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Message from the Immediate Past Section Chair

By Nancy M. Thevenin

Dear Members of the International Section:

At the end of my term as chair of the International Section, I want to recap our accomplishments in the last several months and thank several people for making them possible.

I. Events

The first major event was our **Seasonal Meeting in Antigua, Guatemala**, featuring three days of excellent panels and networking opportunities in a historic and beautiful environment. Many thanks to the steering committee, which was ably led by **Jay Safer** of Wollmuth Maher & Deutsch LLP; **Jay L. Himes** of Labaton Sucharow, and especially **Ruby Asturias** of Pacheco Coto in Guatemala. Ruby came to us with an ambitious idea, which she made a reality through her tireless efforts. The result was an exceptional experience that allowed participants to forge stronger ties with our colleagues in Latin America.

This was followed by our **Annual Meeting** in New York, where we approved the new officers who will be leading us this coming year. We also named **Caroline Fish** of St. John's University Law School as the winner of our Pergam Writing Competition for her article on human trafficking and awarded the Distinction in International Law and Affairs Award to **Judge Iris Yassmin Barrios Aguilar**, former president of one of Guatemala's High-Risk Tribunals. The day ended with panel discussions organized by program chair, **Carlos Ramos-Mrosovsky** of Aston & Bird, on "Digital Currencies and the Disruption of International Finance" and "International Business Disputes in an Age of Nationalism," both of which were well-received and continue to be even more relevant topics months later.

Thereafter, we joined St. John's University School of Law, which edits our *New York International Law Review* (NYILR), in organizing a **Symposium to Celebrate the 30th Anniversary of the NYILR**. The Symposium commenced with a special dinner featuring **D. Stephen Mathias**, Assistant Secretary-General for Legal Affairs at the United Nations, who gave a rousing speech about changes at the United Nations. This was followed by a full-day of programs that focused on the central role of New York in cross-border dispute resolution,

continued on page 4

Message from the New Section Chair

By William Schrag

Welcome to the New York State Bar Association International Section's *International Law Practicum and Chapter News*. The International Section is a dynamic group of attorneys based all over the world that practice international law. If you are reading this, chances are that you are already a member of our Section. If you are not, membership in this Section offers many opportunities to participate in seminars and conferences on important international law topics, meet and network with other international attorneys and stay current with developments in international law through those events and our leading international publications.

We invite you to explore our more than 40 substantive law committees, including committees on Energy and Natural Resources, International Banking, Corporate Counsel, Litigation and Tax. Once a member of our Section, you are welcome to join the committees that reflect your areas of interest and practice. Regardless of your membership in the International Section, however, you are more than welcome to attend a number of our committee programs.

If you practice outside of the United States, we invite you to consider joining one of our overseas chapters. With over 65 chapters in places like London, Colombia, Beijing, Sao Paolo, and Singapore, there are fellow International Section members in nearly every jurisdiction around the world.

In addition to our committees and chapters, which provide professional growth and networking opportunities, we encourage members to participate as organizers, speakers or attendees at our yearly educational programs and networking events and to contribute their views on our discussion forums.

Our International Section Publications Include:

- This publication, the *International Law Practicum*, which features peer-written, substantive articles relating to the practical needs of attorneys in an international setting, emphasizing clinical matters and exploring the application of international law for the generalist.

continued on page 4

Table of Contents

Message from the Immediate Past Section Chair 2

Message from the New Section Chair 2

Message from the Editor 6

Practicum: Form and Policy 7

Practicum

Blockchain and Cryptocurrency: An Introduction and Primer...8
Mayme Donohue

Cryptocurrency Is Borderless—but Still Within the Grip of U.S. Regulators...................................... 11
David H. McGill, Benjamin J.A. Sauter and Beau D. Barnes

Real Property Transfers Ripe for Blockchain Disruption: Laws in the U.S. Must Follow the Technology...16
Mercedes Tunstall, Andrew Caplan, Nathalie Prescott and Brittney Sandler

U.S. Intellectual Property Protection in the Blockchain Industry: Trends and Solutions 21
Matthew R. Schantz and Jeffery T. Gorham

Korean Regulation and Taxation of Cryptocurrencies 26
Soo-Jeong Ahn, Gun Kim, Hyo Sung Lee, Jin Soo Soh and Ja Young Lee

The Korean Premium: Cryptocurrency —Arbitrage Phenomenon in Korea.........................30
Samuel Yim, Gye-Jeong Kim and Mooni Kim

Cryptocurrency Regulation in Canada........................35
Ana Badour and Shauvik Shah

Cryptocurrencies: The Cayman Islands Is Open for Business, for Now 41
Jalil Asif QC, Rebecca Hume and Pamella Mitchell

Cryptocurrency Regulation in Australia 43
Peter Reeves

The Public Offering of Coins and Tokens Under Austrian Capital Markets Law 46
Stefan Paulmayer

Cryptocurrencies as Such and the Austrian Capital Markets Law 50
Raphael G. Toman

Regulation of Cryptocurrencies and Initial Coin Offerings in Switzerland: Declared Vision of a "Crypto Nation"..53
Joanna Diane Caytas

German Regulation of Cryptocurrencies and ICOs...61
Michael Jünemann

Regulation of Cryptocurrencies and Initial Coin Offerings in Poland—Ambivalence at Its Best......65
Joanna Diane Caytas

Chapter News

The Brazil Chapter of the NYSBA International Section...81
Gerald Ferguson

French Chapter Latest News and Plans in 2018 82
François Berbinau

United States Rethinks Its Exiting TPP as Remaining 11 Countries Sign the New Agreement, Which Includes Significant Investment Protections...........................83
Joaquin P. Terceño and Daniel Allen

Canadian Issuers Focused on Legalized Marijuana, but Keep an Eye on the United States 87
Gordon N. Cameron

Why Blackrock's 2018 CEO Letter Matters to Your Company 91
Azish Filabi, Theano Manolopoulou and Julee Milham

Orphan Drug Approval Route Under Ecuadorian Legislation...93
David A. Maldonado

The Past, Present and Possible Future of the Spanish Renewable Energy Arbitration Saga.........96
Clifford J. Hendel and María Antonia Pérez

Intra-EU BITs Arbitration Clause Ruled to Be Against EU Law by the Court of Justice of the European Union 102
Alessandro Benedetti and Iacopo De Totero

Protecting Personal Data: Companies Not in Compliance With EU Regulations Face Serious Penalties...104
François Berbinau

Italian Supreme Court Gives the Green Light to Foreign Judgments Granting Punitive Damages..108
Stefania Boscarolli

New Legislation on Registration of Beneficial Owners.. 111
Carl-Olof Bouveng and Richard Perez

Russian Sanctions: How Do They Affect U.S. Business? 113
Serhiy Hoshovsky

Recent Developments—Financial Centers in the Gulf..114
David Russell QC

The Section's Officers 116

The Section's Committee Chairs...............................118

The Section's Chapter Chairs 119

The Section Welcomes New Members......................120

Immediate Past Chair Message, continued from page 2

international deals and investments and public international law. These riveting discussions and the papers they inspired will be published in the next NYILR. Many thanks to Professor Margaret McGuinness, the entire NYILR editing team, with special thanks to Jennifer Ismat and Ipek Basaran at St. John's for organizing the Symposium.

We then held our first ever **Asia Regional Meeting** in Seoul, South Korea. Co-Chaired by **Hyun Suk Choi** of Choi & Park and **Neil Quataro** of Watson Farley & Williams, the conference helped bring together our chapter chairs in Japan, Singapore, China and Vietnam. We were hosted and warmly welcomed by the Seoul Bar Association (SBA) and the Seoul High Court. This amazing cultural experience, which featured thought-provoking panels on, *inter alia*, international trade and investment and cross-border insolvency, led to the signing of a Memorandum of Understanding (MOU) with SBA, and the Seoul Bankruptcy Court signing an MOU with the Bankruptcy Court of the Southern District of New York. Overall, the conference helped us create new opportunities and build upon existing relationships with our colleagues in Asia.

Many thanks to the conference co-chairs, our hosts in Seoul, as well as **Chief Judge Cecilia B. Morris** of the Bankruptcy Court of the Southern District of New York, **Judge Sydney Stein** of the U.S. District Court of the Southern District of New York, and special recognition to **Judge Jennifer Choe-Groves** of the United States Court of International Trade, who became a key feature of our program.

We ended the year by hosting a delegation of 30 law school deans and law firm managing partners from **China** with a dinner in New York City, and then a visit to the Southern District of New York Courthouse the following day. Special thanks to **Mike He** of Zhihe College, who co-chairs our China Chapter, for organizing this trip and to the judges and staff at SDNY for facilitating our visit.

II. Chapters

Developments in our chapters worldwide include appointing **Paul McGarry, SC** who joined **Eve Mulconry** of Arthur Cox as co-chairs of our Ireland Chapter; **May Kim Ho** of Duane Morris as chair of our Singapore Chapter and regional chair for the Asia chapters; **Michael Bowes** of Outer Temple Chambers as co-chair of our UK Chapter; **Anke Meier** of Noerr as co-chair of our Germany Chapter; **David Harrell** of Locke Lord as co-chair of our newly created Texas Chapter; and **Rico V. Domingo** of R.V. Domingo & Associates as chair of the Philippines Chapter.

III. Committees

As for our committees, we approved new guidelines for managing committees and created a new committee on Cybersecurity and Data Privacy appointing **Gerald**

continued on page 5

New Chair Message, continued from page 2

- The *New York International Law Review*, which provides substantive articles related to the practice of international law on such topics as NAFTA, the collection of money judgments outside the U.S., foreign direct investments and trade agreements

We just completed our signature event, the Global Law Week, on June 11-13, in New York City, featuring an International Law Bridging the Gap program on June 14-15.

You are also invited to attend the following events that our Section has planned for the coming months:

- Our Seasonal Meeting on October 24-26 in Montreal, Canada.
- Our Annual Meeting on January 14, 2019 in New York, NY.

A list of our schedule events and sponsored programs can always be found at www.nysba.org/ilp.

The International Section aims to fulfill the professional needs of those interested in and practicing public or private international law. We hope to welcome you as a member or have your participation in our activities and events.

Feel free to contact me directly at william.schrag@thompsonhine.com if you are interested in joining this vibrant group. You can also always contact the New York State Bar Association's Member Resource Center at mrc@nysba.org; 518.463.3200/800.582.2452, with any membership or Section question.

With best regards,
William H. Schrag
Section Chair
NYSBA Member Since 1979

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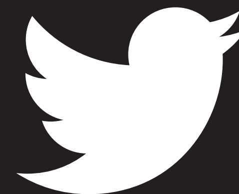

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continued from page 4

Ferguson of BakerHostetler and **Corey Omer** of Sullivan Cromwell as its co-chairs; appointed **Thomas Telesca** of Ruskin Moscou Faltischek P.C. and **Rekha Rangachari** of the New York International Arbitration Center as co-chairs of the Committee on International Contracts and Commercial Law; and changed the name of the Art Law Committee to the Committee on International Private Restitution, appointing **Teresa Peacocke** of Outer Temple Chambers to be its chair.

IV. Publications

On publications, NYILR has been and remains our signature publication and now has a new design in popularity. We appointed **Torsten M. Kracht** of Hunton Andrews Kurth as the new vice-chair of publications and chair of the editorial board for the *International Law Practicum (Practicum),* which includes the *Chapter New*s. **Dunniela Kaufman** of Kaufman Trade Law remains its editor but has now been joined by **Beatriz Marques** as co-editor of the *Chapter News*. We have NYSBA email for publication submissions and continue to seek additional volunteers to help review and edit the submissions for these publications. If you are interested, please contact Tiffany Bardwell at tbardwell@nysba.org.

V. Special Projects

We also worked on two special projects initiated by our Latin American Council (LAC), a group of attorneys practicing or interested in Latin America.

LAC Best Practice Guidelines

The first is a set of ethical guidelines drafted by LAC for Latin American counsel engaged in cross-border legal work. Many thanks to the Section Executive Committee team with whom I had the pleasure to serve including **Kenneth Standard** of Epstein, Becker & Green; **Neil Quataro** of Watson Farley & Williams; **Lawrence Darby** of the Law Offices of Lawrence A. Darby; and **Gonzalo Zeballos** of Baker Hostetler, who worked on the Guidelines, which were later approved by the Section. The Guidelines are on to bigger things and news about that should be coming in the next few weeks.

LAC Training Program for Young Latin American Lawyer

LAC also launched a training program for junior Latin American attorneys to work with New York-based firms (or firms with a New York office) for up to three months at no cost to the firm. For more information about this program, please contact **Sandra González** and **Rodrigo Solá Torino,** Co-Chairs of the LAC Training Program, at sgonzalez@ferrere.com and RST@marval.com, respectively.

My thanks to LAC's immediate past chair, **Sandra González** of Ferrere Abogados, and especially to LAC's current chair, **Mary Fernandez** of Headrick, for their innovative leadership of this engaged group.

VI. Recent and Upcoming Events

As for recent and upcoming events, please see the following information:

- June 11 to 13: **Global Law Week** (GLW), one of our signature events, GLW featured various panels on different international law topics organized around New York City. Generously sponsored by the hosting firms, these programs were free of charge, so be sure to take advantage of the educational and networking opportunities they present in the future.
- June 14-15: **Bridging the Gap**, organized for new attorneys or those who want to refresh their skills in international legal practice, this two-day course aimed to prepare participants embarking on an international practice in New York or representing New York clients.
- October 24-26: **Seasonal Meeting in Montreal**, co-chaired by **Mark Rosenberg** of Sullivan & Cromwell in New York and **Stéphanie Lapierre** of Stikeman Elliott LLP in Montreal, this conference promises to be one of our best meetings ever. Save the date on your calendars and plan to be there if at all possible.

VII. Other Business

Finally, building upon the work of my predecessors, I leave the Section in the best financial shape it has been in in some years, yet work still needs to be done on membership. I hope this report motivates you to renew your membership and to spread the word to your colleagues and friends about our Section. If you have any questions about how to join or to check on your membership status, please contact Tiffany Bardwell at tbardwell@nysba.org.

In conclusion, none of the activities described above would have been possible without the support of our Senior Executive Committee members: **William "Bill" Schrag** of Thompson Hines; **Diane O'Connell** of PricewaterhouseCoopers; **Jay L. Himes** of Labaton Sucharow; and **Edward Lenci** of Hinshaw Culbertson. My thanks to each one and especially to **Neil Quartaro** of Watson Farley & Williams for his work on numerous projects as well as on the GLW and BTG programs. Many thanks to the past chairs of this Section who are still actively engaged with the Section's work, to **NYSBA's immediate past President Sharon Stern Gertsman** and past president **Claire Gutekunst**, for their support and guidance; to **Tiffany Bardwell** of NYSBA for her tireless efforts on the Section's behalf, and to all of you for your membership, your attendance at our meetings and your participation in our activities. As you can see, like New York itself, this is a vibrant and dynamic group, unique in state bar associations across the United States, and we welcome your voice and engagement in our activities.

Thank you for the honor of serving as your chair this past year. Please join me in welcoming **Bill Schrag** of Thompson Hines as your new Chair for the 2018-2019 term.

With best regards,
Nancy M. Thevenin
Immediate Past Chair
NYSBA International Section

Message from the Editor

By Torsten Kracht

Dear Friends and Readers:

It is an honor and privilege to welcome you to the 31st volume of the *International Law Practicum*, my first since being appointed vice-chair of publications for our Section and assuming the role of editor-in-chief for the *Practicum*. I first had the good fortune of editing for the *Practicum* well over a decade ago when David Detjen at Walter, Conston, Alexander & Green led the publication. For almost twenty years now, the *Practicum* has been dedicated to featuring articles of interest to New York lawyers engaged in international practice. I intend to commit at least one of our biennial publications to a central topic or theme and would appreciate hearing from you if there are particular topics or themes that you think may be of interest to our readership. The central topic for this issue is blockchain technology and the regulation of cryptocurrencies in various jurisdictions.

In recent years, entrepreneurs and businesses large and small around the world have been focused on the application of blockchain technology to their businesses. In response, governments have considered and implemented a wide range of regulatory approaches to monitor and address the unique attributes of the technology and the products associated with it, including cryptocurrencies. For those unfamiliar with the technology, this edition starts with an introduction and primer on blockchain technology and cryptocurrency. The articles that follow explore the specific regulatory regimes of countries such as Australia, Germany, Korea, Canada, and Switzerland as they relate to the technology.

Many hours of hard work have gone into producing this exciting new issue. In addition to our contributing authors, I would like to thank Simone Smith at NYSBA for her tireless efforts to bring this edition to print, and our executive editor, Andria Adigwe, for assembling and leading our team of talented student editors, including Christina Graziadei (Syracuse University College of Law), Karen Jin (University of Virginia School of Law), Aaron Records (Syracuse University College of Law), Vincent Rotondo (New York Law School), Matthew Venuti (Villanova University School of Law), and Bernard Katz (Georgetown University Law Center).

I hope this issue provokes further thought and discussion. Feedback and suggestions about this edition or the *Practicum* in general are highly encouraged and I hope that together, as a community, we can continue to develop our publication as a practical forum for the exchange of useful information for our members.

Best,
Torsten M. Kracht
tkracht@hunton.com

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PRACTICUM: FORM AND POLICY

The *International Law Practicum* is a semi-annual publication of the International Section of the New York State Bar Association. The *Practicum* welcomes the submission of articles prepared by practicing attorneys. The length of an article, as a general rule, should not exceed 10,000 words, footnotes included. Shorter pieces, notes, reports on current or regional developments, and bibliographies are also welcomed. All manuscripts must be sent via e-mail in Microsoft Word or WordPerfect format to ILPArticles@nysba.org. Both text and endnotes must be double-spaced. Endnotes must appear at the end of the manuscript and should conform to *A Uniform System of Citation* (the Harvard Bluebook). Authors are responsible for the correctness of all citations and quotations. Manuscripts that have been accepted or published elsewhere will not be considered. The *Practicum* is primarily interested in practical issues facing lawyers engaged in international practice in New York. Topics such as international trade, licensing, direct investment, finance, taxation, and litigation and dispute resolution are preferred. Public international topics will be considered to the extent that they involve private international transactions or are of general interest to our readership.

Manuscripts are submitted at the sender's risk, and the New York State Bar Association, International Section, assumes no responsibility for the return of material. Material accepted for publication becomes the property of the New York State Bar Association, International Section. No compensation is paid for any manuscript. The *Practicum* reserves the right (for space, budgetary, or other reasons) to move an accepted manuscript from an earlier issue to a later issue. Articles, reports and other materials reflect the views of the authors or committees that prepared them and do not necessarily represent the position of the New York State Bar Association, International Section, or the Editorial Board of the *Practicum*.

Deadlines

Manuscripts intended for publication in the semi-annual issues must be received by the Editor-in-Chief by the preceding 1 December and 1 June, respectively.

Reprints

Each author will receive three complimentary copies of the *Practicum* issue in which the author's material is published. Additional copies may be ordered at cost before an issue goes to press by communicating with at the Newsletter Dept., New York State Bar Association, One Elk Street, Albany, N.Y. 12207-1096 (telephone (518) 487-5671 or 487-5672) or via e-mail at newsletters@nysba.org.

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Requests for back issues, advertising and subscription information and general correspondence should be sent to the Newsletter Dept., New York State Bar Association, One Elk Street, Albany, N.Y. 12207-1096 or via e-mail at newsletters@nysba.org.

Back issues (2000 to present) of the *International Law Practicum* are available, in pdf format, online to Section members on the New York State Bar Association's Web site at www.nysba.org/IntlPracticum. A searchable index is also available.

PRACTICUM

Blockchain and Cryptocurrency: An Introduction and Primer

By Mayme Donohue

Blockchain may be new, but the trajectory of disruptive technologies from inception to widespread adoption is a familiar path. Consider how much has changed since the internet was first introduced to mainstream use and e-mail and online shopping were novelties rather than primary tools for communication and commerce. Since the 1990s, people around the world have become increasingly dependent on the Internet and the immediate ability to communicate and engage in commerce. Without thinking much about the technical mechanics of the Internet, society relies on it as a resource for almost everything.[1] Of the billions of people dependent on the internet for commerce and entertainment, only a small fraction of individuals actually understand how or why it works. People just trust it, because the internet has proven itself over time as a tool worth using. There are flaws and cybersecurity issues, but our global society has come to the tacit agreement that the benefits far outweigh the potential risks of conducting business and sharing personal content on the internet.

