method of payment or investing without giving it the legal status of government issued currencies. Many benefits provided by VC as a payment system for users are notable. At the same time, they also pose a number of dangers for the financial industry if they remain in their unregulated status.

Bibliography

Literature

Acuña G A & Pullas A S “The digital currency challenge for the regulatory regime” (2016) 5 *Revista Chilena De Derecho Y Tecnología* 173-209.

Ajello NJ, “Fitting a square peg in a round hole: bitcoin, money laundering, and the Fifth Amendment privilege against self- incrimination,” (2015) 80 *Brooklyn Law Review* 435 – 461.

Arnfield R “Regulation of Virtual Currencies: A Global Overview” *Networld Media Group* 2015, 7.

Austin LLP S “United States” In Sackheim M S & Howell N A (eds) *The virtual currency regulation review* (2018) London: Law Business Research Ltd Chapter 30.

Brito J & Castillo A “Bitcoin: a primer for policymakers” (2013) *Mercatus Center at George Mason University*.

Brown-Hruska S & Wagener T, “Recent trends in virtual currency regulation, enforcement, and litigation” 2018 *NERA Economic Consulting*.

Bryans D “Bitcoin and money laundering: mining for an effective solution” (2014) 89 *Indiana law journal* 441-472.

Carlisle D “Virtual currencies and financial crime: Challenges and opportunities” 2017 *Royal United Services Institute*.

De Mink J “Dangers inherent in Bitcoin and other cryptocurrencies” 2018 *De Rebus* 33-35.

Everette J “Risks and vulnerabilities of virtual currency cryptocurrency as a payment method” 2017 *Public-Private Analytic Exchange Program*.

Falkena H, Bamber R, Llewellyn D & Store T, *Financial Regulation in South Africa* (2nd ed 2001).

Fu A “China” in Sackheim M S & Howell N A (eds) *The virtual currency regulation review* (2018) Chapter 9.

Gatto J & Broeker E “Bitcoin and beyond: current and future regulation of virtual currencies” (2015) 9 *The Ohio State Entrepreneurial Business Law Journal* 429 – 469.

Griffiths M E “Virtual currency businesses: an Analysis of the evolving regulatory landscape” (2015) *Texas Tech Administrative Law Journal* 303 – 331.

Grinberg R “Bitcoin: An Innovative Alternative Digital Currency” (2011) 4 *Hastings Science & Technology Law Journal* 159 – 208.

Houben R & Snyers A “Cryptocurrencies and blockchain: Legal context and implications for financial crime, money laundering and tax evasion” 2018 *Policy Department for Economic, Scientific and Quality of Life Policies*.

Hughes S D “cryptocurrency regulations and enforcement in the U.S.” 2017 *Western State Law Review* 3.

Hunton & Williams, “Recent development in the regulation of bitcoin under state and federal securities law” 2014 *Client Alert* 58.

Itzikowitz A, Meiring I & Gunning E “South Africa” in J Dewey (ed) *Blockchain & Cryptocurrency Regulation* (1st ed 2019) London: Global Legal Group Ltd 432 – 437.

Kayondo S *Aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience* 2016 LLM University of Pretoria.

Leckow R “Virtual currencies: the regulatory challenges” (2017) 36 *Yale Journal on Regulation: Notice & Comment* 132-142.

Lim J W “A facilitative model for cryptocurrency regulation in Singapore” in Lee Kuo Chuen (ed) *Handbook of digital currency: Bitcoin, Innovation, financial instructions and bid data* (2015) London Chapter 18.

Marian O, “A conceptual framework for the regulation of cryptocurrencies” (2017) 82 *University of Chicago Law Review Online* 53- 68.

McConnell K “Best practice for bitcoins regulatory, legal and financial approaches to virtual currencies in a hesitant, global environment.”

Nieman A “A few South African cents' worth on bitcoin” (2015) 18 *PER* 1979 – 2011.

Orffer M *The inclusion of virtual currencies in the calculation of income tax* (2018) LLM Dissertation (North-West University).

Van der Westhuizen C, *Future digital money: the legal status and regulation of bitcoin in Australia* (2017) LLM Thesis University of Pretoria.

Case law

US case law

In the Matter of Munchee Inc, Release No. 10445, Admin. File No. 3-18304 (Dec. 11, 2017), <https://www.sec.gov/litigation/admin/2017/33-10445.pdf>.

Security Exchange Commission v Trendon T Shavers and Bitcoin Savings and Trust Case No. 4:13- CV-416.

In the Matter of Munchee Inc. Release No. 10445, Admin. File No. 3-18304 (Dec. 11, 2017).

In the Matter of: Coinflip, Inc, d/b/a Derivabit, et al CFTC No. 15-29 (Sept. 17, 2015).

In the Matter of: BFXNA Inc d/b/a Bitfinex CFTC No. 16-19 (June 2, 2016).

CFTC v. McDonnell and CabbageTech Corp (d/b/a Coin Drop Markets) No. 1:18-cv-00361.

Legislation

SA legislation

Banks Act 94 of 1990.

Constitution of the Republic of South Africa, 1996.

Consumer Protection Act 28 of 2008 (CPA).

Exchange Control Regulations, 1961.

Financial Advisory and Intermediaries Services Act, 2002.

Financial Intelligence Centre Act 31 of 2001.

Financial Intelligence Centre Amendment Act 1 of 2017.

Financial Markets Act 19 of 2012.

Financial Sector Regulation Act 9 of 2017.

Financial Services Ombuds Schemes Act, 2004.

Income Tax Act 58 of 1962.

National Credit Act, 2005.

Taxation Laws Amendment Act 23 of 2018.

The South African Reserve Bank Act 90 of 1989.

Value Added Tax Act 89 of 1991.

US legislation

Bank Secrecy Act of 1970 as amended by the USA Patriotic Act 31 U.S.C.

Commodity Exchange Act

International Money Laundering Abatement and Financial Anti-Terrorist Financing Act of 2001.

Securities Act of 1933

Securities Exchange Act of 1934

Others

CFTC “A CFTC Primer on Virtual Currencies” 2017, available at

https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_prime_rcurrencies100417.pdf.

Chair Yellen’s Press Conference “Transcript of Chair Yellen’s Press Conference December 13, 2017” (2017) online at

<https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20171213.pdf>.

Coindesk <https://www.coindesk.com/price/> (Accessed on 20 September 2018).

Eha B P “Why Regulate Bitcoin?” 2013

<http://www.newyorker.com/business/currency/why-regulate-bitcoin>

European Central Bank “Virtual currency Scheme” 2012.

European Central Bank “Virtual Currency Schemes – A Further Analysis” 2015.

EY “Financial Sector Regulation Act: Implementing Twin Peaks and the impact on the industry” [http://www.ey.com/Publication/vwLUAssets/ey-financial-sector-regulation-act-twin-peaks/\\$FILE/ey-financial-sector-regulation-act-implementing-twin-peaks-](http://www.ey.com/Publication/vwLUAssets/ey-financial-sector-regulation-act-twin-peaks/$FILE/ey-financial-sector-regulation-act-implementing-twin-peaks-and-the-impact-on-the-industry.pdf)

[and-the-impact-on-the-industry.pdf](http://www.ey.com/Publication/vwLUAssets/ey-financial-sector-regulation-act-twin-peaks/$FILE/ey-financial-sector-regulation-act-implementing-twin-peaks-and-the-impact-on-the-industry.pdf).

FATF Force “Virtual Currencies Key Definitions and Potential AML/CFT Risks” 2014
FATF Report 1-15.

Financial Crimes Enforcement Network, “Application of FinCEN’s regulations to persons administering, exchanging, or using virtual currencies” (2013), Guidance FIN-2013-G001, <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

Financial Intelligence Centre “A new approach to combat money laundering and terrorist financing 13 June 2017”

<https://www.fic.gov.za/Documents/A%20NEW%20APPROACH%20TO%20COMBAT>

[%20MONEY%20LAUNDERING%20AND%20TERRORIST%20FINANCING%20\(2\).pdf.](#)

Financial Regulation Reform Steering “Committee implementing a twin peak model of financial regulation in South Africa” 2013.

IMF Staff Discussion Note, “Virtual Currencies and Beyond: Initial Considerations” 2016.

Intergovernmental FinTech Working Group “Consultation paper on policy proposals for crypto assets” 2019, available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9037/CAR%20WG%20Consultation%20paper%20on%20crypto%20assets_final.pdf.

International Monetary Fund “Virtual Currencies and Beyond: Initial Considerations” 2016.

International Money Laundering Abatement and Financial Anti-Terrorist Financing Act of 2001.

Kiel Institute for the World Economy “Virtual currencies: monetary dialogue July 2018”

Mabunda S “Cryptocurrency: The new face of cyber money laundering” (2018) 2, available at <http://dx.doi.org/10.1109//ICABCD.2018.8465467> (date accessed: 17 July 2018).

National Treasury “User Alert: Monitoring of virtual currencies” 2014, Available at http://www.treasury.gov.za/comm_media/press/2014/2014091801%20-%20User%20Alert%20Virtual%20currencies.pdf.

Securities and Exchange Commission “Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO, Exchange Act Release No. 81207” 2017 <https://www.sec.gov/litigation/investreport/34-81207.pdf>.

South African Reserve Bank “Position Paper on Virtual Currencies” 2014, Available at [https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem\(NP\)/](https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NP)/)

[Legal/Documents/Position%20Paper/Virtual%20Currencies%20Position%20Paper%20%20Final_02of2014.pdf](#).

Steyn G “Crypto shake-up: SARB publishes regulation views on cryptocurrency” 15 January 2019 *Business Report*, available at <https://www.iol.co.za/business-report/economy/crypto-shake-up-sarb-publishes-regulation-views-on-cryptocurrency-18840077>.

The Financial Action Task Force “Virtual Currencies Key Definitions and Potential AML/CFT Risks” 2014 *FATF Report* 1-15.

The Warwick Commission “The Warwick Commission on International Financial Reform: In praise of unlevel playing fields” 2009 *The University of Warwick*.

United States Government Accountability Office (GAO) “Virtual economies and currencies: Additional IRS guidance could reduce tax compliance risks” (2013) 12 available at <https://www.gao.gov/assets/660/654620.pdf>.

United States Government Accountability Office “Virtual currencies emerging regulatory, law enforcement, and consumer protection challenges” 2014 *Report to the Committee on Homeland Security and Governmental Affairs, U.S. Senate*.