Mayme Donohue

Born from the internet's connectivity, blockchain technology is charting a similar course in the history of technological advancement. Though development of this disruptive technology began in the early 1990s, the first blockchain was born with the release of the Bitcoin protocol almost 10 years ago by the pseudonymous individual (or individuals), Satoshi Nakamoto.[2] As Bitcoin matured and its market expanded, the blockchain that settled peer-to-peer transactions in virtual currency began to emerge as the playground for technologists and entrepreneurs around the world. At its core, the Bitcoin blockchain allowed for peer-to-peer payments processing without the use of a central intermediary, cutting out the numerous parties currently involved and taking fees in the payments processing lifecycle.[3] Institutions responsible for settling all types of financial transactions are now racing to own the blockchain solutions that stand to replace their role our financial ecosystem.[4] Beyond finance and cryptocurrencies, business enterprise applications for blockchain are exploding onto the scene as the world's largest companies are all investing in the technology.[5] In the same way that the internet's beginnings look nothing like the internet we know today, it is impossible to predict the contours of blockchain's eventual mainstream adoption and widespread dependence. Despite that uncertainty, blockchain has had, and will continue to have, a growing impact on the global economy and the fundamental ways businesses operate.

Blockchain Basics

As is true with most technologies people trust and use daily, it is much more important to understand what blockchain can do as a tool and resource, rather than understand the technical processes behind the technology. The percentage of internet users who know what their IP address is, or how to find it for that matter, is likely very low. Understanding the basic mechanics of how a blockchain operates, however, unlocks the ability to think creatively about how this new technology can be applied across industries. Additionally, the legal profession needs a basic understanding in order to apply blockchain to existing legal and regulatory frameworks around the world.[6]

Blockchain is a decentralized record keeping system that leverages military grade cryptography and complex mathematical algorithms to create a secure, immutable and chronological ledger of transactions. Said another way, blockchain is a distributed ledger that records and organizes transactions in "blocks" of data that are irreversibly "chained" together using cryptography to secure the record and prove the identities of the parties to the transaction. Each participant in a particular blockchain system maintains an identical copy of the ledger of all transactions since the beginning of that blockchain. As each new block is added to the chain, the copy of the ledger maintained by each participant is automatically updated in real-time. Rather than relying on a central intermediary to verify and settle transactions, the network of "nodes" that make up a blockchain does the work of comparing the multiple copies of the ledger to ensure only valid transactions are included in new blocks.

Because the code that runs a blockchain allows each participant in the system to individually store the history of transactions, the network of participants collectively knows whether the parties to a transaction actually own the assets being traded. A blockchain only settles transactions that the network agrees are valid by achieving a consensus among the distributed copies of the ledger. For example, in the Bitcoin context, if Person A originally purchased five bitcoins, the blockchain would record that transaction and update the ledger across participants to show that Person A owns five bitcoins. If Person A buys a service from Person B in exchange for three bitcoins, the blockchain would check that transaction against the distributed ledger and, upon consensus from the network of participants, that transaction would be validated, settled and recorded in a new block to the ledger. With the addition of the new block, each participant's ledger updates to show that Person A owns two bitcoins and Person B owns three bitcoins. Next, if Person A attempts to buy something from Person C in exchange for three bitcoins, the network would reject that transaction because the ledger maintained by each participant would show Person A does not have sufficient bitcoins to settle that transaction.

The security built into the code and systems governing blockchains allow parties that do not know each other and have no reason to trust each other to transact business. To begin with, the cryptography and algorithms used to validate the record and participants' identities is extremely secure. In fact, to date there have been no successful hacks of the Bitcoin blockchain; rather, all of the reported hacks related to Bitcoin were security breaches at the individual user or third-party vendor level. Additionally, the fact that the ledger is shared among participants means there is no single copy of the truth and, therefore, no single weak point for a bad actor to target. If any individual's copy of the ledger is tampered with, when a blockchain compares ledgers to create consensus, that single incorrect copy will not be acknowledged and will be overwritten with the addition of a new block of transactions. Furthermore, the requirement that the network agree to a new transaction before settling and recording it eliminates the possibility that a participant can double-spending a bitcoin in two separate transaction. While there are no perfect systems, blockchain offers a superior framework within which transactions have the potential to be settled faster, for less money and with more security than the current systems.

Blockchain's Practical Applications

Contrast the example above to the current payment processing lifecycle, which includes multiple intermediaries each extracting fees, and it becomes clear why the world's largest financial institutions are rushing to develop proprietary blockchain solutions. Billions of dollars are being invested around the world to develop blockchains for settling a wide variety of financial transactions, including securities offerings and settlement, loan syndication, payment processing and more.[7] Financial institutions have a clear interest in creating blockchain platforms in an order to preserve their relevance in commerce. As these blockchain platforms mature and currency evolves from fiat to a crypto, the entire financial model within which the world operates today could look entirely different in the coming decades.

Blockchain's applications expand far beyond finance, and business enterprise blockchain solutions are some of the most creative and interesting applications of the technology.[8] Supply chain, for example, is one of the most developed landscapes for blockchain innovation. By applying the same mechanics described above related to a transaction in bitcoin to the movement of goods and assets around the globe, supply chains become more efficient, transparent and trusted. Particularly within the context of food safety, blockchain-based supply chains have the potential to save lives in in addition to money. Major retailers have found that using a blockchain-based system for tracking food from farm to consumer reduces the time it takes to identify the origin of a contaminated food product from almost seven days to just over two seconds.[9] In addition to supply chain applications, blockchain is being explored to, among other things, manage electronic health records, secure rights to digital media, enhance energy grid management and even improve government administration.[10] As the blockchain develops, new applications reveal themselves and it is impossible to predict the breadth of applications that will achieve widespread adoption in the years to come.

The Lawyer's Role in Blockchain's Future

Given the size of investments and the speed of developments in this new technology, blockchain is often described as a fundamental feature of the Fourth Industrial Revolution.[11] Lawyers need to stay informed and stay involved as blockchain develops. The articles that follow demonstrate the varying legal and regulatory regimes governing cryptoassets around the world, the future of the legal landscape is uncertain at best. As more blockchain applications hit the mainstream, lawyers will be essential in navigating the sometimes frustrating interaction between a new technology and old legal regimes. Innovation within the law and law firms will be necessary as blockchain's impact is felt across industries and around the world. For a profession grounded in precedent and well-established principles, the emergence of blockchain and cryptocurrencies presents lawyers with an exciting opportunity to participate in something new.

Endnotes

1. Use of the Internet as a percentage of the world's population has grown from 0.049% in 1990 to 45.78 percent in 2016. *See Individuals Using the Internet*, The World Bank, https://data.worldbank.org/indicator/IT.NET.USER.ZS (last visited Jul. 17, 2018).
2. Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System* (October 31, 2008), https://bitcoin.org/en/bitcoin-paper.
3. David Mills Et Al., Distributed Ledger Technology In Payments, Clearing, And Settlement 2-4 (2016), https://doi.org/10.17016/FEDS.2016.095.
4. For example, Goldman Sachs has been granted a patent for a settling securities trades using its own cryptocurrency, SETLcoin. *See* Chuan Tian, *Goldman Sachs Granted 'SETLcoin' Cryptocurrency Patent*, CoinDesk (Jul 13, 2017), https://www.coindesk.com/goldman-sachs-granted-setlcoin-cryptocurrency-patent/.
5. Michael del Castillo, *The 10 Largest Companies in the World Are Now Exploring Blockchain*, Forbes (Jun. 6, 2018), https://www.forbes.com/sites/michaeldelcastillo/2018/06/06/the-10-largest-companies-exploring-blockchain/#390acc2d1343.
6. The explanation of blockchain that follows is intended to be simple and is not a comprehensive description of the technology. For a more detailed explanation of blockchain, *see What Is Blockchain Technology?*, CoinDesk, https://www.coindesk.com/information/what-is-blockchain-technology/ (last visited Jul. 17, 2018).
7. For a more in-depth analysis of how securities can be offered and traded using blockchain, *see* Reade Ryan & Mayme Donohue, *Securities on Blockchain*, 73 Bus. Law 85 (Winter 2017–2018).
8. *See, e.g.*, Mayme Donohue & Bob King, *Major Companies Are Quietly Amassing Blockchain Patents Across Industries*, Blockchain Legal Resource (June 28, 2018), https://www.blockchainlegalresource.com/2018/06/major-companies-quietly-amassing-blockchain-patents-across-industries/.
9. Lead by Walmart and IBM, 10 of the world's biggest companies are working together on the "Food Trust" project, which is building a food safety supply chain. In tests conducted in 2017, Walmart reduced the time it took to track the source of a package of sliced mangos from almost seven days to 2.2 seconds by using the blockchain-based system. *See* Kim S. Nash, *Walmart-Led Blockchain Effort Seeks Farm-to-Grocery-Aisle View of Food Supply Chain*, Wall St. J. (June 25, 2018), https://blogs.wsj.com/cio/2018/06/25/walmart-led-blockchain-effort-seeks-farm-to-grocery-aisle-view-of-food-supply-chain/.
10. *See, e.g.*, John D. Halamka, MD, Andrew Lippman & Ariel Akblaw, *The Potential for Blockchain to Transform Electronic Health Records*, Harv. Bus. Rev. (Mar. 3, 2017), https://hbr.org/2017/03/the-potential-for-blockchain-to-transform-electronic-health-records; Leigh Cuen, *Intel Thinks Blockchain Could Power a Next-Gen Media Rights Manager*, CoinDesk (May 19, 2018), https://www.coindesk.com/intel-thinks-blockchain-power-next-generation-media-manager/; Sam Hartnett & Peter Bronski, *How Blockchain Can Manage the Future Electricity Grid*, World Economic Forum (May 30, 2018), https://www.weforum.org/agenda/2018/05/how-blockchain-can-manage-the-electricity-grid/; Lucas Mearin, *Delaware to Test Blockchain-Based Business Filing System*, Computerworld (Jul. 12, 2018), https://www.computerworld.com/article/3289484/blockchain/delaware-to-test-blockchain-based-business-filing-system.html.
11. *See, e.g.*, Blockchain, *4th Industrial Revolution*, World Economic Forum, https://www.weforum.org/agenda/archive/blockchain/ (last visited Jul. 17, 2018).

Mayme Donohue is an associate at Hunton Andrews Kurth LLP, where she practices securities and capital-markets law. She writes and speaks regularly on legal issues related to blockchain technology and cryptocurrencies.

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Cryptocurrency Is Borderless—but Still Within the Grip of U.S. Regulators

A Cross-Agency Perspective for Investors Worldwide

By David H. McGill, Benjamin J.A. Sauter and Beau D. Barnes

As cryptocurrencies and open blockchain network technology have become an ever-greater part of the global economy, governments around the world have taken divergent approaches to regulating their trading and use. Some governments, such as China's, have banned them outright, fueled by fears of money laundering and fraud. Other governments have taken a hands-off approach, providing little legal framework for this new technology. And still others have taken a third route, opting to balance concerns of unlawful activity with cautious support for this fledgling but promising part of the modern economy.

David H. McGill

Benjamin J.A. Sauter

Beau D. Barnes

The U.S. government has taken this third route. Instead of enacting significant legislation or regulatory frameworks to govern cryptocurrencies, the U.S. has instead pursued regulation through enforcement litigation. Actors in the cryptocurrency economy have so far been subject to rigorous enforcement of registration, disclosure, and anti-fraud rules handed down by an assortment of regulatory agencies that rely on the creative use of decades-old legal authorities. Not surprisingly, these agencies have without fail found that Bitcoin and other digital currencies are subject to their jurisdiction because they are, these agencies argue, simultaneously commodities, money, property, and (sometimes) securities. Consistent with their longstanding willingness to aggressively enforce U.S. laws beyond its borders, these agencies have not shied away from bringing enforcement actions against individuals and companies operating abroad.

Cryptocurrency market participants fall under the purview of an array of U.S. regulatory agencies, each with differing jurisdictional reach, enforcement priorities, budgets, and leadership. This uncertain enforcement landscape is unsettling for many, but it can be particularly risky for individuals and companies overseas that may not realize that even a minor and unintended impact on the U.S. can subject them to U.S. laws and regulations.

We aim here to unpack this bureaucratic tangle and provide guidance for overseas participants in the cryptocurrency economy. The following provides an overview of the most important U.S. federal agencies regulating cryptocurrency, their enforcement efforts thus far, and the likely trajectory and cross-border implications of those efforts in the future.

U.S. Department of Justice—Cryptocurrencies as "Money"

The U.S. Department of Justice (DOJ) has asserted jurisdiction over various aspects of the cryptocurrency economy, principally via fraud, money laundering, and the operation of unlicensed money transmitting businesses. The DOJ also has the ability to enforce U.S. securities and commodities laws, alongside regulatory agencies. While federal fraud statutes are defined broadly (generally addressing transmission of "money *or* property," such as in the wire fraud statute),[1] other statutes apply only to "monetary instruments" or "funds." As in other areas of criminal enforcement, the extraterritorial application of U.S. criminal laws to conduct related to cryptocurrencies has been common.

The first test of the DOJ's jurisdiction over cryptocurrencies came in 2014, when federal prosecutors in New York charged Ross Ulbricht, the founder of online black market Silk Road, with various crimes including money laundering.[2] Ulbricht argued that the money laundering charges were improper because the transactions involved Bitcoin, which was neither "funds" nor a "monetary instrument" under the statute.[3] The court disagreed, finding that "Bitcoins carry value—that is their purpose and function—and act as a medium of exchange," and therefore fit within the meaning of a financial transaction involving the laundering of "funds" under the statute.[4] Acknowledging the breadth of federal criminal statutes, the court noted that "[t]he money laundering statute is broad enough to encompass use of Bitcoins in financial transactions."[5]

The DOJ has also asserted jurisdiction over cryptocurrencies in the context of the prohibition of operating an unlicensed money transmitting business. Federal law (like many U.S. state laws) makes it a crime to "knowingly" operate "all or part of an unlicensed money transmitting

business" and defines "money transmitting" to include "transferring funds on behalf of the public by any and all means."[6] Courts have generally accepted the DOJ's characterization of cryptocurrencies, finding that Bitcoin represented "funds" under the money transmitting statute.[7] According to these courts, "Bitcoin can be easily purchased in exchange for ordinary currency, acts as a denominator of value, and is used to conduct financial transactions."[8]

The DOJ has asserted its substantive jurisdiction over cryptocurrencies extraterritorially. The agency has long maintained an aggressive enforcement posture against overseas conduct in violation of U.S. criminal laws, supported by court decisions upholding prosecutions of foreign nationals for overseas conduct where there is "a sufficient nexus between the defendant and the United States, so that such application would not be arbitrary or fundamentally unfair."[9] It has been no different with cryptocurrencies.

In but one example, in 2017, federal prosecutors in California unsealed charges against the digital currency trading platform and exchange BTC-e and owner Alexander Vinnik, a Russian national arrested in Greece in connection with an alleged U.S. $4 billion money laundering scheme.[10] Highlighting the extraterritorial reach of the DOJ, BTC-e was located in Bulgaria, its corporate parent was based in the Seychelles, and BTC-e's web domains were registered to shell companies located outside the United States.[11] Vinnik is currently in extradition proceedings in Greece (the Russian government is also seeking his extradition).[12]

These prosecutions are likely just the beginning of the DOJ's efforts to enforce U.S. criminal laws in the cryptocurrency economy—regardless of where the conduct occurred. Indeed, just as the rise of algorithmic trading prompted the DOJ to send a message by pursuing novel criminal prosecutions involving "spoofing," so too will the ongoing shift toward cryptocurrency trading inevitably compel the DOJ to take action, particularly in light of stories of trading abuses that have populated major newspapers for months.

U.S. Commodity Futures Trading Commission—Digital Currencies as "Commodities"

The U.S. Commodity Futures Trading Commission (CFTC) asserts that Bitcoin and other digital currencies are "commodities" within the meaning of the Commodity Exchange Act.[13] While the CFTC generally regulates commodity *derivatives* (such as wheat futures and options), it also claims the ability to regulate underlying commodities markets in certain circumstances. In particular, the CFTC claims jurisdiction over the use of "any manipulative or deceptive device or contrivance" in connection with commodities transactions. The CFTC also has jurisdiction over commodities transactions when (i) the transaction is done on a leveraged or margined basis *and* (ii) the commodity is not "actually delivered" to the customer within 28 days.

Recent enforcement actions indicate that the CFTC's cryptocurrency enforcement efforts are ramping up, with three separate actions announced in one week alone in early 2018.[14] A recent spate of reported subpoenas further shows how the agency intends to exercise its broad assertion of jurisdiction over the cryptocurrency economy, including with respect to individuals and entities located and doing business abroad. With the recent listing of Bitcoin futures products in the United States, trading practices in the underlying Bitcoin or other correlated markets, regardless of geographical location, may soon come under close scrutiny by the CFTC.[15]

Still, the CFTC's jurisdiction over cryptocurrencies as "commodities" may be challenged. While one federal district court has thus far agreed with the CFTC's interpretation of its jurisdictional mandate over cryptocurrencies, that decision may not have significant precedential value in future disputes. In *CFTC v. McDonnell et al.*, a federal district court in New York found that "virtual currencies can be regulated by [the] CFTC as a commodity" under the CEA (at least with respect to fraud claims), noting that they are "goods exchanged in a market for a uniform quality and value."[16] But the court issued that decision without receiving a substantive opposition brief from the unrepresented defendant.[17] More importantly, the court's decision did not address various legal authorities and arguments that might have been raised regarding the lack of CFTC jurisdiction to pursue its claims.[18]

Despite these uncertainties, rigorous enforcement by the CFTC appears here to stay, including against companies and individuals overseas. In June 2016, the CFTC settled an enforcement action against the Hong Kong-based Bitcoin exchange Bitfinex for violating restrictions on leveraged commodity transactions.[19] This case represented the first extraterritorial CFTC enforcement action in the digital currency arena. It also signaled that the regulator would not allow digital currency exchanges to facilitate leveraged transactions involving U.S. investors—a position that was recently confirmed by CFTC proposed public guidance.[20] While many non-U.S. exchanges continue to offer leveraged trading, they do so at significant risk if they allow U.S. persons to participate in those activities (or if they do not conduct adequate customer due diligence).

As an example of the difficulty entities can have in avoiding the long arm of U.S. law, press reports indicate that Bitfinex is again the subject of a CFTC subpoena, despite having recently announced its intent to cease activities with U.S. customers.[21] While the CFTC's powers are subject to certain limitations when investigative subpoenas are issued beyond U.S. borders, because of the global nature of the cryptocurrency economy, the CFTC's

future investigations into cryptocurrencies will inevitably continue to take the agency overseas.

U.S. Securities and Exchange Commission—Cryptocurrencies as "Securities"

The U.S. Securities and Exchange Commission (SEC) has stated broadly that it will regulate many new cryptocurrencies—including those issued through Initial Coin Offerings, or ICOs[22]—as "securities" under U.S. law. This classification may subject individuals and companies in the cryptocurrency economy around the world to the strict disclosure, registration, and antifraud provisions of U.S. securities laws.[23] Indeed, the SEC recently created a new enforcement unit dedicated to enforcing violations for "cyber-related misconduct," including violations related to ICOs. And in light of recent amendments to those laws, the SEC likely has enforcement authority over ICOs outside the U.S., so long as significant steps in the transaction took place in the U.S. or the non-U.S. conduct had a "foreseeable substantial effect" there.[24]

The SEC has already begun to wield this enforcement authority both at home and abroad. In recent months, it has brought several domestic enforcement actions related to ICOs, including for failing to register an ICO,[25] for allegedly defrauding investors in an ICO,[26] and for making false and misleading statements in promoting an unregistered ICO.[27]

The SEC has also looked to enforce U.S. securities laws against the issuers of foreign ICOs where those ICOs have a nexus with the U.S. The SEC's first public foray into cryptocurrency enforcement of ICOs resulted in a 2017 investigative report on an organization called The DAO, a "decentralized autonomous organization" created by non-U.S. citizens who were affiliated with a German corporation acting outside the U.S.[28] The SEC based its jurisdiction over The DAO on the fact that the digital tokens at issue were "publicly-accessible, including to individuals in the United States" and that a small proportion of the overall transactions in that token were executed by U.S. customers.[29]

More recently, in *SEC v. PlexCorps*, *et al.*, the SEC brought an enforcement action in New York against two Canadian individuals and a U.K. company, PlexCorps, based on allegations of misappropriating investor funds through a fraudulent and unregistered sale of securities via an ICO of PlexCoin.[30] Such extraterritorial enforcement efforts are expected to increase, as more and more ICOs based abroad seek (even if indirectly) to attract funds from U.S. investors. Indeed, press reports indicate that the SEC has in recent months issued numerous subpoenas directed at foreign companies and foreign conduct, foreshadowing further extraterritorial enforcement actions.[31]

The SEC's assertion of jurisdiction over overseas ICOs may soon be put to the test. In the *PlexCorps* matter, the court will determine whether the SEC has proper territorial jurisdiction over the ICO in light of the SEC's allegations that all of the defendants and most of the activity occurred in Quebec. Notably, the defendants have argued that they specifically attempted to *exclude* U.S. persons from participating in the PlexCoin ICO by requiring purchasers to confirm that they were not a U.S. citizen and were not purchasing tokens on behalf of a U.S. citizen.[32] The case could prove to be a milestone for the SEC's cryptocurrency enforcement efforts, as the defendants have indicated that they will also challenge the status of the digital token at issue as a "security" if the case is not dismissed on territorial jurisdiction grounds.[33] (The status of cryptocurrencies as "securities" is also being challenged in a DOJ criminal prosecution in New York.)[34] Despite these challenges, the SEC has made ICO-related enforcement a priority and its extraterritorial enforcement efforts are likely to continue for the foreseeable future.

The Internal Revenue Service—Cryptocurrencies as "Property"

The Internal Revenue Service (IRS) is also getting into the game of cryptocurrency regulation based on its tax enforcement mandate. The IRS fired its opening salvo in 2014 when it issued guidance declaring that "[f]or federal tax purposes, virtual currency is treated as property."[35] In that notice, the IRS noted that digital currencies were not a "currency" because they do "not have legal tender status in any jurisdiction."[36] As property, any profits made by U.S. persons—including U.S. citizens and U.S. legal residents, wherever they are located in the world—would be subject to capital gains tax upon sale.

The IRS has been laying the groundwork for a global tax enforcement campaign for several years. In 2016, the IRS determined that fewer than 900 persons had reported capital gains on bitcoin-related transactions in each year between 2013 and 2015. Based on that finding, the IRS sought client and transaction records from the cryptocurrency exchange Coinbase, the largest exchange in the United States and one of the largest exchanges in the world.[37] In November 2017, a federal judge in San Francisco authorized a narrowed IRS subpoena, which Coinbase determined covered approximately 8.9 million transactions over U.S. $20,000 and 14,355 account holders.[38]

The next steps in the IRS's enforcement campaign will likely proceed in two parallel directions. First, emboldened by its victory in its subpoena enforcement action, the IRS may attempt to gather additional taxpayer information from other cryptocurrency exchanges, including those based overseas with U.S. customers. Second, the IRS's campaign will shift from broad information-gathering to investigation of and enforcement proceedings against specific individuals and companies.

The IRS's recent enforcement efforts against tax evasion in the offshore banking industry followed a similar playbook, using a variety of methods to collect information about suspected tax evaders. In August 2009, the IRS and DOJ pressured Swiss bank UBS to provide the names of over 4,000 American clients suspected of using UBS's offshore services to avoid paying U.S. taxes.[39] The agencies followed up with "John Doe" subpoenas on offshore banks around the globe and used additional indictments of individuals and companies abroad to pressure defendants to cooperate and provide additional information.[40] Importantly, these past enforcement efforts by the IRS and the DOJ's Tax Division culminated in high-profile charges not just against tax evaders, but also against other individuals and entities that allegedly facilitated tax evasion by U.S. persons.[41] Future cross-border enforcement efforts—as well as extraditions and inter-governmental cooperation—will be an inevitable part of IRS and DOJ efforts.

The Future of U.S. Enforcement in the Cryptocurrency Economy

The digital currency economy is here to stay, and so is U.S. regulatory enforcement. Each passing week seems to bring a new statement from a U.S. regulator about the importance of growing this new and vibrant area of economic activity while also protecting investors from the risks of fraud.[42] Additional regulators (such as the Office of Foreign Assets Control within the U.S. Treasury Department) are entering the cryptocurrency economy,[43] with still more likely to come in the future.[44] While the U.S. government still faces challenges in exercising its enforcement authority across the global cryptocurrency economy, history shows that U.S. enforcement agencies can fill regulatory gaps by creatively interpreting their authority to cover new technologies, and national borders may not protect persons overseas who find themselves in the crosshairs of the U.S. government. Those who transact and invest in cryptocurrencies, no matter where they are in the world, should be aware of these risks.

Endnotes

1. *See, e.g.*, 18 U.S.C. § 1343.
2. Indictment, *United States v. Ulbricht*, Case No. 14-cr-068, 2014 WL 901601 (S.D.N.Y. Feb. 4, 2014).
3. *See United States v. Ulbricht*, 31 F. Supp. 3d 540, 569 (S.D.N.Y. 2014) (summarizing defendant's argument). 18 U.S.C. § 1956 statute does not define "funds," but it defines "monetary instruments" as "(i) coin or currency of the United States or of any other country, travelers' checks, personal checks, bank checks, and money orders, or (ii) investment securities or negotiable instruments, in bearer form or otherwise in such form that title thereto passes upon delivery." 18 U.S.C. § 1956(c)(5). Notably, Ulbricht pointed out that the Internal Revenue Service (IRS) and the Financial Crimes Enforcement Network (FinCEN) had expressly rejected characterizations of Bitcoin as "funds" or a "monetary instrument." *Ulbricht*, 31 F. Supp. 3d at 569.
4. *Ulbricht*, 31 F. Supp. 3d at 548.
5. *Id.* at 570.
6. 18 U.S.C. § 1960(b)(2). If a broker or dealer in digital currencies accepts or transmits funds only for the purpose of a bona fide purchase or sale with a customer, the broker/dealer may not be a money transmitter. *See* U.S. Dep't of Treasury, FinCEN, FIN-2008-G008, *Application of the Definition of Money Transmitter to Brokers and Dealers in Currency and other Commodities* (Sept. 10, 2008).
7. *United States v. Murgio*, 209 F. Supp. 3d 698 (S.D.N.Y. 2016).
8. *United States v. Faiella*, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014). *But see United States v. Petix*, 2016 WL 7017919, at *4 (W.D.N.Y. 2016) (holding that "Bitcoin was *not* 'money' or 'funds' but rather 'simply computer files generated through a ledger system that operates on block chain technology'").
9. *United States v. Al Kassar*, 660 F.3d 108, 118 (2d Cir. 2011) (quoting *United States v. Davis*, 905 F.2d 245 (9th Cir. 1990)).
10. Superseding Indictment, *United States v. BTC-e, a/k/a Canton Business Corporation and Alexander Vinnik*, Case No. 16-cr-00227 (N.D. Cal. Jan. 17, 2017) (unsealed July 26, 2017), *available at* https://www.justice.gov/usao-ndca/press-release/file/984661/download. Vinnik was also charged with operating an unlicensed money transmitting business under 18 U.S.C. § 1960. *Id.*
11. *Id.* BTC-e was also civilly fined U.S. $110 million by FinCEN for willfully violating the Bank Secrecy Act. FinCEN noted that this was its first enforcement action taken against an overseas money services business for doing business in the United States. *See* Press Release, "FinCEN Fines BTC-e Virtual Currency Exchange $110 million for Facilitating Ransomware, Dark Net Drug Sales," https://www.fincen.gov/news/news-releases/fincen-fines-btc-e-virtual-currency-exchange-110-million-facilitating-ransomware. Because the transactions at issue "included funds sent from customers located within the United States to recipients who were also located within the United States, FinCEN noted that BTC-e was required to comply with U.S. laws "[r]egardless of its ownership or location." *Id.*
12. *See Greek Top Court Clears Way for U.S. Extradition of Russian Cybercrime Suspect*, Reuters (Dec. 13, 2017), https://www.reuters.com/article/us-greece-russia-extradition/greek-top-court-clears-way-for-u-s-extradition-of-russian-cybercrime-suspect-idUSKBN1E71K7; Geoff White, *UK Company Linked to Laundered Bitcoin Billions*, BBC News (Mar. 7, 2018), http://www.bbc.com/news/technology-43291026.
13. The CFTC first asserted that "Bitcoin and other virtual currencies" were "properly defined as commodities" in 2014. *See In re: Coinflip, Inc.*, at 3. This view was recently adopted by a court in the Eastern District of New York. *See CFTC v. McDonnell*, et al., 18-cv-0361 (E.D.N.Y. Mar. 6, 2018). However, the case, which involves a pro se defendant, so far has not addressed numerous legal authorities or arguments that might have been raised regarding the existence and/or scope of the CFTC's jurisdiction.
14. *See, e.g.*, Complaint, *CFTC v. McDonnell, et al.*, Case No. 18-cv-0361 (E.D.N.Y. Jan. 18, 2018); Complaint, *CFTC v. Dean, et al.*, 18-cv-00345 (E.D.N.Y. Jan. 18, 2018); *CFTC v. My Big Coin Pay, Inc., et al.*, 18-cv-10077 (D. Mass. Jan. 16, 2018); *see also* Complaint, *CFTC v. Kantor*, Case No. 18-cv-02247 (E.D.N.Y. Apr. 16, 2018).
15. One of the CFTC's earliest enforcement actions in the cryptocurrency arena involved a settlement with TeraExchange LLC for failing to enforce its prohibition on wash trading and prearranged trading. *See* Press Release, "CFTC Settles with TeraExchange LLC, a Swap Execution Facility, for Failing to Enforce Prohibitions on Wash Trading and Prearranged Trading in Bitcoin Swap" (Exchange Release No. 7240-15) (Sept. 24, 2015), https://www.cftc.gov/PressRoom/PressReleases/pr7240-15.
16. *CFTC v. McDonnell, et al.*, Case No. 18–CV–361, 2018 WL 1175156, at *12 (E.D.N.Y. Mar. 6, 2018).

17. The *pro se* defendant moved to dismiss the complaint but did not oppose the CFTC's motion for a preliminary injunction. *See id.*, Dkt. No. 18-2 (Feb. 15, 2018).

18. Nor is the *McDonnell* decision, which held simply that "virtual currencies" are a commodity, necessarily applicable to each of the estimated 1,500 cryptocurrencies that currently exist. The statutory definition of commodities requires that the "services, rights and interests" must be something for which "contracts for future delivery are presently or in the future dealt in." 7 U.S.C. § 1a(9). While futures in Bitcoin (and other mainstream cryptocurrencies) are currently available for trading across a number of established trading platforms, futures trading markets do not exist in the U.S. for other cryptocurrencies and utility tokens that continue to emerge on an almost daily basis. Even the court in the *McDonnell* case, which found that virtual currency is a commodity, noted that "[w]here a futures market exists for a good, service, right, or interest, it may be regulated by the CFTC, as a commodity, without regard to whether the dispute involves futures contracts." *McDonnell*, 2018 WL 1175156 at *11. This analysis suggests that the CFTC may have difficulty demonstrating that other cryptocurrencies are also "commodities."

19. *See* Press Release, "CFTC Orders Bitcoin Exchange Bitfinex to Pay $75,000 for Offering Illegal Off-Exchange Financed Retail Commodity Transactions and Failing to Register as a Futures Commission Merchant," CFTC Release No. 7380-16 (June 2, 2016), https://www.cftc.gov/PressRoom/PressReleases/pr7380-16.

20. *See Proposed Interpretation on Retail Commodity Transactions Involving Virtual Currency*, 82 Fed. Reg. 60335 (Dec. 20, 2017).

21. Michelle Price & Anna Irrera, *U.S. Regulator Subpoenas Cryptocurrency Platforms Bitfinex and Tether: Source*, Reuters (Jan. 30, 2018), https://www.reuters.com/article/us-usa-cftc-subpoena/u-s-regulator-subpoenas-cryptocurrency-platforms-bitfinex-and-tether-source-idUSKBN1FJ2ZK.

22. Although they can come in all forms, a "typical" ICO involves a company proposing a project to potential supporters, who then acquire (through investment, donation, or otherwise) an amount of the company's own proprietary digital currency. *See, e.g.*, Mike Orcutt, *What the Hell Is an Initial Coin Offering?*, MIT Tech. Rev. (Sept. 6, 2017), https://www.technologyreview.com/s/608799/what-the-hell-is-an-initial-coin-offering/.

23. In addition, FinCEN has publicly stated its interpretation that an ICO issuer that is not registered with the SEC or CFTC is a money transmitter subject to the Bank Secrecy Act that must comply with anti-money laundering and counter-terrorist financing regulations. *See* Letter from Drew Maloney (Asst. Sec'y for Legis. Affairs, U.S. Dept. of the Treasury) to Senator Ron Wyden (Ranking Member, Committee on Finance, United States Senate), Feb. 13, 2018, available at https://coincenter.org/files/2018-03/fincen-ico-letter-march-2018-coin-center.pdf.

24. *See* 15 U.S.C. §78aa(b).

25. SEC, Order Instituting Cease-And-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-And-Desist Order, *In the Matter of Munchee, Inc.* (Exchange Rel. No. 10445) (Dec. 11, 2017).

26. Complaint, *SEC v. AriseBank, et al.*, Case No. 18-cv-00186-M (N.D. Tex. Jan. 25, 2018); *see also SEC v. Sharma et al.*, Case No. 18-cv-02909 (S.D.N.Y. Apr. 2, 2018).

27. Complaint, *SEC v. Jon E. Montroll and Bitfunder*, Case No. 18-cv-01582 (S.D.N.Y. Feb. 21, 2018).

28. SEC, *Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO* (Exchange Rel. No. 81207) (July 25, 2017). The investigative report noted that the 11 relevant individuals at The DAO "all appear to live outside of the United States." *Id.* at 7 n.2.

29. *Id.* at 16.

30. *See* Complaint, *SEC v. Plexcorps, et al.*, Case No. 17-cv-07007-DLI-RML (E.D.N.Y. Dec. 1, 2017).

31. *See* Nathaniel Popper, *Subpoenas Signal S.E.C. Crackdown on Initial Coin Offerings*, N.Y. Times (Feb. 28, 2018), https://www.nytimes.com/2018/02/28/technology/initial-coin-offerings-sec.html.

32. *See* Letter-Motion of Defendants, Dkt. 27, at 2, *SEC v. Plexcorps, et al.*, Case No. 17-cv-07007-DLI-RML (E.D.N.Y. Dec. 21, 2017).

33. The enforcement action in *Plexcorps* may also be affected by a pending case in the U.S. Court of Appeals for the Tenth Circuit in which the SEC has brought an enforcement action against an internet advertising company for allegedly orchestrating a Ponzi scheme in violation of U.S. securities laws, despite the fact that approximately 90 percent of the sales of the alleged securities were to non-U.S. investors. *See SEC v. Traffic Monsoon, LLC*, Case No. 17-4059 (10th Cir. 2017). In that case, a federal appellate court will soon decide whether the SEC can enforce U.S. securities laws where the foreign sales had a "substantial effect" in the U.S. based on another obscure provision of the 2010 Dodd-Frank Act. *Id.* Notably, the defendants in that matter are also challenging whether the transactions at issue constituted "securities." *See* Appellants' Opening Brief, *SEC v. Traffic Monsoon, LLC*, Case No. 17-4059 (10th Cir. Sept. 13, 2017).

34. *See United States v. Zaslavskiy*, Case No. 17-cr-00647-RJD-RER (E.D.N.Y.). The defendant has moved to dismiss the indictment against him "because cryptocurrencies are both exempt from securities regulation as currencies and because they do not represent investment contracts—and therefore securities—within the meaning of the law." Dkt. No. 22, at 2 (Feb. 27, 2018).

35. IRS Notice 2014-21, *IRS Virtual Currency Guidance*, https://www.irs.gov/irb/2014-16_IRB.

36. *Id.*

37. *See United States v. Coinbase*, Case No. 16-cv-06658-JSC, 2017 WL 5890052 (N.D. Cal. Nov. 28, 2017).

38. *Id.* at 4.

39. *See* Lynnley Browning, *Fearing I.R.S., 14,700 Americans Disclose Foreign Accounts*, N.Y. Times (Nov. 17, 2009), http://www.nytimes.com/2009/11/18/business/global/18irs.html?mtrref=www.google.com.

40. *See* Michael Klein, *IRS Expands Use of Legal Tools Against Tax Evaders*, Cayman Compass (May 8, 2015), https://www.caymancompass.com/2015/05/08/irs-expands-use-of-legal-tools-against-tax-evaders/ ("The so-called John Doe summonses were a breakthrough for the IRS in tackling offshore tax evasion when they were first addressed to banks to divulge the identity of U.S. customers suspected of maintaining undeclared offshore bank accounts. The use of the legal tool served on UBS in 2008 launched an ongoing U.S. offshore tax evasion crackdown.").

41. These charges were generally brought as conspiracies to defraud the United States, a charge known as a "*Klein* conspiracy" after the landmark case of *United States v. Klein*, 247 F.2d 908 (2d Cir. 1957).

42. *See, e.g.*, *Joint Statement by SEC and CFTC Enforcement Directors Regarding Virtual Currency Enforcement Actions* (Jan. 19, 2018), https://www.sec.gov/news/public-statement/joint-statement-sec-and-cftc-enforcement-directors; *Statement on Potentially Unlawful Online Platforms for Trading Digital Assets* (Mar. 7, 2018), https://www.sec.gov/news/public-statement/enforcement-tm-statement-potentially-unlawful-online-platforms-trading.

43. *See, e.g.*, Office of Foreign Assets Control, U.S. Dep't of the Treasury, *Publication of New Digital Currency-related Frequently Asked Questions* (Mar. 19, 2018), https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx#vc_faqs.

44. *See, e.g.*, Michael del Castillo, *US Bank Regulator Opens Door to National License for Bitcoin Firms*, Coindesk (Sept. 29, 2017), https://www.coindesk.com/us-currency-boss-opens-door-licensed-bitcoin-banks/.

Real Property Transfers Ripe for Blockchain Disruption: Laws in the U.S. Must Follow the Technology

By Mercedes Tunstall, Andrew Caplan, Nathalie Prescott, and Brittney Sandler

As any first-year law student can tell you, real property law is one of the most antiquated areas in the U.S. legal system. Much of this law has been borrowed—in many instances with little change—from the common laws that our nation's forebearers carried across the pond with them from 17th Century England.

Our system for recording and transferring ownership interests in real property is similarly mired in paper-based formality and bureaucracy indicative of a bygone era. Each time a person seeks to acquire real property, that person must order a search of local government records to determine if there are competing interests in the property's title history that could frustrate the acquirer's full use and enjoyment of the property. This process is costly and time consuming because it requires a person to identify, locate, and review myriad records—a process that is also subject to human error.

Imagine a future, however, where each piece of real property is essentially "tattooed" with its own incorruptible, digital signature that stores the title history associated with that property. Instead of searching through county land records each time a property is conveyed, we could retrieve this information in real (or near real) time from a digital platform to determine if there is clear title. Even better, imagine if we could transfer title to the real property directly on this same digital platform, without needing to wrangle with paper documents and wet stamps and signatures.

Blockchain technology has made that future a reality, and has the potential to change how real property titles are maintained and transferred. In addition to eliminating the need for title searches and paper-wrangling (and the accompanying potential for human error), a blockchain-based system could further streamline the recordation process by removing intermediaries, such as county recorders' offices and title insurance companies, and also create authoritative, cryptographically secure records that stand on their own.

Notwithstanding this potential, current real property transfer and recordation law in the United States is still largely written for paper-based systems, which impedes legal recognition of real property records that are transferred and stored on blockchain-based platforms. This article, after providing a brief refresher on the current system for real property recording in the United States and blockchain technology, discusses the types of legal requirements that would need to be modified in the U.S.—using New York State law as an example—to accommodate blockchain recordation and transfers of real property title. This article further surveys some of the projects and initiatives that are already under way to disrupt the status quo of real property recordation and transfers in the U.S. and abroad.

Mercedes Tunstall

Andrew Caplan

Nathalie Prescott

Brittney Sandler

The Current System of Recording Real Property Interests

In its most basic form, our system of recording real property title was designed essentially to answer the following question: as between two different parties, "A" and "B," whose interest in a particular property prevails? Or, posed from B's point of view, "How do I know that the property I just received from A is really mine, and not someone else's?" The answer, unfortunately, can be quite complicated.

Although we often think of real property as being "owned" by one individual or entity, in actuality, it may

be subject to a variety of simultaneous (and often competing) interests. For example, a mortgage lender attaches a lien to a piece of real property until the underlying debt is satisfied. In that case, although property owner A nominally "owns" the property—which we will call Greenacre—in order for A to convey clear title to B, A's mortgage debt on Greenacre must first be extinguished (today, this is usually achieved by applying the proceeds of Greenacre's sale to A's mortgage debt). This is the simplest of examples, but there are more nefarious situations that may keep prospective property owners (or more likely, title insurers and first-year law students) up at night. What if, immediately before A conveys title to Greenacre to B, A also conveys title to Greenacre to "C"? Or, what if A never really had clear title to Greenacre in the first place, due to some defect or fraud?

To prevent issues like these from occurring, and to protect good faith purchasers when such issues do occur, common law countries like the United States have a highly formalized system, developed over centuries, of executing and filing paper instruments with centralized government actors (usually county recorders' offices) each time an event occurs that encumbers real property (e.g., a sale, mortgage, lien, or easement). Accordingly, each time a person seeks to purchase real property, that person (or, in today's world, a title insurance company that person hires) must scour local government records to try and identify any potential "clouds" (competing interests) on the title that could frustrate the purchaser's full use and enjoyment of the property. To protect against a latent or undiscovered cloud later rearing its angry head, property owners and mortgage lenders also typically obtain and pay for title insurance.

A Brief Refresher on Blockchain

Unlike the centralized system of government land records currently in effect (e.g., stored with one central administrator, such as a county recorder's office), a blockchain-based system is essentially a database that is stored across a network of many computers, institutions, and/or countries, so that each participant in the system simultaneously maintains the ledger of all transactions on his or her own computer.[1] The blockchain itself, also known as a distributed ledger, is made up of multiple information "blocks," each reflecting a certain number of transactions that are stacked on top of each other to create a digital record of every transaction ever executed on that blockchain.

Drilling down a step further, each participant in this widely dispersed network is referred to as a "node." Blocks of information must be "verified" by a consensus of nodes before they become part of the official blockchain record (imagine a consensus of bystanders all recording that they saw the same event, rather than relying upon one central actor to record that the event happened). In practice, blocks are "verified" by nodes solving complex cryptographic equations that are baked into the underlying platform.

The elegance of this system is that once a block is verified it cannot be withdrawn or easily edited, which renders transactions recorded on a blockchain transparent and immutable. This concept harkens back to the "digital tattoo" concept we mentioned in the introduction. Because each block is cryptographically linked to the blocks that came before it, a blockchain is virtually incorruptible. A hacker would need to access a majority of nodes in a very short time to successfully corrupt the entire blockchain, which is an extremely difficult task that requires an immense amount of computing power. Because of this, blockchains create secure, authoritative records without the need for a validating central administrator. This, in turn, has the potential to reduce the friction and cost of transactions, such as transferring, and recording the transfer of, title to real property.

Legal Impediments to Executing and Recording Property Transfers on Blockchains

As noted above, real property title laws throughout the U.S. have developed over time using formalities that help central administrators combat fraud and protect property owners' interests through a paper-based system. Unfortunately, these laws requiring wet signatures and central administration present significant impediments to legal recognition of a system that instead uses distributed ledgers and open source technology. Take, for example, New York law:

> A conveyance of real property, within the state,…may be recorded *in the office of the clerk of the county where such real property is situated,* and…[e]very such conveyance not so recorded is void as against any [subsequent good faith purchaser]…[2]

This recording requirement makes sense in a system where county recording officers serve as the authoritative, central repository for real property records. But if the real property records are no longer maintained "in the office of the clerk of the county where such real property is situated," but instead "exist" as blocks of data across a distributed network of participants in a blockchain-based system, New York's law would need to be amended to allow land records to be recorded on distributed ledgers, along the following lines:

> A conveyance of real property, within the state…may be recorded ~~in the office of the clerk of the county where such real property is situated~~ on or by means of one or more electronic networks or databases (including one or more distributed electronic networks or databases), pro-

vided that the records can be converted into clearly legible paper form within a reasonable time…[3]

Alternatively, a state law could specify the particular distributed ledger(s) upon which real estate records may be stored. The key point is that requiring that such records be stored in a particular physical location of a government office frustrates the efficacy of distributed ledger technology.

In addition to laws prescribing where title transfers must be recorded, laws governing the form and execution of real property titles ("deeds" in New York) also raise special challenges for blockchain-based recording systems. Pursuant to New York law, deeds must be in writing, signed by the grantor, and use words to demonstrate that title to property is being transferred.[4] Furthermore, by using statutory forms containing specific words and promises, a particular conveyance can be afforded heightened legal protections. For example, if a seller uses the form entitled "Deed With Full Covenants," the deed enjoys status as a general warranty deed, the most iron-clad form of property transfer for a buyer.[5] This type of deed comes with particular legal guarantees (e.g., the grantor is the lawful owner, the property is free of encumbrances) by virtue of using the statutory magic language.

New York law also specifies certain authentication protocols that deeds must use to be legally recorded. For instance, the signatures on a deed (at least of the grantor) must be acknowledged by a recognized official, typically a notary public, who attaches a written certification,[6] and who must also "print, typewrite, or stamp…in black ink" certain information below his or her signature.[7] Official acknowledgements like this serve to authenticate the signatures on a deed, in turn allowing it to be introduced as evidence in court.[8] What is more, many title insurers require deeds to be acknowledged before agreeing to insure a person's property ownership.

It is clear that these types of formal requirements do not transfer seamlessly to a blockchain-based system of recordation, in which land titles would be memorialized via information coded onto interconnected digital blocks of encrypted information. Accordingly, merely changing the law to allow for real property title records to be *stored* on a blockchain-based system, but continuing to require legacy formalities such as wet signatures and notary stamps, would mean unnecessary duplication that frustrates the purpose of adopting a blockchain-based system in the first place, i.e., to streamline transactions by *removing* intermediaries, and to create authoritative, cryptographically secure records that stand on their own.

In contrast, a more efficient and effective option would be to use the blockchain record *itself* to represent the authoritative real property record, and to effect conveyances directly on the blockchain. Under this construct, parcels of land could be tokenized (i.e., represented by an encrypted unit of measure), perhaps using GPS coordinates, and coded onto a distributed ledger along with information like the identity of the current and past owner(s), and any liens or encumbrances attached to the land. The property could then be legally conveyed by transferring the property's tokenized "coin" to another person using a blockchain-based system, the same way Bitcoins are currently transferred among owners on the Bitcoin blockchain. This system would create a chain of digitally recorded history that is securely stored across multiple nodes instead of by one central actor. Authenticity could be established through the use of private keys to access and transfer the coin (digital deed) and by the date/time stamp automatically recorded on each transaction block. These digital representations would, of course, need to be reproducible in some human-readable, natural language format. The key, however, is that the definitive record *is* the tokenized recording on the blockchain itself.

To give life to this novel system of records, applicable real property laws, such as those of New York noted above, would need to be amended to recognize not only legacy records, but also tokenized records. Such changes are necessary to give participants in this system the confidence that their blockchain-based records are indeed the authoritative representation of their real property interests, and that the records will be given full evidentiary weight in a court of law should a dispute over real property ever arise. Without such assurances, it may be difficult for many participants to embrace the idea of a blockchain-based real property recording system.

A Brief Survey of International Developments

Despite potential legal impediments, blockchain's potential in the real property recordation space (and for recordkeeping, generally) is more than conceptual.

Right here in the United States, Chicago's Cook County Recorder of Deeds and technology company Velox.re recently demonstrated that real property can be successfully transferred peer-to-peer and recorded on the public Bitcoin blockchain using blockchain-based "coins" as digital deeds.[9] Due to Illinois' legacy legal requirements, however, program participants must still adhere to the state's recording formalities and thus duplicate the information recorded on the blockchain by, for example, printing out a paper copy of the digital deed and delivering it to a county recorder's office for official recordation.[10] Similarly, the City of South Burlington, Vermont recently announced that it is launching a pilot to record real estate conveyances on a blockchain-based platform, but as is the case in New York and Illinois, Vermont real property law requires a number of formalities that could impede the full benefits of a blockchain-based system.[11] These initiatives in Illinois and Vermont illustrate the need to adapt the law to this rapidly changing technology.

A few states in the U.S. have also started to move in the direction of legally recognizing blockchain-based records, outside of the specific context of real estate records. As of 2016, Delaware law permits corporations with wholly uncertificated stock to create and maintain their official corporate records on a distributed ledger,[12] and Vermont law now presumes that blockchain-based records are authentic.[13] In 2017, Nevada enacted a law that recognizes blockchain data where a written record or signature is required.[14] And in March 2018, the governor of Tennessee signed into a law a bill that recognizes the legal authority of signatures, records, contracts, and certain other ownership rights that are secured and conducted through blockchains.[15] These types of laws are important to help usher in wide-scale commercial adoption of blockchain technology here in the United States.

Nevertheless, the U.S. has been slower to embrace blockchain disruption compared with other countries, especially as it relates to real property records. This may be because, according to the World Bank Group, roughly 70 percent of the world's population lives in a country without an official or transparent and accessible land title registry.[16] Unsurprisingly, countries with less developed property systems view blockchain as a transparent, cost-effective way to develop or improve their land registry systems and to fight corruption therein. Furthermore, because many of these developing countries have little to no precedent as it relates to real property laws, they do not face the same legal impediments as common law countries like the U.S. when adopting this technology.

The Republic of Georgia, for example, recently became the first national government to launch a private blockchain as the government's official system for recording title to certain real property records.[17] There, the government executes the conveyance between the parties and the public-facing bitcoin blockchain is essentially superimposed over the government's private blockchain, so that the general public can view the property interests that are recorded on the private blockchain.[18]

Ghana is also reportedly eying a blockchain-based system as a way to develop a secure and transparent land registry system. (Anecdotally, in the current system, citizens frequently mark their homes with paint to let others know a particular property is spoken for).[19] Honduras also piloted a blockchain initiative (that has since stalled) to verify and record nearly 200 years' worth of land records in an effort to bring certainty and transparency to what many experts consider a corrupt system of property ownership.[20] Similarly, Ukraine recently announced that it will begin to use blockchain technology to manage its land registry in an effort to bring transparency and security to its property recordation system.[21]

It is not only developing countries that are eager to explore blockchain-based land registries, however. Sweden, a wealthy country with a well-developed property system, has been testing a way to record property transactions using blockchain technology since 2016.[22] That project is spearheaded by the country's central land registration authority, the government agency Lantmäteriet.[23] According to agency officials, Lantmäteriet was drawn to blockchain solutions as a way to (a) save Swedish taxpayers over $106 million per year by eliminating antiquated paperwork and (b) make their land titling system more efficient, transparent, and secure.[24] Using a private blockchain that is visible to all parties to a transaction—such as buyers, sellers, real-estate agents, and banks—each step in a land title exchange is verified and recorded, and the records are then summarized in an external public blockchain so that the general public can also view the property interests.[25] After two years of testing, Sweden is preparing to conduct its first transactions soon.[26]

It is notable that Sweden, like the United States, faces legal obstacles to full-scale adoption of blockchain-based land records—namely, a legal requirement for physical signatures on paper. Lantmäteriet has made proposals directly to the Swedish Ministry of Justice, which would oversee a change to that law, and a committee run by Sweden's Department of Finance is actively reviewing how to make such changes.[27] In the meantime, the agency is moving forward with what many consider to be the most advanced blockchain-based land registry system in the world to date,[28] and other developed countries are taking note—last year, Japan and Dubai also announced that they desire and intend to move their land registry records to a blockchain-based system.[29]

Concluding Thoughts

When we step back and consider the core goals of the U.S. real property recordation system—to assure owners that they are gaining clear title to a particular parcel of real property—the benefits of a blockchain-based system (e.g., reduced risk of fraud, automatically recorded history, cost and time savings, ease of use) are so glaring that transformation in this direction seems almost inevitable. With that said, while technology moves without speed limits, legal processes are necessarily slow and deliberate. This is especially true in the U.S., where property law is state/county-based. Unlike countries with a centralized land registry system, wherein one government actor may be able to champion a relatively quick move to blockchain-based land registries, the type of state-by-state legal overhaul that must occur to transform the U.S.'s legacy real property system into a real-time, blockchain-based system that enjoys full legal recognition will necessarily require additional time and careful planning. As a starting point for that process, lawmakers, regulators, and market participants should begin thinking carefully about existing legal impediments that must be modified to accommodate blockchain-based recordation and transfers of real property interests.

Endnotes

1. One twist, however, is that a blockchain can also be permission-based or "private," whereby a central authority, such as a government entity, sets up a blockchain and permissions others to participate on it as nodes.
2. N.Y. Real Prop. Law § 291 (RPL) (emphasis added).
3. This language closely reflects statutory language that was recently amended in Delaware to permit certain corporate records to be created and/or stored on a distributed ledger. *See* Del. Code Ann. tit. 8, § 224

   > ("Any records administered by or on behalf of the corporation in the regular course of its business, including its stock ledger, books of account, and minute books, may be kept on, or by means of, or be in the form of, any information storage device, method, or 1 or more electronic networks or databases (including 1 or more distributed electronic networks or databases), provided that the records so kept can be converted into clearly legible paper form within a reasonable time . . .").

4. RPL § 243; N.Y. Gen. Oblig. Law § 5-703 and § 15-301(5) (GOL); *See generally Cohen v. Cohen*, 188 A.D.2d 933, 176 N.Y.S.2d 893 (1919) (finding no deed or conveyance where a writing "failed in the requirements of a specific grantor, a specific grantee, a proper designation of the property, a recital of the consideration, and it contained no technical operative words").
5. *See* RPL § 258; RPL § 253; Terrence Dunn and Ira H. Goldfarb, *Deeds to Real Property*, New York City Bar, July 2017 (discussing commonly recognized types of deeds in New York), http://www.nycbar.org/get-legal-help/article/real-property-law/deeds-real-property/.
6. RPL § 291-92; RPL § 298; RPL § 303; RPL § 306; RPL § 308.
7. N.Y. Exec. Law § 137.
8. *See* RPL § 293; *Osborne v. Zornberg*, 16 A.D.3d 643, 644, 792 N.Y.S.2d 183, 184 (2005) ("A certificate of acknowledgment attached to an instrument such as a deed raises a presumption of due execution").
9. Ragnar Lifthrasir, *Permissionless Real Estate Title Transfers on the Bitcoin Blockchain in the USA!—Cook County Blockchain Pilot Program Report*, Medium (June 28, 2017), https://medium.com/@RagnarLifthrasir/permissionless-real-estate-title-transfers-on-the-bitcoin-blockchain-in-the-usa-5d9c39139292.
10. *Id.* (discussing how the pilot program accounts for these requirements by making the information available in a plain-language format that can be printed); *see also* 765 ILL. COMP. STAT. 5/28 ("Deeds, mortgages, powers of attorney, and other instruments relating to or affecting the title to real estate in this state, shall be recorded in the county in which such real estate is situated…").
11. Press Release, Propy, Inc., Propy, Inc. Launches Pilot to Record Real Estate Transfers on Blockchain in the City of South Burlington, VT (Jan. 22, 2018), https://www.prnewswire.com/news-releases/propy-inc-launches-pilot-to-record-real-estate-transfers-on-blockchain-in-the-city-of-south-burlington-vt-300584407.html. Like New York and Illinois, Vermont law, among other things, requires deeds to be "recorded at length in the clerk's office of the town in which such lands lie." VT. Stat. Ann. tit. 27, § 341(a).
12. S. 69, 149th Gen. Assemb., Reg. Sess. (Del. 2017).
13. Vt. Stat. Ann. tit. 12, § 1913.
14. S. 398, 79th Gen. Assemb., Reg. Sess. (Nev. 2017); *see also* Nev. Rev. Stat. § 719.240-719.350.
15. *See* S. 1662, 110th Gen. Assemb., Reg. Sess. (Tenn. 2018).
16. Caroline Heider & April Connelly, *Why Land Administration Matters for Development*, World Bank group (June 28, 2016), http://ieg.worldbankgroup.org/blog/why-land-administration-matters-development.
17. *See, e.g.*, Laura Shin, *The First Government to Secure Land Titles on the Bitcoin Blockchain Expands Project*, Forbes, Feb. 7, 2017, https://www.forbes.com/sites/laurashin/2017/02/07/the-first-government-to-secure-land-titles-on-the-bitcoin-blockchain-expands-project/#3540ff364dcd.
18. *Id.*
19. *See, e.g.*, Frederick Reese, *Land Registry: A Big Blockchain Use Case Explored*, Coindesk, Apr. 19, 2017, https://www.coindesk.com/blockchain-land-registry-solution-seeking-problem/.
20. *See, e.g.*, Rina Chandran, *Modernizing Land Records in Honduras Can Help Stem Violence, Says Analyst*, Reuters, Aug. 11, 2017, https://www.reuters.com/article/us-honduras-landrights-tech/modernizing-land-records-in-honduras-can-help-stem-violence-says-analyst-idUSKBN1AR151.
21. *See, e.g.*, Volodymyr Verbyany, *Ukraine Turns to Blockchain to Boost Land Ownership Transparency*, Bloomberg Technology, Oct. 3, 2017, https://www.bloomberg.com/news/articles/2017-10-03/ukraine-turns-to-blockchain-to-boost-land-ownership-transparency.
22. *See generally* Giulio Prisco, *Swedish Mapping Authority Pioneering Blockchain-Based Real Estate Sales*, Nasdaq, Mar. 15, 2018, https://www.nasdaq.com/article/swedish-mapping-authority-pioneering-blockchain-based-real-estate-sales-cm935347.
23. *Id.*
24. *Id.*
25. *See, e.g.*, *Blockchain and Future House Purchases Third Phase to Be Completed in April 2018*, ChromaWay, https://chromaway.com/landregistry/ (last visited Apr.1, 2018) (discussing ChromaWay's involvement in Sweden's real estate blockchain project, the status of the project's phases, and how the project works).
26. *Id.*
27. *See, e.g.*, Jonathan Keane, *Why Sweden Is Taking a Chance on Blockchain Land Registry*, coindesk, Apr. 24, 2017, https://www.coindesk.com/sweden-taking-chance-blockchain-land-registry/.
28. *Id.*
29. *See* The Midas Guide, *Dubai Will Put Entire Land Registry on a Blockchain—100% by 2020*, Medium, Oct. 11, 2017, https://medium.com/@TheMidasGuide/dubai-will-put-entire-land-registry-on-a-blockchain-100-by-2020-18dca77f95e8 (discussing the announcements and intentions of Japan and Dubai).

Mercedes Tunstall (Partner), Andrew Caplan (Senior Associate), Nathalie Prescott (Associate), and Brittney Sandler (Associate) are members of the Blockchain and Fintech, Consumer Finance, and Global Sourcing and Technology Transactions Practices at Pillsbury Winthrop Shaw Pittman LLP. They counsel and defend financial institutions, technology companies, and other clients on a wide range of issues related to banking, credit, payments, data privacy, cybersecurity, and advertising.

U.S. Intellectual Property Protection in the Blockchain Industry: Trends and Solutions

By Matthew R. Schantz and Jeffery T. Gorham

Blockchains and cryptocurrencies have been experiencing booming growth. In the nine short years since the Bitcoin Whitepaper and open-source software implementation were released in 2008 and 2009, respectively, approximately 1,600 new cryptocurrencies have been created, representing approximately $300 billion (USD) in market capitalization.[1] The collective innovations therein show great promise to enhance many other industries. If organizations are not careful, though, myths, misconceptions, and blockchain-industry-specific pitfalls will undercut the opportunities they have to develop and commercialize intellectual property (IP) in this market.

Organizations in the blockchain industry, with their brilliant software developers often operating on bootstrapped budgets, frequently seek to minimize costs in several areas, especially legal costs. In this environment, IP practitioners will not be surprised to hear that blockchain organizations are employing questionable practices based on some old but lingering fallacies about IP law. Although catastrophic results might be avoided early on, damage from these penny-pinching practices can turn disastrous if left unchecked. On the other hand, zealously seeking IP protection may seem natural from an IP practitioner's perspective, but such a strategy can have unintended consequences that clash with client objectives, even attracting unwanted regulatory enforcement.

This article explores some nuances for intellectual property practitioners to consider and common misunderstandings practitioners may have to overcome when advising blockchain-based organizations concerning IP protection and risks.

Patents and Blockchain Technology

The original bitcoin technology was described in a 2008 publication and implemented in code released publicly in 2009. The code is available under the permissive "MIT" open-source license, and no patent owner has made claim to that technology. It therefore appears that this basic system is available on favorable terms for implementation in other systems. That being said, there have been huge opportunities for developers to build on this technology to solve many business and technical issues and apply to patent any improvements made. Of course, the Patent Office does not just issue a patent on every application, so the intersection of blockchain-based organizations and the patent world is worthy of some discussion.

Patent-Related Challenges

One patent-related challenge that blockchain-based organizations face is the combined newness and extreme popularity of the technology. Significant obstacles make it difficult—if not impossible—to determine with a reasonable amount of searching what technology is publicly known or already the subject of a patent application. The most notable of these confounding factors are that there are so many organizations in early stages of development, many with but a trivial public presence, while vocabulary around blockchain-related concepts is just being defined, and most patent applications are only made public 18 months after filing. Without a reliable way to determine what is publicly known, it is impossible to evaluate with certainty whether any given technology is novel or nonobvious over the prior art. Thus, the potential value of the patent on new blockchain technology must be discounted by the possibility that some unknown source has already made that technology public.

Matthew R. Schantz

Jeffery T. Gorham

Another challenge relates to the uncertain contours of patentable subject matter as applied to inventions implemented in software. Patent applications claiming such inventions face a high level of scrutiny after the U.S. Supreme Court's decision in *Alice Corp. v. CLS Bank International.*[2] In *Alice*, the Court held that claims to a computer-implemented algorithm used to facilitate financial escrow transactions were not directed to patentable subject matter because they attempted to cover a mere implementation of an abstract idea and failed to transform that abstract idea into a patent-eligible invention with "something more."[3] Although the *Alice* opinion did not *explicitly* rule that software patents are not patentable, the Court cited its opinions in previous case law[4] for the position that "a fundamental economic practice long prevalent" in an industry is not patentable subject matter, even if it is implemented via a computer, unless there is a "new and useful" application of, or improvement on the idea. Therefore, an invention that merely uses software to implement an abstract idea, or to implement a practice that is already used in a particular industry, is not patentable; only claims to recite "new and useful" implementa-

tions or improvements of those ideas can achieve patent protection.[5]

Subsequent cases that have applied and interpreted *Alice* have come to a variety of conclusions.[6] Recently, the inventions claimed in successfully defended patents improve how computers work at the technical level[7] or use technical means to solve technical problems.[8] Simply applying well understood computing technology to implement concepts that are well understood in the off-line world has been rejected as unpatentable subject matter. In the context of blockchain technology, this means that innovations to blockchain technology itself, applications of blockchain technology that quantifiably improve how computers work or work together, and applications of blockchain technology to existing systems that do more than simply implement database functions in a blockchain context might have a shot at success. In contrast, it would be hard to imagine an examiner or other fact-finder finding patentable subject matter in novel economic systems for exchanging rights through a cryptocurrency, or in mediating traditional economic arrangements with a blockchain-based token. Between those two extremes, the terrain is still uncertain.

Patent Applications

So, what is a blockchain-based organization to do? Under our current first-inventor-to-file regime,[9] any organization hoping to obtain patent protection should connect early with a patent attorney who understands the space. A provisional patent application can save the inventor's place in line at the Patent Office, protecting an applicant from later filers without the need for all of the formalities of a nonprovisional application or even the scope-defining "claims." Then, up to a year later, the applicant can file the nonprovisional application, getting the benefit of the provisional application's filing date as to everything disclosed therein, but hopefully with more complete development, a better view of what aspects of the invention are worth trying to protect, and even better funding. The claims and even the description should be carefully crafted to maximize the likelihood of success given the amorphous state of the law of patentable subject matter discussed above.

Defensive Publication

Even if the organization decides not to try to patent its innovations, it could still face patent infringement risk. Publishing a technical white paper might mitigate that risk, at least as to patent applications filed after that publication. To ensure that any patent application filed *after* the publication would not be able to cover anything that was sufficiently disclosed *in* the publication, such a paper should describe the organization's system in enough detail that one could read the paper and build a system. The organization would also need to make the publication well documented and public enough to be indexed and findable. Note, however, that defensive publication of a white paper could not remove the risk of infringing patents on earlier filed applications or protect aspects of the implementation that are not disclosed in the white paper.

Copyright Protection on Blockchain Applications and White Papers

A developer's white paper and computer code are typically protected by copyright as soon as they are written, as copyright in a creative work of authorship automatically springs into existence (with a very low threshold for creativity), and there is no registration requirement for copyright protection in the U.S. Any original work of authorship, such as a white paper or computer code, is covered by copyright at the moment it is "fixed in any tangible medium of expression."[10] One of several caveats for the "originality" requirement, however, is that a derivative work, or a work that is based upon one or more preexisting works,[11] only enjoys protection of the contributions from the new author, i.e., the derivative author's own original expression.[12]

> *"Given the much greater cost to file patent applications, this practice subsequently spread to the patent industry."*

Of course, then, any white paper or blockchain code that the organization uses as a resource for its own development may be covered by copyright owned by many different authors, each of whom contributed part of the source work. Fortunately, a great deal of blockchain source code has been released under generous open-source licenses, reducing the risk of copyright infringement liability for the organization. The same is not true of white papers, so to minimize infringement risk, organizations should write their whitepapers from scratch.

Industry Trend: Using Outside Developers to Develop Technology

New organizations and their leadership often do not possess the deep understanding of blockchain coding needed to implement their ideas. As a solution, many organizations rely on outside developers who *do* understand the technology, bringing on these outside developers as independent contractors. As part of this process, many organizations ask that the developer sign a non-disclosure agreement and/or an independent contractor agreement that members of the organization drafted in-house, often from one or more templates which the organization found online after a cursory Google search. This is troublesome for many reasons.

Non-Disclosure Agreements are used predominantly to protect trade secrets and potential patent rights and to prevent a receiving party from sharing a disclosing party's trade secrets to other parties. Although this sounds like a good way to protect the organization in its interactions with outside developers, a traditional NDA does nothing to effectuate an assignment or transfer of IP rights from a developer to the organization, or to set-forth that such developed IP will be considered a "work made for hire," and therefore the exclusive property of the organization. Simply put, this industry practice is insufficient to fully protect an organization's IP interests.

Independent Contractor Agreements come closer to protecting an organization's IP interests. Independent Contractor Agreements should set forth the clear understanding that the developer is an independent contractor, that the developed work will be considered a "work made for hire" and therefore the sole and exclusive property of the organization, and, in the event that the IP is not considered a work made for hire, that the developer agrees to *and presently assigns*[13] any rights he or she may have in the developed work to the organization. Rights in inventions that the developer invents during the engagement should also be assigned to the organization in the Independent Contractor Agreement. Like the non-disclosure agreements discussed above, when organizations attempt to draft these agreements in-house they generally fail to draft the IP assignment or work-made-for-hire provisions to fully protect the organization.

Industry Trend: Posting a White Paper or Code to Seek "Poor-Man's" (Copyright/Patent) Protection

Many practitioners will be familiar with the various forms of "poor-man's copyright." This mythical creature usually constitutes a developer sending a copy of their work in a sealed, self-addressed, stamped envelope back to themselves via certified mail or other means, in order to have some evidence of authorship and defend oneself from future infringement claims. This is often attempted in order to avoid the trouble of registering the work with the U.S. Copyright Office.[14] However, no provision in the U.S. Copyright code allows a poor-man's copyright to substitute for registration,[15] and although courts have discussed matters related to a poor-man's copyright, no court has yet endorsed the practice as substitute for formal registration of a copyrighted work.[16]

Given the much greater cost to file patent applications, this practice subsequently spread to the patent industry.[17] Not surprisingly, mailing a disclosure to oneself does not secure for the inventor the exclusive rights that come with a patent granted by the U.S. Patent and Trademark Office (USPTO). Further, reliance on a poor-man's patent can be disastrous for developers, as it yields neither the benefit of an actual patent application (the possibility that the USPTO will grant a patent on the invention) nor protection against subsequent filings on the invention by others, as the first inventor to file an application wins over subsequent filers under the America Invents Act ("AIA") since the U.S. became a first-inventor-to-file country on March 16, 2013.[18]

The blockchain industry has seen its own iteration of the poor man's patent/copyright, where a developer will post the organization's white paper on a publicly visible website, and will often share his or her code on open developer websites such as GitHub, to stake the organization's claim that it had a particular idea as of a certain date. Unfortunately, that "claim" alone has little competitive value, and any sense of protection is not well-founded. Keeping this in mind, there are four fundamental problems with the practice of posting one's white paper in this manner.

> *"Protecting features of a full-scale blockchain-based product as trade secrets is often impractical, though, in large part because most blockchains extend beyond the boundaries of a single organization."*

First, we have the same issues as the poor-man's patent with regard to achieving actual patent rights. Although many developers are primarily concerned with defending themselves against future infringement allegations, and they are less concerned with obtaining patent rights to exclude others from making the invention, investors may want to prevent others from copying the functionality of the organization's systems. The "poor-man's patent" strategy certainly does nothing to achieve patent protection and may lead to a complete loss of any potentially patentable subject matter that the organization may have otherwise enjoyed.

Second, this practice, unlike the poor man's copyright, may have the effect of completely throwing away any possibility of securing effective patent coverage. If a developer fails to file any patent application, they will certainly have no patent protection. Further, while publishing the white paper would prevent others from later patenting subject matter described therein, it would not prevent others from patenting improvements to that technology, effectively blocking the original innovator's optimal commercialization of the technology.

Third, this practice provides a clear roadmap to current patent holders who might believe that this new blockchain-based "invention" infringes their prior patent rights. Rather than providing protection, a poor man's patent can bring unwanted attention and potential liability to the new blockchain developer who might otherwise have gone unnoticed if he or she had not publicly posted the white paper or code. Some of this risk can be avoided

by the developer commissioning a freedom-to-operate search early in the development process, but in our experience, developers rarely even consider such a search.

Fourth, this practice invites other developers and competitors to manipulate the code to create their own work, which they might include in their own applications, potentially creating a competitor who got to skip the work and expense of developing the idea for themselves. While sharing the fruits of one's labors is friendly, it does not help the organization succeed in a fast-moving, competitive landscape.

Industry Trend: Defensive Patents

A more beneficial industry trend is seeking a "defensive patent." This involves a developer patenting his or her innovations, but purely as a preventative measure.[19] The developer never plans to pursue others for infringing their patents, but rather intends to use the patent as a bargaining chip. This strategy has led to multiple "defensive patent license" cooperatives, where developers pool their collective patents for all others in the pool to use.[20]

Other IP Considerations

Trademarks

Generally speaking, a trademark is any word, name, symbol, or device, or any combination thereof, used by a person to identify and distinguish his or her goods from those manufactured or sold by others and to indicate the source of the goods, even if that source is unknown.[21] Trademark rights vest when a mark is used in connection with goods and services, and as an indicator of the source of those same goods and services. These rights are afforded to the mark user against *subsequent* users (but not already-existing users) in the specific geographic market(s) where the mark is used. This bundle of rights is often referred to as "common law" trademark rights, and no registration is required to obtain them. One can obtain additional rights, putting other potential users on-presumptive notice of this mark and thereby extending these same rights to every U.S. state and jurisdiction, by registering the mark with one or more states and the USPTO.

Although neither an organization's white paper nor its computer code may serve as a source identifier, a blockchain organization's name, the name of its token, or an abbreviation of the same may become a protected trademark. However, developing trademark rights in an abbreviated name for its token, should be done cautiously to avoid consequences adverse to a client's objectives.

Some organizations plan to issue a token that will be considered a security by the U.S. Security Exchange Commission (SEC), while other organizations seek to issue a utility token, which often falls outside of SEC regulation. Regardless of the organization's intent on this point, if the organization plans to list the token on an exchange or anticipates others will do so, the SEC may consider the token a speculative investment and, thus, a security. If the organization also applied for trademark protection of abbreviated names for that token, characterizing the abbreviated name as a "ticker symbol," it could bolster the SEC's argument that the token is a security and the abbreviation is a "ticker symbol" like those that refer to stock. Therefore, caution should be used when applying for trademark protection of abbreviated names for a token, and, even without an application, in referring to the mark as a "ticker symbol" to promote its use in conjunction with a cryptocurrency exchange.

Trade Secrets

Some developers will opt for trade secret protection for their works. A trade secret is information that (i) is not generally known to the public, (ii) confers economic benefit to its holders because the information is not publicly known, and (iii) is the subject of reasonable efforts by the holder to maintain its secrecy. Although trade secret protection is often appropriate during early development of a blockchain-based technology, trade secrets are only protected so long as they *stay* a secret. For the information to have and maintain "trade secret" status, the owner must employ reasonable measures to protect that information from losing its secrecy. To that end, organizations working with outside developers should seek early IP assignments in their NDAs and contractor agreements, as discussed above, and further establish clear criteria for developers to follow for handling and safeguarding trade secrets.

Protecting features of a full-scale blockchain-based product as trade secrets is often impractical, though, in large part because most blockchains extend beyond the boundaries of a single organization. Since many blockchain applications rely on network nodes to process transactions on the blockchain, the code must be shared with those nodes. This process necessarily puts the code in the hands of many outside parties and exposes the code to be used, seen, or shared by parties outside of the developer's control. Unless the developer plans to offer a private blockchain and maintain contractual agreements with the operator of each network node to obligate those operators to keep certain trade secrets confidential, trade secret protection has limited application to blockchain technologies.

Conclusion

Blockchains and cryptocurrencies have experienced booming growth in just the past few years and look to change the way many industries operate in the years to come. Despite the rapid growth and bright future, however, blockchain organizations often cut spending on legal fees, and traditional approaches to IP protection may not fit the mold. An intentional, even cautious approach to managing IP rights and risks, coupled with consideration for industry peculiarities, can yield great, cost-effective results for developers.

Endnotes

1. *See Cryptocurrency Market Capitalizations: All Cryptocurrencies*, Coin Market Cap (March 18, 2018), www.coinmarketcap.com/all/views/all (showing total market capitalization of $296,025,148,676).
2. *See generally Alice Corp. v. CLS Bank Int'l*, 573 U.S. __, 134 S. Ct. 2347 (2014) (setting a two-step process for determining patent eligibility for software inventions).
3. *Id.* at 2354.
4. *Id.* at 2355-56 (citing *Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, 566 U.S. __, 132 S.Ct. 1289, 1294-97 (2012); *Bilski v. Kappos*, 561 U.S. 593, 611 (2010); *Diamond v. Diehr*, 450 U.S. 175, 187 (1981)).
5. *Alice Corp.*, 134 S. Ct. at 2357.
6. *Cf. Chamberlain Group, Inc. v. Linear LLC*, 114 F. Supp. 3d 614, 627 (N.D. Ill. 2015) (validating a claimed invention that tied a garage door opener system to a computer network to "do new things like provide for remote monitoring and control of the garage door opener"), *with Electric Power Group, LLC v. Alstom S.A.*, 830 F.3d 1350, 1354, 135 (D.C. Cir. 2017) (affirming the district court's ruling that claimed inventions in collecting and monitoring power grid data sources in real time were invalid because the inventions were directed at an abstract idea and not sufficiently transformative).
7. *See Enfish v. Microsoft*, 822 F.3d 1327, 1337 (Fed. Cir. 2016) ("Here, the claims are not simply directed to any form of storing tabular data, but instead are specifically directed to a self-referential table for a computer database.").
8. *See DDR Holdings, LLC v. Hotels.com, L.P. et. al.*, 773 F.3d 1245, 1257 (Fed. Cir. 2014) (finding valid a claimed invention that "addresses a business challenge (retaining website visitors) that is particular to the Internet").
9. Leahy-Smith America Invents Act, 35 U.S.C. § 3 (2011).
10. 17 U.S.C. § 102 (2010); *Apple Computer, Inc. v. Franklin Computer Corp.*, 714 F.2d 1240, 1247 (3d Cir. 1983).
11. 17 U.S.C. §101 (2010).
12. 17 U.S.C. § 103 (2010).
13. *See Board of Trustees of Leland Stanford Junior University v. Roche Molecular Systems, Inc.*, 563 U.S. 776, 786 (2011) (holding that the language "agree to assign" in the agreement that Stanford had Holodniy sign was merely a promise to assign his invention rights to Stanford at some undetermined future point, and did not presently assign the rights upon execution of the agreement).
14. *See* David Mikkelson, *Poor Man's Copyright: Can you effectively copyright your work by mailing a copy of it to yourself?*, Snopes (Nov. 29, 2009), https://www.snopes.com/fact-check/poor-mans-copyright.
15. *See generally FAQ's: Copyright in General*, U.S. Copyright Office, available at https://www.copyright.gov/help/faq/faq-general.html (last visited Mar. 13, 2018).
16. *See, e.g.*, *Smith v. State*, 901 N.Y.S.2d 902, *8 (N.Y. Ct. Cl. July 14, 2009); *Barefoot v. Goulian*, 2010 WL 2696760, *3 (E.D. N.C. July 7, 2010); *Swensen v. Bender*, 2008 WL 2382757 (D. Minn. Feb. 22, 2008), rev'd, 764 N.W.2d 596 (Minn. Ct. App. 2009).
17. *See* Kirk Teska, *The Poor Man's Patent*, IEEE Spectrum (Aug. 1, 2008), https://spectrum.ieee.org/at-work/innovation/the-poor-mans-patent.
18. Leahy-Smith America Invents Act, 35 U.S.C. § 3 (2011).
19. *See Defensive Patent*, Techopedia, https://www.techopedia.com/definition/28565/defensive-patent (last visited Mar. 13, 2018) ("A defensive patent is a patent that is used with the primary intention of defending a company against patent infringement lawsuits.").
20. *See Defensive Patent License: Troll Proofed. Innovation Protected*, Defensive Patent Alliance, https://defensivepatentlicense.org/ (last visited Mar. 13, 2018); *Blockstream's Defensive Patent Strategy*, Blockstream, https://blockstream.com/about/patent_pledge/ (last updated Apr. 24, 2017); *Start a Blockchain Patent Sharing Era*, Blockchain IP Foundation, http://www.bpsa.io/ (last visited Mar. 13, 2018).
21. 15 U.S.C. § 1127 (2006).

Authored by Matthew R. Schantz, Member, and Jeffery T. Gorham, Senior Associate, of Frost Brown Todd, LLC's Blockchain and Digital Currency team. Special thanks to fellow Blockchain and Digital Currency team member Kacy Joy for her support in drafting this article.

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Korean Regulation and Taxation of Cryptocurrencies

By Soo-Jeong Ahn, Gun Kim, Hyo Sung Lee, Jin Soo Soh and Ja Young Lee

I. Legal Concept of Cryptocurrencies

At present in Korea, there is neither a statute specifically addressing the regulation of cryptocurrencies nor any statutory provision or authoritative ruling by the regulatory authorities legally defining a cryptocurrency. However, discussions for the legislation of such regulation are progressing actively; draft bills for amending the existing Act on Electronic Financial Transactions (AEFT) and various new laws[1] specifically governing cryptocurrencies are being proposed in the Korean National Assembly. Although there is no definitive legal framework for cryptocurrencies yet, it would still be meaningful to extrapolate its legal properties in comparison with the existing legal concepts available in the statutes.

Due to the nomination as crypto-"currencies," cryptocurrencies are often compared to traditional legal currencies, i.e., legal tender. However, the fact that cryptocurrencies do not have any enforceability as tender, and that their function as a medium for exchange is still limited, poses a significant difference from the traditional legal tender. It is also noteworthy that under Korean law, only the Bank of Korea has the authority to issue legal tender.[2]

Despite the lack of a legal regime specifically governing cryptocurrencies at present, it would still be meaningful to consider the characteristics of cryptocurrencies as property rights. Section 98 of the Korean Civil Code recognizes the title to specific goods; goods, in turn, are defined as "tangible goods, electricity and other natural forces that can be controlled." Since cryptocurrencies, a form of electronic information, cannot readily be conceptualized as tangible goods, it is difficult to recognize a concept of ownership or title to them. Similarly, it is difficult to recognize cryptocurrencies as a claim or right. To constitute a claim or right, it would be necessary for the cryptocurrency to give rise to a right to demand specific consideration from a specified person. However, this is not the case with cryptocurrencies, as the issuer is not always specified and it normally is not premised on any right to demand specific consideration from a specified person.

All the while, it is undeniable that cryptocurrencies do have value as property; based on such premise, a lower court of Korea has held that Bitcoin can be subject to confiscation.[3] Even so, because none of the statutes including those governing patent, copyright and other intellectual property recognizes a right concerning cryptocurrencies, it currently remains unclear what kind of property rights the holders of cryptocurrencies are entitled to. This ambiguity could become especially problematic with regard to the relationship between account holders and creditors of cryptocurrency exchanges. In the absence of any legal provision providing otherwise, under the current regime, it will be difficult to consider that the account holders have any priority over the creditors.

Another consideration of cryptocurrencies is whether they could fall under "securities" or "means (or method) of payment" and be subject to regulations under the relevant regimes. The Korean concepts of "securities" are provided under the Financial Investment Services and Capital Markets Act (FISCMA) and "electronic currencies" or "prepaid electronic payment method" under the AEFT. "Securities" under the FISCMA is comparable to "securities" under the Securities Act of the United States, though unlike the Securities Act, the FISCMA exhaustively lists the different categories of securities. The broadest category of securities enumerated by the FISCMA is the "investment contract security," which is defined as an investor's contractual right to profits and losses arising from the conduct of a joint business with other persons in which the investor has invested money or other property. Despite the breath of its legal scope, in practice, the concept of investment contract security is rarely used in Korea. Also, depending on the character of individual cryptocurrencies, certain cryptocurrencies may not squarely fall under the foregoing definition; therefore, it appears difficult to consider all cryptocurrencies to constitute securities within the meaning of the FISCMA. However, it should be noted that for those that do fall within the definition of securities, various regulations under the FISCMA may apply, such as obligation to file a registration statement in connection with their issuance.

The AEFT, on the other hand, regulates electronic means or methods of payment by prescribing certain approval requirements and regulations concerning refund and other matters. However, it seems difficult to consider the use as a payment method as the core function of cryptocurrencies and cryptocurrencies do not necessarily presuppose the existence of an issuer. For these reasons, the AEFT does not appear to be an appropriate regulatory standard to govern cryptocurrencies.[4] Again, as in the case of the FISCMA, we should note the possibility that individual cryptocurrencies, depending on their characteristics, may fall under the scope of the AEFT and be subject to regulations thereunder.

To summarize, depending on the characteristics of individual cryptocurrencies, it is possible for certain cryptocurrencies to fall under the preexisting concepts of the current Korean law and be subject to regulations thereunder. However, considering the broad variety and flexibility of cryptocurrencies, in most cases it would be difficult to capture the core concept of cryptocurrencies and regulate them within the existing legal framework.

II. Korean Regulations on Cryptocurrency Transactions

Regulatory Framework

Currently, there is no Korean law that specifically addresses or regulates cryptocurrencies. However, with an exponential increase in transactions since mid-2017 and overheating in investments, cryptocurrencies have become a forefront social issue in Korea. The Korean government has been addressing the issue by applying the preexisting regulations to the extent possible and closely monitoring the trend of transactions involving cryptocurrencies.

Regulations relating to cryptocurrencies can be categorized into two main categories, namely (1) regulations on cryptocurrency exchanges and (2) regulations on cryptocurrency transactions themselves.

First, as for regulations on exchanges, given that there is no explicit statute that addresses them, the Korean government has been resorting to indirect means of governance, by regulating banks whose services are crucial for their operation. They include the strict enforcement of the banks' compliance with the real-name verification process of the account holders at the time of establishing an account for cryptocurrency transactions, and prohibitions of any account opening for cryptocurrency transactions by minors or non-residents.[5] The Korean government has further announced an anti-money laundering guideline that must be observed in transactions involving cryptocurrency exchanges.[6]

In addition, the Korean government is making use of measures available under the existing legal regimes such as on-site audits on exchanges for any potential violations of data privacy laws[7] and compliance with electronic security laws, as well as orders for compliance with the certification requirement for data privacy safety systems.

With various bills on regulating cryptocurrency exchanges currently being discussed, it is expected that such regulation will ultimately include the approval procedures for establishing and operating an exchange, anti-money laundering measures, prohibition of self-dealings and manipulation of exchange prices, and customer protection and compensation for damages.[8]

As for regulations on cryptocurrency transactions, a few of the proposed bills contained the express prohibition of transactions for an illegitimate purpose. However, as of now there is no law that can be applied to transfers of cryptocurrencies among holders. From a practical point of view, given the nature and means by which cryptocurrency transactions are conducted, it would appear difficult to regulate the transactions themselves.

Foreign Exchange Restrictions

As far as foreign exchange regulations are concerned, the fact that cryptocurrencies can freely be transferred across the border without any reporting or restriction, tends to render the government's ability to monitor foreign exchange transactions largely inept. If cryptocurrencies were considered "means of payment" within the meaning of the Korean Foreign Exchange Transaction Act, they would have to comply with the procedure for importing and exporting the means of payment. Because it is difficult to consider cryptocurrencies an embodiment of tender, however, and because the Foreign Exchange Transaction Act in its definition of payment means also does not contain any reference to cryptocurrencies, it is unlikely that cryptocurrencies could be considered means of payment subject to regulation by the Foreign Exchange Transaction Act as currently written.

It is worth noting at this point that the Foreign Exchange Transaction Act requires a Korean resident, when making or receiving cross-border payments arising out of capital transactions, to do so through a bank.[9] The Foreign Exchange Transaction Act further requires the submission of documentation to verify individual amounts and underlying transaction where the annual gross amount of transmitted payments exceeds U.S. $50,000. This means that the use of cryptocurrencies to make payments for capital transactions without going through a bank constitutes a violation of the Foreign Exchange Transaction Act. On the other hand, where payments are not made for a capital transaction, but rather for a commercial transaction such as paying for goods and services, there is no specific restriction under the Foreign Exchange Transaction Act.

Due to uncertainties emanating from the absence of authoritative classification under the Foreign Exchange Transaction Act, and the Korean government's announced policy to regulate cryptocurrency transactions, banks in Korea are taking a conservative stance and are not processing transactions associated with cryptocurrency transactions as a matter of practice. Therefore, cryptocurrency transactions are in fact subject to practical restrictions in Korea.[10]

Customs Issue

If cryptocurrencies are classified as goods with value as property within the meaning of customs law, it will be necessary to comply with import and export reporting procedures.[11] As of now, no determination has been made as to cryptocurrencies' legal character under customs law, and there is no guidance as to what kind of import or export procedures would have to be followed. Furthermore, there currently exists no means to file customs reports with regard to cryptocurrencies, as these are transferred only by electronic means.

III. Accounting Treatment of Cryptocurrencies

In 2011, Korea implemented the International Financial Reporting Standards (IFRS). Listed corporations and financial institutions are mandatorily required to apply the IFRS, while other businesses are allowed to choose between either the IFRS or other local generally accepted accounting principles (local GAAP). However, neither of

these accounting standards provides for any guidance with regard to transactions involving cryptocurrencies, and it is in the hands of the individual business's judgement to determine how to account for these transactions.

Yet, recent developments give rise to the expectation that guidance under at least the local GAAP is forthcoming in the near future. Recently, BTC Korea, which operates Bithumb, the world's seventh largest cryptocurrency exchange,[12] in preparation for its external audit obligation from fiscal year 2017, made an inquiry to the Korea Accounting Institute concerning the cryptocurrency accounting standard. The Korea Accounting Institute is currently preparing a response to that request.[13]

While a number of issues arise in relation to the accounting of cryptocurrencies, the question of what kind of assets cryptocurrencies should be classified as is the most fundamental issue in that it requires determination of the nature and function of cryptocurrencies.

If cryptocurrencies are, as their name suggests, considered a type of currency, they will be classified as cash-equivalent financial assets. In this case, they will have to be accounted for in accordance with their fair market value as of the end of fiscal year. However, a review of the characteristics and function of cryptocurrencies suggests that it will be difficult to treat cryptocurrencies as either cash or foreign currencies. For instance, in the case of fiat currency, the issuer (the Bank of Korea) provides certain guarantees, which is not the case for cryptocurrencies.

Similarly, it would be difficult to classify cryptocurrencies as other types of financial assets, such as stocks or bonds (other than cash-equivalent financial assets), either. In the case of stocks or bonds, it entitles the shareholder or the bondholder to exercise rights against the issuing company. However, none of these rights is expected for holders of cryptocurrencies. Holders of cryptocurrencies are not considered to hold any rights similar to certain rights afforded to holders of securities.

For certain businesses, it might be possible to treat cryptocurrencies as inventory. A business engaged in crypto-mining could allocate the expenses incurred in mining the cryptocurrencies as acquisition costs and subsequently recognize revenue when it receives cash in return for the cryptocurrencies on the exchange. The unsold portion of cryptocurrencies should be recorded at their acquisition costs, and should give rise to a loss, if at the end of the fiscal year their market price is lower than the acquisition cost or if they have become obsolete or otherwise no longer marketable. This way of accounting would provide investors with clearer and more transparent information as to the financial condition of the mining business.

However, in most cases, cryptocurrencies do not readily fall under any particular traditional accounting category. One possible category would appear to be intangible asset, but it does not seem to provide an entirely appropriate treatment either. While the costs of intangible assets are accounted for over time by amortization, amortization of cryptocurrencies does not appear appropriate. Furthermore, though it varies among the individual types of cryptocurrencies, cryptocurrencies can be used as means of payment, and recently have become the focus of great interest as objects of investment. These characteristics are not shared by conventional intangible assets such as trademarks, patents or goodwill. Moreover, while intangible assets are traditionally used to create revenue, this kind of concept does not readily apply to cryptocurrencies. Rather than being "used" to create value, cryptocurrencies themselves are conferred value through the mutual trust of the transaction parties involved.

The Korea Accounting Institute is reported to be considering classifying cryptocurrencies as either liquid assets or non-current assets, depending on the holding purpose. Presumably, the Korea Accounting Institute is considering it difficult to classify cryptocurrencies as either financial assets or intangible assets under IFRS or local GAAP for the same reasons discussed above.

The Korea Accounting Institute plans to expeditiously, but thoroughly, review and provide a cryptocurrency accounting standard, and is expected to further raise related inquiries with the International Accounting Standards Board (IASB). In light of the heightened interest in cryptocurrencies and the related "investment boom," there is a growing demand for such guidance in order to prevent confusion in the market and to pave the way for further development of related technologies.

IV. Taxation of Cryptocurrencies

As of now, the Korean tax authorities have not issued any guidelines on the tax treatment of transactions involving cryptocurrencies. A major factor playing into this reserved stance seems to be the fact that, as discussed above, there has not been any authoritative interpretation of the legal nature of cryptocurrencies.

Under current Korean tax law, categories of taxes that would require determination of the character of cryptocurrencies are corporate income tax, personal income tax (taxation as capital gains or business income), value added tax and gift and inheritance taxes.

- Corporate Income Tax: The profits and losses from a corporation's transactions in cryptocurrencies are understood to be taxable under the Korean Corporate Income Tax Act, which provides for the recognition of a corporation's increase and decrease in net assets as taxable income or loss, with certain exceptions. Since there is no specific exception for cryptocurrencies, it appears reasonable to consider that profits and losses from cryptocurrency transactions are taxable for corporate income tax purposes.
- Personal Income Tax (capital gain or business income): Profits realized by an individual taxpayer

through sale of cryptocurrencies are unlikely to be taxed as capital gains. This is so because the Korean Personal Income Tax Act exhaustively lists the different types of capital gains that are subject to taxation. Since cryptocurrencies are not included in this list, there should be no taxation of profits from the sale or exchange of cryptocurrencies. Furthermore, the Personal Income Tax Act also does not include gains from foreign exchange fluctuations or from the sale of bonds in taxable capital gains; therefore, it would appear equitable that cryptocurrency transactions do not to fall under taxable gain under the Personal Income Tax Act. However, it is possible that the Korean government will, in the future, try to effect legislative changes that enable taxation of cryptocurrencies gains for individuals.

On the other hand, if an individual taxpayer continuously and repetitively engages in the mining or dealing of cryptocurrencies, such that those activities give rise to a "business," profits from such business would be taxed as business income in the hands of such individual. Taxation as business income in such a situation would appear possible under the current law.

- Value Added Tax: The characterization of cryptocurrencies for the purpose of value added tax, on the other hand, remains unclear. While the Korean Value Added Tax Act defines taxable events as supply of "goods and rights that have value as property" or services, it is unlikely that cryptocurrencies constitute such goods or rights based on the discussions of legal characteristics of cryptocurrencies above. Depending on individual viewpoints, however, it might be possible to argue that cryptocurrencies are taxable for purposes of the Value Added Tax Act because they are being traded as goods having certain property value. For now, the Korean tax authorities are said to have, after review of statutory interpretations and precedents from other countries, unofficially adopted the view that cryptocurrency transactions are not subject to value added tax.
- Gift and Inheritance Taxes: For gift tax and inheritance tax purposes, taxable objects are "all goods that have economic value which can be assessed in terms of currency" and "all legal and factual rights which have property value." Due to the broad definition used by the law, it is expected that cryptocurrencies would fall within the scope of taxable objects for gift and estate tax purposes.

V. Conclusion

Given the absence of a determinative legal definition of cryptocurrencies under current Korean law and the lack of clarity as to which regulations apply to cryptocurrencies as discussed above, there still remains much uncertainty with regard to the tax treatment of cryptocurrencies. However, the heightened interest in cryptocurrencies and the increasing investment amounts at stake inevitably suggest that the Korean government's regulation of cryptocurrencies as well as their treatment for tax purposes will have to be clarified in the near future.

Endnotes

1. Bill for a special law on cryptocurrency businesses (drafted by Tae-Ok Jung and tabled on 2 February 2018), bill for the act on cryptocurrency transactions (drafted by Byeong-Kook Jung and tabled on 6 February 2018), amendment bill to the AEFT (drafted by Yong-Jin Park and tabled on 31 July 2017) are only a few of the drafts that are being prepared by the government and various members of the national assembly.
2. Act on the Bank of Korea § 47.
3. Decision 2017 No 120 rendered by the Suwon District Court on 30 January 2018.
4. Kwang-Soo Lee and Ik-Gu Choi, *Problems surrounding the concept of cryptocurrencies based on their legal nature*, presentation material from seminar on cryptocurrency regulation and user protection held by Byeong-Kook Jung and the Korean Bar Association on 27 February 2018, p. 12.
5. Press report issued on 28 December 2017, *Government provides for special measures which are to restrict speculative investments on cryptocurrencies*.
6. Under the guideline which was enforced on 30 January 2018, financial institutions are subjected to additional obligations to identify their clients (including whether their clients are cryptocurrency exchanges), to report on suspected money laundering transactions, and must further take on heightened due diligence procedures.
7. On 24 January 2018, the Korea Communications Commission issued penalties and rectification orders against eight businesses operating cryptocurrency exchange websites for the reason that their data privacy protection measures were insufficient and not up to the standard required by the Act on Information Data Networks.
8. Dong-Joo Kim and Jang-Gon Cho, *Implementation discussion on a law on cryptocurrency transactions and user protection*, presentation material from seminar on cryptocurrency regulation and user protection held by Byeong-Kook Jung and the Korean Bar Association on 27 February 2018, p. 33.
9. Foreign Exchange Transaction Act § 7-3(1).
10. Up to mid-2017, a number of banks transmitted funds overseas after receiving relevant documentation relating to purchased goods (invoices) for cryptocurrency transactions. However, following the guidance of the Financial Supervisory Service, financial institutions are now refraining from transferring or receiving funds related to cryptocurrencies as payments for goods.
11. No guidance or authoritative interpretation has been issued by governmental agencies on this point yet.
12. www.coinhills.com/market/exchange/, last visited on 22 March 2018.
13. www.businesskorea.co.kr/english/news/money/20620-accounting-standard-crytocurrencies-korea-accounting-institute-considers, last visited on 22 March 2018.

Soo-Jeong Ahn, Gun Kim and Jin Soo Soh are partners of Yulchon LLC, in Seoul, Korea. Hyo Sung Lee and Ja Young Lee are associates of Yulchon LLC, in Seoul, Korea.

The Korean Premium: Cryptocurrency—Arbitrage Phenomenon in Korea

By Samuel Yim, Gye-Jeong Kim and Mooni Kim

I. Introduction

In January 11, 2018, the Justice Minister of Korea,[1] Sang-ki Park, indicated that the Korean cryptocurrency market "has started to resemble gambling and speculation" and the "fact that the media have used the phrase 'Kimchi premium' reflects foreigners' assessment that the Korean market is abnormal."[2] The Justice Minister's comment was a reflection of Korea's cryptocurrency price premium soaring up to around 30 percent higher than the rest of the world at the end of 2017 and then recording an all-time high at more than 50 percent premium in early January 2018.[3]

Samuel Yim

Gye-Jeong Kim

Mooni Kim

This exceptional cryptocurrency price variance became known as the "Korean premium," but no one could explain the causes of this phenomenon. Nevertheless, arbitrage traders around the world ("foreign-arbitrage traders") took notice of the Korean premium and sought to take advantage of this possible opportunity. In reality, however, the foreign-arbitrage traders were generally unable to take advantage of this cryptocurrency price premium. This article will address the legal basis for the restrictions on cryptocurrency arbitrage trading in Korea.

II. Why the High Premium?

Korea plays an outsize role in the world of cryptocurrency despite having a population of around 51.7 million[4] and representing less than 2 percent of the global economy.[5] Korea alone accounts for as much as 20 percent of all bitcoin trades around the world, making it the third largest bitcoin market by trade volume.[6] For all cryptocurrency trading combined, Korea represents approximately 17 percent of the global trading volume.[7] As of January 24, 2018, two of the top three exchanges of the world were Korean exchanges.[8]

There has been an inflated demand for cryptocurrencies in Korea that caused prices to be higher than overseas cryptocurrency exchanges. At various times during the peak of the Korean cryptocurrency price premium, CoinMarketCap.com[9] excluded the trading prices in Korea in their daily average price of various cryptocurrencies as it distorted the global average prices.[10] Possible reasons for the high adaptation and ownership of cryptocurrencies by Koreans may be attributed to the advanced internet infrastructure and familiarity with online payment services and virtual investments.[11] In a survey of salaried employees in Korea, about 30 percent claimed to have invested in cryptocurrencies with an average investment of U.S. $5,000.[12] In essence, cryptocurrencies have become a mainstream in Korean society and many Koreans have seen them as a widely accepted investment instrument that is an alternative to traditional securities.

III. Legal Classification of Cryptocurrency in Korea

There is no statute or guidance from the Korean regulatory authorities that provides a coherent insight on how cryptocurrencies would be classified under Korean law. The Financial Supervisory Service (the FSS)[13] issued a press release on June 23, 2017 where it announced their views on what cryptocurrencies are *not* from a financial regulatory perspective.[14] Namely, the FSS, at that time, gave a view that cryptocurrencies are not considered (i) currencies,[15] (ii) prepaid electronic means or electronic currencies,[16] or (iii) financial investment instruments.[17] Unfortunately, the FSS press release did not provide any guidance on how cryptocurrencies *are* classified and in what legal form.

The characterization of cryptocurrencies from a legal perspective has just begun in Korea and will likely develop in the near future. Other Korean regulatory authorities may have a different view from the FSS's announcement and the legal classification of cryptocurrencies. There is currently no law or clear guidance from any regulatory authority in Korea that provides clarity on the legal issues relating to cryptocurrencies and how they will be treated under Korean law.

IV. Arbitrage Model in Theory

Notwithstanding the legal uncertainty of cryptocurrency under Korean law, many foreign arbitrage traders have looked into how they can take advantage of the Korean cryptocurrency price premium. To do this, in theory, a foreign arbitrage trader would have profited by follow-

ing this simplified trading model (the "Korea-Arbitrage Model"):

(a) Buy cryptocurrency outside of Korea;

(b) Transfer the cryptocurrency to a Korean ex change;

(c) Sell the cryptocurrency on the Korean exchange for Korean won (KRW);

(d) Remit the funds from the sale proceeds of cryptocurrency from Korea to overseas; and

(e) Repeat steps (a) to (d) until the cryptocurrency price premium disappears.[18]

For example, a U.S. person buys 1 bitcoin for U.S. $10,000 on a U.S. exchange. U.S. person realizes that 1 bitcoin is sold KRW15,000,000 in Korea (approximately US $14,000).[19] Assuming the U.S. person has an account on a Korean exchange,[20] the U.S. person transfers the 1 bitcoin to the U.S. person's account in the Korean exchange. The U.S. person sells the 1 bitcoin for KRW15,000,000 on the Korean exchange. The U.S. person then repatriates the KRW15,000,000 back to the U.S. and, after converting the KRW to U.S. dollars, deposits U.S. $14,000 in the U.S. person's U.S. bank account. Thus, the U.S. person profits U.S. $4,000 from this arbitrage trade.

The U.S. person, in this simplified example, would have to execute the Korea-Arbitrage Model in Korea and repeat this cycle until the Korean cryptocurrency price premium disappeared in the Korean cryptocurrency market. However, this type of arbitrage trading is practically not possible in Korea.[21] This is mainly due to the restrictions of remitting fiat currency out of Korea from the arbitrage profits in step (d) of the Korea-Arbitrage Model.

V. Arbitrage Restrictions: Foreign Exchange and Transaction Act

A. Overseas Remittance of Funds from Cryptocurrency Trades

Remittance of funds out of Korea to an overseas account is governed under the Foreign Exchange Transaction Act (FETA) and, the FETA's subordinate regulations, the Foreign Exchange Transactions Regulations (FETR).[22] As a general principal under the FETA, there has to be a "legal basis" (e.g., loan repayment, dividend payments, sale proceeds payment, etc.) along with supporting documents to repatriate funds overseas as prescribed under the FETA. The FETA prescribes certain procedures and documents for each type of transaction listed in the FETA for both the remitter of funds overseas and the bank handling the remittance. Each type of transaction has different procedures and requirements to remit funds overseas. Nonetheless, there are *no guidelines* under the FETA for cryptocurrency transactions. Without any guidance regarding remittance of funds from cryptocurrency sale proceeds, the foreign exchange bank is not permitted to remit the funds overseas. This has been one of the key reasons for the lack of arbitrage trade transactions of cryptocurrency in Korea that allowed the Korean cryptocurrency price premium to be sustained for so long.

Generally, any person engaging in a cross-border capital transaction must file a foreign exchange report ("FX report")[23] under the FETA[24] with, and obtain approval from, the Bank of Korea (BOK) or a designated foreign exchange bank[25] for all remittances exceeding the limit of U.S. $3,000 per transaction[26] or a yearly aggregate limit of U.S. $50,000 from Korea to other countries.[27]

In practice, however, foreign exchange banks have rejected to process wire transfers to non-residents when they are related to cryptocurrency trading.[28] A foreign arbitrage trader may consider repatriating U.S. $3,000 or below per transaction through a series of repeated transactions in order to avoid the above reporting requirement with an aggregate annual limit of U.S. $50,000 for all overseas remittances. Nevertheless, the foreign arbitrage trader's Korean bank would be obligated to verify such repeated transactions under the know-your-customer rules and regulations. Once the funds are determined as proceeds from trading cryptocurrencies, such transfers will be prohibited by the bank. Even if the overseas remittances do not trigger Korea's foreign exchange reporting requirement, the foreign arbitrage trader will still need to specify the purpose of the wire transfer at the bank. If the wire transfer is described as "proceeds from the sale of cryptocurrency," the bank is likely to reject such wire transfer due to the regulatory uncertainty.[29]

Because there is no guidance under the FETA on cross-border capital transactions involving cryptocurrency, there is no "legal basis" for a foreign arbitrage trader to remit funds and for the BOK or the designated foreign exchange bank to accept the FX report. In essence, this has been the key legal reason that restricts foreign arbitrage traders from taking advantage of the high cryptocurrency-price premium in Korea.

B. Sanctions for Violation of FETA

The foreign arbitrage trader may be subject to sanctions for making an improper overseas remittance in relation to a cryptocurrency transaction. An administrative fine up to KRW 50 million (approximately U.S. $47,000) may be imposed on the foreign arbitrage trader if it makes overseas remittances in violation of the relevant procedures prescribed by the Ministry of Strategy and Finance (MOSF).[30] In addition, sanctions that may be imposed on a foreign exchange bank for making an improper overseas remittance for a cryptocurrency transaction. Generally, a foreign exchange bank is obligated to confirm whether the arbitrage trader requesting the remittance has obtained requisite approval or complied with the reporting obligation under the FETA.[31] If an employee of the foreign-exchange bank has will-

fully failed to perform his/her obligation to confirm the above, he/she will be subject to imprisonment for not more than one year or a fine of KRW100 million (approximately U.S. $96,000) or an amount that is triple the remittance amount, whichever is larger.[32]

In such case, the foreign exchange bank may be held vicariously liable for the act committed by its employee.[33] If an employee of a foreign exchange bank has violated the obligation to confirm the above details willfully or negligently, the MOSF may impose sanctions on the foreign exchange bank, such as restriction or suspension of its foreign exchange business, taking into account the seriousness of the violation.[34] Given the possible penalties, though the foreign arbitrage trader may be willing to risk sanctions, the foreign exchange banks have declined to remit funds from cryptocurrency transactions due to the potentially severe penalties. Without an approval from a foreign exchange bank, the foreign arbitrage trader will not be able to remit funds overseas.[35]

VI. Practical Restrictions

On December 28, 2017, the FSC released a statement that the government would require local banks to implement real-name banking services (the "Real-Name Services")[36] to facilitate the government's previously announced policy to prohibit minors and non-residents of Korea (e.g., foreign arbitrage traders) from trading cryptocurrencies at Korean cryptocurrency exchanges. As a result, a Korean bank would need to verify the status of each accountholder (i.e., whether he/she is an adult, minor, resident and/or non-resident) through the Real-Name Services so that it can exclude minors and non-residents of Korea from transferring KRW in and out of their cryptocurrency trading accounts. In light of this development, opening a non-resident bank account by a foreign arbitrage trader to trade cryptocurrencies does not appear to be viable in Korea, as the local banks have implemented the Real-Name Services to verify transactions with Korean cryptocurrency exchanges. As such, any transaction by a non-resident of Korea with a Korean cryptocurrency exchange would be effectively prohibited.

In addition, to open an account at Korean cryptocurrency exchanges, a foreign arbitrage trader would need three important components: a Korean registered mobile phone, a bank account, and verification of identity. Without establishing a residency in Korea (e.g., long-term visa), a non-resident arbitrage trader cannot open a bank account or register a mobile phone. Without a bank account and a mobile phone, the Korean cryptocurrency exchanges do not allow a customer to open a cryptocurrency account as the exchanges will not be able to complete the customer verification process. Without an account at one of the Korean cryptocurrency exchanges and at one of the Korean banks, it will be practically impossible to implement the Korea-Arbitrage Model by the foreign arbitrage trader.

VII. Conclusion

The foreign exchange restrictions under the FETA allowed for the high cryptocurrency-price premium to persist in Korea and, consequently, foreign arbitrage traders have not been able to take advantage of these high premiums. In addition, Korean-cryptocurrency investors are mostly restricted to purchase cryptocurrency in foreign exchanges as they are restricted to send fiat currency overseas for the purchase of cryptocurrencies. Due to this insulated Korean market and the strong appetite for cryptocurrency by Korean investors, there have been high premiums in cryptocurrency prices in Korea when compared to other regions.

As of the date of this article, the Korean premium phenomenon no longer exists. In some cases, it has been the reverse, where it has been cheaper to purchase cryptocurrency in Korea as opposed to the U.S. Notwithstanding, though Korean foreign exchange laws have not caught up to the technological advances of cryptocurrency—this of course applies to the rest of the world as well—we do expect the Korean government to introduce cryptocurrency laws in the near future,[37] that may affect the legal restrictions for foreign-arbitrage traders to take advantage of any cryptocurrency price premiums in Korea. At this moment, we need to wait and see how the forthcoming cryptocurrency laws will allow for the Korean premium to rise again.

Endnotes

1. In this article, "Korea" refers to the Republic of Korea, also known as South Korea.
2. Eun-jung Kim, *GM to Establish Asia Pacific Headquarters in S. Korea*, Yonhap News Agency (May 10, 2018, 4:48 PM), http://english.yonhapnews.co.kr/business/2018/05/10/0501000000AEN20180510004651320.html.
3. *See* Kyungji Cho, *Bitcoin's "Kimchi Premium" Has Vanished*, Bloomberg (Feb. 2, 2018, 3:04 AM), https://www.bloomberg.com/news/articles/2018-02-02/bitcoin-s-kimchi-premium-has-vanished.
4. *See World Economic Outlook (April 2018)-Population*, Int'l Monetary Fund, http://www.imf.org/external/datamapper/LP@WEO/KOR?year=2018 (last visited May 14, 2018).
5. *See World Economic Outlook (April 2018)-GDP Based on PPP, Share of World*, Int'l Monetary Fund, http://www.imf.org/external/datamapper/PPPSH@WEO/KOR?year=2018 (last visited May 14, 2018).
6. *See* David Josef Volodzko, *Why Is South Korea Suddenly Terrified of Bitcoin?*, South China Morning Post (Jan. 1, 2018), http://www.scmp.com/week-asia/business/article/2126189/why-south-korea-suddenly-terrified-bitcoin.
7. *See All Digital Currency Exchanges Volume Ranking*, Coinhills, https://www.coinhills.com/market/exchange/ (last visited May 14, 2018).
8. *See* Raphael Rashid, *Kimchi Premium? A Quick Guide to Cryptocurrency Trading in South Korea*, Korea Exposé (Jan. 25, 2018),

https://www.koreaexpose.com/kimchi-premium-arbitrage-cryptocurrency-regulations-korea/.

9. CoinMarketCap is a website for tracking capitalization of various cryptocurrencies and has become the leading resource to track cryptocurrencies prices. *See* CoinMarketCap, https://www.coinmarketcap.com.

10. *See* William Suberg, *CoinMarketCap Removes South Korean Exchanges, Ripple Market Cap Drops $20 Billion*, Cointelegraph (Jan. 9, 2018), https://cointelegraph.com/news/coinmarketcap-removes-south-korea-exchanges-ripple-market-cap-drops-20-billion.

11. *See* Rashid, *supra* note 8.

12. *See* Cindy Wang, *Survey Says 31% of South Korean Workers Are Cryptocurrency Investors*, Bitcoin.com (Dec. 27, 2017), https://news.bitcoin.com/31-of-south-korean-workers-are-cryptocurrency-investors.

13. The FSS is the financial regulatory enforcement arm of the Financial Services Commission (FSC). The FSC is the Korean government agency with the statutory authority over financial policy and regulatory supervision.

14. *Instructions on Investment in Virtual Currency*, FSS (June 22, 2017), http://www.fss.or.kr/fss/kr/promo/bodobbs_view.jsp?seqno=20581.

15. Fiat currency, such as the Korean won or the U.S. dollar, backed by a sovereign government and declared to be legal tender, but not backed by a physical commodity.

16. A "prepaid electronic payment means" means any certificate, or information on such certificate, issued with transferable monetary values stored by electronic means, subject to certain requirements under Article 2(14) of the Electronic Financial Transaction Act (EFTA). *See* EFTA, Act. No. 14839, Jul. 26, 2017, art. 2(14) (S. Kor.). The term "electronic currency" means any certificate, or information on such certificate, issued with transferable monetary values stored by electronic means, subject to certain requirements under Article 2(15) of the EFTA. *Id.* art. 2(15).

17. Under the Financial Investment Services and Capital Markets Act (FSCMA), the term "securities" is defined as a financial investment instrument issued by a Korean national or a foreigner, for which an investor does not owe any obligation to make any additional payment on any ground, in addition to the money, etc., that the investor paid at the time he/she acquires such instruments (excluding obligation of payment that the investor assumes by exercising a right to effectuate the trading of an underlying asset), subject to certain qualifications under Article 4(1). *See* FSCMA, Act No. 14827, Apr. 18, 2017, art. 4(1) (S. Kor.). The term "financial investment instruments" is defined as a right acquired by an agreement to pay money or any other thing with property value at a specific point in the present or in the future, with intent to earn a profit or avoid a loss, where there is a risk that the total amount of such money, etc., paid or payable, to acquire that right (excluding sums specified by Presidential Decree, such as sales commissions) may exceed the total amount of money, etc., already recovered or recoverable from such right (including sums specified by Presidential Decree, such as termination fees), subject to certain qualifications under Article 3(1) of the FSCMA. *Id.* art. 3(1).

18. This article assumes that U.S. dollar is the counterparty currency, but any other foreign currency may be used.

19. All foreign currency conversions are based on conversion rate of U.S. $1 = KRW 1070 as of May 10, 2018.

20. It is unclear whether a non-resident of Korea (i.e., U.S. person) could open an account in a Korean cryptocurrency exchange. Even if possible, such non-resident's transactions at the exchange will be limited to cryptocurrency-to-cryptocurrency trading only. *See infra* Part VI for an explanation of the practical restrictions.

21. To achieve the Korea Arbitrage Objective, a foreign arbitrage trader could create and invest in a company in Korea by filing a direct foreign investment report with a foreign exchange bank or the Korea Trade Investment Promotion Agency under the Foreign Investment Promotion Law (FIPL). The company then will be permitted to conduct its business of trading cryptocurrencies and transfer dividends abroad from its distributable income without submitting a report under the FETR. Set forth below are the main procedures for sending dividends overseas.

    (i) Year-End Dividends: The company may pay year-end dividends subject to its shareholders' approval. The shareholders' approval must be contemporaneously obtained with the shareholder approval of financial statements for the given fiscal year.

    (ii) Interim Dividends: The company can make an interim dividend payment once a year on the date set and approved by its board of directors so long as the company's articles of incorporation provides for such interim dividend.

    Once the dividends are declared with appropriate corporate authorization, the company can remit the dividend payments to its overseas shareholders. When remitting the funds, the company will need to submit corporate authorization documents to its designated foreign exchange bank. By providing capital to the company, the foreign arbitrage trader will be able to achieve the Korea-Arbitrage Model provided that repatriation can take place, in general, once or twice per year. However, due to the restrictions and limitations in the time period to send dividend payments, it is not a practice strategy for arbitrage trading where time is of the essence.

22. The purpose of the FETA is to "contribute to the sound development of the national economy by striving to facilitate foreign transactions, to maintain equilibrium in the balance of international payments and to stabilize the value of currency by ensuring liberalization of foreign exchange transactions and of other foreign transactions, and by revitalizing market functionality." FETA, Act No. 14525, Jan. 17, 2017, art. 1 (S. Kor.).

23. An FX report allows for the BOK to monitor and manage foreign exchange transactions in Korea.

24. "Any person who intends to perform capital transactions, shall file a report on such capital transactions with the Minister of Strategy and Finance pursuant to Presidential Decree." FETA, *supra* note 22, art. 18(1).

25. The term "foreign exchange bank" refers to a bank registered with the MOSF to conduct foreign exchange business such as buying and selling foreign currency (i.e., currency exchange) and taking foreign currency deposit.

26. FETR, Public Announcement No. 2017-20, MOSF, Dec. 28, 2017, art. 4-2(1) (S. Kor.).

27. *Id.* art. 4-3.

28. Hyun-Ok Ha, *Banks Blocking Overseas Transfers for Cryptocurrency*, JoongAng Daily (Dec. 12, 2017, 5:05 PM), http://news.joins.com/article/22197550.

29. *Id.*

30. The MOSF is the ministry of the Korean government that oversees the financial policies in Korea. "Any person who falls under any of the following subparagraphs shall be punished by a fine for negligence not exceeding fifty million won: Any person who has paid, received or moved funds in violation of the procedures for payment, etc. under Article 15(1)." FETA, *supra* note 22, art. 32(1). "The Minister of Strategy and Finance may determine necessary matters such as procedures for money exchange, remittance and transference of property in connection to payments or receipts subject to application of this Act." *Id.* art. 15(1).

31. "When a foreign exchange agency, a money exchanger, and a foreign exchange brokerage company (hereinafter referred to as the "foreign exchange agency, etc.") make transactions subject hereto with their customers, it shall confirm whether transactions, payments or receipts of their customers are permitted or reported

under this Acts." *Id.* art. 10. As mentioned in Part V, Subpart A of this article, there are currently no guidelines under the FETA or FETR for cryptocurrency transactions that foreign exchange banks can follow. Consequently, foreign exchange banks have declined to process overseas remittances connected to cryptocurrency transactions.

32. "Any person who has failed to confirm in violation of Article 10." *Id.* art. 29(1)5. "When a foreign exchange agency, a money exchanger, and a foreign exchange brokerage company make transactions subject hereto with their customers, it shall confirm whether transactions, payments or receipts of their customers are permitted or reported under [the FETA]." *Id.* art. 10.

33. "If the representative of a juristic person, or an agent, an employee or other workers of a juristic person or an individual commits a violation falling under any of Articles 27 through 29 in connection with assets or business of the juristic person or an individual, not only shall such offenders be punished but the juristic person or the individual shall also be punished by a fine prescribed in the relevant Article." *Id.* art. 31.

34. "Where a foreign exchange agency, etc. falls under any of the following subparagraphs, the Minister of Strategy and Finance may revoke a registration or authorization prescribed in Articles 8 and 9, or may restrict the business of foreign exchange agency, etc. (including their business offices) or may suspend, in whole or in part, business thereof for a period not exceeding six months: Where the agency, etc. has violated its obligation of confirmation prescribed in Article 10." FETA, *supra* note 22, art. 12(1)7.

35. As a result, foreign arbitrage traders that sold cryptocurrency in Korea, usually through a cryptocurrency exchange account held by a Korean resident, saw their profits from the cryptocurrency sales *trapped* within Korea.

36. The real-name financial transaction system was introduced into Korea in 1993. Under this system, banks request name verification, such as a national identification number, a passport, or a business registration certificate, and may request presentation or submission of other documents as required to confirm the real identity of a person or legal entity opening and owning a bank account in Korea.

37. Dong-Yun Kim, the deputy prime minister of economy and the head of the MOSF, stated on May 3, 2018 that he expects to introduce detailed outlines for cryptocurrency regulations after the research on cryptocurrency and ICO by G20 is concluded and ministerial discussions among G20 countries are made at the conference scheduled in July 2018. *See* Jung-Yeon Park, *G20 Financial Ministerial Summit to Resume Discussions on Cryptocurrency*, Seoul Economy (Apr. 20, 2018, 7:01 PM), http://decenter.sedaily.com/NewsView/1RYBY0DPYN.

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Samuel Yim, Gye-Jeong Kim and Mooni Kim practice law at Kim & Chang in Seoul, South Korea. Kim & Chang specializes in corporate, securities and capital markets, finance and banking, mergers and acquisitions, privatization, foreign investment, bankruptcy/corporate restructuring, antitrust and fair trade, international trade, litigation and arbitration, tax, product liability, and labor and employment.

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Cryptocurrency Regulation in Canada

By Ana Badour and Shauvik Shah

Introduction

There have been a number of developments to-date in Canada relating to the regulation of cryptocurrencies, particularly in the area of securities regulation and anti-money laundering and counter-terrorism financing. In some respects, Canada has been an early leader in the adoption of cryptocurrency. The first bitcoin ATM in the world was installed in Vancouver and similar cryptocurrency ATMs are now installed across the country in all major Canadian cities.[1] Canadian securities regulators in particular have adopted a "regulatory sandbox" approach and the Canadian government endorsed a light touch approach to regulation in its 2015 report of the Standing Senate Committee on Banking, Trade and Commerce.[2]

In addition to the developments described below, there have been a number of developments in respect of taxation of cryptocurrencies, which are outside the scope of this article.

Canadian Regulatory Developments

There are many questions that arise when trying to reconcile cryptocurrencies within existing legal frameworks. As is the case in most countries with similar legal systems to Canada, the recognition and regulation of cryptocurrencies remains in flux.

"As a result, the CSA assesses the merits of each business model, on a case-by-case basis, and allows innovative businesses to register or be granted relief from certain requirements to permit them to test products and services throughout the Canadian market."

As a federal state, the federal government in Canada shares distinct and overlapping jurisdiction with its provincial and territorial legislative counterparts. A number of regulatory bodies, such as the Office of the Superintendent of Financial Institutions (OSFI) and provincial securities regulators, are also involved in regulating the financial, securities and banking sectors.

Ana Badour

Shauvik Shah

Legal Nature of Cryptocurrencies

The Currency Act in Canada provides that tender of payment is "legal tender" in Canada only if made in coins issued by the Royal Canadian Mint or in notes issued by the Bank of Canada.[3] Cryptocurrencies therefore would not qualify as "legal tender" under Canadian law. This is consistent with the view expressed by the Department of Finance, which has stated that "[o]nly Canadian bank notes and coins are recognized as legal tender in Canada. Bitcoin digital 'currency' is not legal tender in Canada."[4]

Securities Regulation

Securities and capital markets activities in Canada are subject to the rules and regulations of the securities regulatory authorities in each of the country's 13 provinces and territories. In addition to the securities statutes applicable in each province and territory, Canada's capital markets are also regulated by national instruments, multilateral instruments, local rules and policies adopted by the various securities regulators and the rules of the applicable Canadian stock exchange.

In August 2017, the CSA released CSA Staff Notice 46-307—Cryptocurrency Offerings, which weighs in on the applicability of Canadian securities laws to cryptocurrencies.

The CSA Notice addresses a number of considerations of relevance to fintechs, investors and their advisors, including the potential applicability of Canadian securities laws to initial coin offerings (ICOs) and initial token offerings (ITOs), cryptocurrency exchanges and cryptocurrency investment funds. It follows a press release issued by the Ontario Securities Commission (OSC), one of the principal securities regulators in Canada, earlier this year confirming that Ontario securities laws

may apply to any use of distributed ledger technologies, such as blockchain, as part of financial products or service offerings. The effect of the CSA Notice is to confirm the potential applicability of Canadian securities laws to cryptocurrencies and related trading and marketplace operations.

Regulatory Sandbox

In February 2017, the Canadian Securities Administrators (CSA) announced the launch of a regulatory sandbox. The CSA is an umbrella organization of Canada's provincial and territorial securities regulators whose objective is to improve and harmonize regulation of the Canadian capital markets.

A regulatory sandbox aims to support fintech businesses by allowing them to apply to the regulator to benefit from a more tailored approach to regulation that balances the need to facilitate the use of innovative products, services and applications across Canada with appropriate investor protection.

"Two of the key characteristics of a 'marketplace' are that (1) it brings together orders for securities of multiple buyers and sellers; and (2) it uses established, non-discretionary methods[6] under which the orders interact with each other."

As a result, the CSA assesses the merits of each business model, on a case-by-case basis, and allows innovative businesses to register or be granted relief from certain requirements to permit them to test products and services throughout the Canadian market. The CSA regulatory sandbox is intended to allow fintechs that meet the CSA's criteria to register and/or obtain exemptive relief from Canadian securities law requirements under a faster and more flexible process than through the standard channels.

Potential business models eligible for the CSA regulatory sandbox include cryptocurrency-based ventures.

To apply to the CSA regulatory sandbox, businesses need to contact their local securities regulator, which considers their eligibility and refers them to the CSA regulatory sandbox if it provides genuine technological innovation in the securities industry. As part of the application process, CSA staff may request live environment testing, a business plan and demonstration of potential investor benefits, as well as how investor risks are minimized.

Registration Requirements

Under Canadian securities laws, a person (i.e., an entity or an individual) must not (1) trade in a security, (2) act as an adviser, (3) act as an investment fund manager, or (4) act as an underwriter, unless such person is registered with a securities regulatory authority. Registration is the process of being approved by a securities regulator to conduct such specified activities, subject to compliance with the detailed rules and regulations in the securities act of that province or territory, and National Instrument 31-103—Registration Requirements and Exemptions (NI 31-103)—as well as oversight by the securities regulator.

The terms "trade" and "advising" are broad under Canadian securities laws; therefore, the determining factor as to whether the type of activity carried on by a person requires registration under NI 31-103 is whether the activity is carried on for a business purpose (often referred to as the "business trigger"). Certain factors may suggest that a person is in the "business of trading" or advising, including acting as a market maker, contacting someone to solicit trades or to offer advice, and expecting or receiving compensation or remuneration as a result of such activities.

Cryptocurrency Exchanges

While no cryptocurrency marketplaces or exchanges have registered to date with any securities regulators in Canada, the CSA has emphasized the need for cryptocurrency exchanges to determine whether the cryptocurrencies that they offer are "securities" and, if so, to register as a marketplace or get an exemption from registration.

"In September 2017, the British Columbia Securities Commission (BCSC) announced the first registration of an investment fund manager in Canada dedicated solely to cryptocurrency investments."

Marketplace Requirements

In Canada, marketplaces[5] are regulated and must meet the requirements prescribed by National Instrument 21-101—Marketplace Operation (NI 21-101). Exchanges, quotation, trade reporting systems and alternative trading systems are marketplaces that provide a market facility or venue on which securities can be traded. Two of the key characteristics of a "marketplace" are that (1) it brings together orders for securities of multiple buyers and sellers; and (2) it uses established, non-discretionary methods[6] under which the orders interact with each other.

Securities legislation in most provinces of Canada does not define the term "exchange." However, the Canadian securities regulatory authorities have provided guidance[7] that they will generally consider a marketplace to be an exchange, if the marketplace:

1. Requires an issuer to enter into an agreement in order for the issuer's securities to trade on the marketplace, i.e., the marketplace provides a listing function;

2. Provides, directly, or through one or more marketplace participants, a guarantee of a two-sided market for a security on a continuous or reasonably continuous basis, i.e., the marketplace has one or more marketplace participants that guarantee that a bid and an ask will be posted for a security on a continuous or reasonably continuous basis. For example, this type of liquidity guarantee can be carried out on exchanges through traders acting as principal such as registered traders, specialists or market makers;

3. Sets requirements governing the conduct of marketplace participants, in addition to those requirements set by the marketplace in respect of the method of trading or algorithm used by those marketplace participants to execute trades on the system; or

4. Disciplines marketplace participants, in addition to discipline by exclusion from trading, i.e., the marketplace can levy fines or take enforcement action.

First Registration of a Cryptocurrency Fund Manager in Canada

In September 2017, the British Columbia Securities Commission (BCSC) announced the first registration of an investment fund manager in Canada dedicated solely to cryptocurrency investments. First Block Capital Inc., which will operate a bitcoin investment fund, was registered as an investment fund manager and exempt market dealer.

In its news release announcing the registration, the BCSC noted that cryptocurrency investments raise unique risks, such as cybersecurity risks that accompany dealing in digital currencies, that distinguish such investments from investments in traditional asset classes. These risks relate not only to the registrant but also to the cryptocurrency fund's custodian, which is a third party chosen to facilitate the safekeeping and exchange of the cryptocurrency.

The BCSC imposed various conditions of registration on First Block Capital in order to provide the company with the flexibility to allow it to operate within the present regulatory framework and to simultaneously provide the BCSC with the necessary tools to evaluate the unique risks that accompany cryptocurrency investments. The BCSC's news release noted that there is a strong appetite for access to cryptocurrency investments in Canada. It should be expected that additional investment funds dedicated to cryptocurrency investments will appear in the near future.

In another interesting development in British Columbia, it was reported in February 2018 that the BCSC found that it did not consider the tokens underlying the collectible blockchain-based virtual cartoon cats—"CryptoKitties"—to be securities . This would be in line with the CSA's intention to approach on a case-by-case basis the classification of digital tokens or coins.

First Application for Cryptocurrency ETF

Also in September 2017, Evolve Funds Group Inc. filed a preliminary prospectus with the securities regulators in all of the provinces and territories in hopes of launching Canada's first actively managed cryptocurrency exchange-traded fund (ETF). If approved, the fund would invest directly or indirectly in bitcoin futures launched by the Chicago Board Options Exchange and other financial instruments and derivatives.

> *"Previous ICOs have usually relied on exemptions permitting tokens to be sold only to accredited investors, thereby limiting the opportunity for retail investors to participate in an offering."*

The ETF would provide Canadian retail investors an opportunity to access the bitcoin market through an actively managed fund listed on the Toronto Stock Exchange. Several firms in the United States have attempted to launch bitcoin ETFs but none of the filings have been able to gain approval from regulators.

Initial Coin Offerings (ICOs)

The CSA Notice clarifies that in the case of an ICO/ITO, regardless of whether the instrument distributed is referred to as a coin/token instead of a share, stock or equity, that instrument may still be a "security" under Canadian securities laws. This is significant as the designation of an instrument as a security results in substantial mandatory compliance on the part of the issuer with respect to the Canadian registration regime, prospectus requirements and other disclosure obligations.

The CSA Notice also makes the following points.

- A security includes an "investment contract." In determining whether a coin/token is an investment contract, a four-prong test should be applied, being does the coin/token involve: (i) an investment of money, (ii) in a common enterprise, (iii) with the expectation of profit, (iv) to come significantly from the efforts of others. Advertisement of a coin or token as a software product is not relevant in determining whether a coin or token constitutes a "security."
- The "investment contract" test looks at the economic realities of the circumstances and provides a very broad and flexible means of capturing new and innovative arrangements, such as ICOs/ITOs, that do not fit within other definitions of a "security."
- Generally, every issuer who distributes (trades) previously unissued "securities" (i.e. new securities being distributed for the first time) is required to file a prospectus with, and obtain a receipt for such prospectus from the relevant securities commissions/regulators. A prospectus is a comprehensive document that discloses all material information about the issuer and the securities being sold. The prospectus must be delivered to each investor who purchases the securities of the issuer. When securities are distributed by an issuer in compliance with the prospectus requirements under Canadian securities law, such securities are freely tradeable in Canada. There are exemptions from the prospectus requirements that allow an issuer to offer securities to investors on a private placement basis without having to file a prospectus with any securities commission or deliver a prospectus to an investor. When securities are delivered by an issuer in reliance of any prospectus exemption (private placement basis), such securities are not freely tradeable in Canada and are subject to restrictions on transfer and hold periods, which may be indefinite in length. "Securities" that are coins/tokens are no different. Any issuer that conducts an ICO/ITO of a coin/token that constitutes a "security" must comply with such prospectus requirements or rely on an applicable prospectus exemption. For example, coins/tokens that meet the definition of a security could be distributed to accredited investors (investors with substantial financial assets, or income) in reliance of the accredited investor prospectus exemption, or could be distributed to retail investors in reliance of the offering memorandum prospectus exemption. A white paper does not constitute a prospectus and does not fulfill the prospectus and disclosure requirements applicable under Canadian securities laws. To date, no business has used a prospectus to complete an ICO/ITO in Canada; however, coins/tokens have been distributed in Canada on a prospectus exempt (private placement) basis.

First ICO Open to Retail Investors in Canada

In a decision widely noted by the start-up community, the OSC approved the first ICO in Ontario. Notably, this ICO by Token Funder Inc. was the first ICO approved by a securities regulator in Canada that would be open to retail investors. Previous ICOs have usually relied on exemptions permitting tokens to be sold only to accredited investors, thereby limiting the opportunity for retail investors to participate in an offering.

The exemptions in this case were granted in the context of the CSA's regulatory sandbox. Token Funder Inc. is only the second such fintech in Canada to receive approval for an ICO in the context of the CSA sandbox. The first was Impak Finance Inc., which received an exemption from the dealer registration and prospectus requirements in August 2017.

While the OSC indicated that innovation and the fostering of capital raising were considerations that led to the approval of this ICO, it cautioned that the decision was based on the particular facts and circumstances of the applicant and should not necessarily be seen as a precedent for other ICOs.

Project Jasper

Project Jasper is an experiment being carried out by the Bank of Canada, Payments Canada (an organization operating the payment clearing and settlement system in Canada) and R3 (a distributed database company) to test the feasibility of using distributed ledger technology (DLT) as the basis for wholesale interbank payment settlements. This project was launched in March 2016 and has completed two phases. Phase 1 of Project Jasper employed the Ethereum platform as the basis for the DLT, while Phase 2 employed the custom-designed R3 Corda platform.

One of the conclusions of Phase 1 was that DLT is not more beneficial, at least for now, than the current centralized system of wholesale payments. However, the successful proof-of-concept highlighted best practices for wide-scale public/private cooperation and uncovered other opportunities for the implementation of the technology within the financial industry.[9] Phase 1 involved the combined efforts of Bank of Montreal, Canadian Imperial Bank of Commerce, HSBC, National Bank of Canada, Royal Bank of Canada, Scotiabank and TD Canada Trust.

Ana Badour is a partner with the law firm McCarthy Tétrault LLP. She advises financial services entities on regulatory compliance matters. She leads the firm's Fintech practice and is a Certified Anti-Money Laundering Specialist.

Shauvik Shah is a business law associate with the law firm McCarthy Tétrault LLP. He focuses on securities law, private equity, mergers and acquisitions and is actively involved with the firm's leading Fintech practice.

Carolyn Wilkins, senior deputy governor of the Bank of Canada, and Gerry Gaetz, president of Payments Canada, concluded following the experiment that, as against the necessity for interbank systems to be safe, secure, efficient and resilient, as well as to meet all international standards, "DLT-based platforms are just not there yet."[10] Consequently, they indicated that near-term modernization of Canada's payments system will not involve distributed ledgers, but will involve wide-scale innovation and collaboration across many public and private parties.

The next phase of Project Jasper will include the involvement of TMX Group, which, among other things, is the owner of the Toronto Stock Exchange. TMX Group will be exploring the creation of an integrated securities and payment infrastructure and identifying potential efficiencies within the end-to-end securities settlement process.

Anti-Money Laundering/Counter-Terrorism Financing Regulatory Developments

The ease and pseudo-anonymity associated with transferring funds using cryptocurrencies can make them susceptible to misuse for the purposes of money laundering, terrorist financing and tax evasion, and Canadian regulators have been most focused on these issues to date.

In the 2014 federal budget, the Proceeds of Crime (Money Laundering) and Terrorist Financing Act was amended to classify persons "dealing in virtual currencies" as "money services businesses" for purposes of Canada's anti-money laundering and counter-terrorist financing regime. The Department of Finance has reported that it is currently in the process of drafting the regulations that will specify the types of cryptocurrency businesses that will be considered money services businesses for the purposes of Canada's anti-money laundering and counter-terrorist financing regime, and that will define the obligations of those entities.[11] The phrase "dealing in virtual currencies" is not yet defined but the government has suggested that it will apply to cryptocurrency exchanges.[12]

In addition, in February 2015, the Québec securities regulator, the Autorité des marchés financiers (AMF), published amendments to the Policy Statement to the Québec Money-Services Businesses Act, requiring any business that operates a cryptocurrency automated teller machine, such as a bitcoin ATM, or that provides a platform for trading cryptocurrencies, to obtain a license under the Quebec Money-Services Businesses Act.[13] An application for a permit as a money service business under this Act requires certain disclosure of information about the business, including the legal and corporate structure, a business plan, and information about any relevant employees and mandataries. Licenses will only be issued to businesses that the AMF deems, having considered input from investigations by the provincial and local municipal police forces, to possess integrity and good moral character. In addition, the obligations required of licensees include maintaining records and registers of clients that may de-anonymize transactions through cryptocurrency exchanges.

The Canadian Approach Going Forward: The Senate Report

The Minister of Finance tasked the Standing Senate Committee on Banking, Trade and Commerce with examining the use of cryptocurrencies in 2014. This Committee pursued an extensive fact-finding mission in Canada and in the United States, speaking with, amongst others, representatives from regulatory bodies, financial institutions, cryptocurrency interest groups, law enforcement, and universities. In June 2015, the Committee published a report entitled *Digital Currency: You Can't Flip This Coin* with a clear message: while there are steps to take to address the risks cryptocurrencies could pose in money laundering, terrorist financing, and tax evasion, the federal government should tread carefully in developing regulations for cryptocurrency so as not to restrict or stifle its use and development.

The Senate report made eight suggestions in total, recommending that the federal government:

1. Take a "light regulatory touch—almost a hands off approach" with respect to cryptocurrencies and their associated technology so as not to stifle further development;
2. Consider employing the underlying blockchain technology for its own purposes of delivering government services and enhancing the security of private information;

3. Regulate cryptocurrency exchanges, other than businesses that solely provide wallet services, as money service businesses, to minimize the risks of money laundering and terrorist financing;

4. Continue to work with other countries to formulate a global approach for regulating cryptocurrencies;

5. Convene a stakeholder roundtable (including banks) to search for solutions to lack of access to banking services for cryptocurrency related businesses that address risks relating to anti-money laundering and anti-terrorism;

6. Provide concise information and educate the public about the risks of using cryptocurrencies and using alternative payment systems;

7. Provide concise information and educate the public about the tax obligations of cryptocurrencies when received as income, held as an investment or used to purchase goods and services; and

8. Review and renew this study of cryptocurrencies to assess the appropriateness of the regulatory environment in three years.[14]

The Senate Committee's endorsement of a "light regulatory touch" stands in contrast with the approach taken by some other jurisdictions. The only specific regulatory recommendation to the federal government was to regulate cryptocurrency exchanges, other than businesses that solely provide wallet services, as money service businesses, to minimize the risks of money laundering and terrorist financing. As discussed above, both the federal government and the Quebec government have already taken steps to implement such regulation.

Future Developments

Looking to the future, the main anticipated regulatory development will be the release of the regulations to the Proceeds of Crime (Money Laundering) and Terrorist Financing Act detailing the types of cryptocurrency businesses that will be considered money services businesses for the purposes of the federal anti-money laundering and counter-terrorist financing regime, and the obligations of those entities. At the moment, no further rules are known to be imminent for cryptocurrency offerings, such as ICOs, but further guidance from securities regulators should be expected given the rapidly evolving nature of, and public scrutiny directed towards, this space.

Endnotes

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2. See Irving R. Gerstein & Celine Hervieux-Payette, Digital Currency: You Can't Flip This Coin! Report of the Standing Senate Comm. on Banking, Trade and Commerce (2015).
3. Currency Act, R.S.C. 1985, c C-52, s. 8 (Can.).
4. David George-Cosh, *Canada Says Bitcoin Isn't Legal Tender*, The Wall Street Journal (Jan. 16, 2014, 4:26pm) http://blogs.wsj.com/canadarealtime/2014/01/16/canada-says-bitcoin-isnt-legal-tender/.
5. Under NI 21-101 a marketplace means (a) an exchange, (b) a quotation and trade reporting system, (c) a person or company not included in clause (a) or (b) that (i) constitutes, maintains or provides a market or facility for bringing together buyers and sellers of securities, (ii) brings together the orders for securities of multiple buyers and sellers, and (iii) uses established, non-discretionary methods under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade, or (d) a dealer that executes a trade of an exchange-traded security outside of a marketplace, but does not include an inter-dealer bond broker. See National Instrument 21-101(a-d)(Can.).
6. The Canadian securities regulatory authorities are of the view that established, nondiscretionary methods include any methods that dictate the terms of trading among the multiple buyers and sellers entering orders on the system. Such methods include providing a trading facility or setting rules governing trading among marketplace participants.
7. Companion Policy 21-101CP to National Instrument 21-101 (Can.).
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Cryptocurrencies: The Cayman Islands is Open for Business, for Now

By Jalil Asif QC, Rebecca Hume and Pamella Mitchell

The recent spike of interest surrounding cryptocurrencies, and the underlying blockchain technology that makes them possible, is having a significant impact on the offshore world. Many offshore jurisdictions are vying to attract businesses that are supported by blockchain technology, given its rapid expansion and its potential to become an important means of facilitating many different kinds of transactions and record keeping. Offshore jurisdictions, particularly the Cayman Islands, are often used to create the structures that issue cryptocurrencies and the funds that invest or trade in them (or in derivatives based on them). However, cryptocurrencies raise specific issues beyond those related to blockchain, and there are significant unanswered questions regarding how cryptocurrencies, and financial trading linked to them, will be regulated. In some jurisdictions, initial enthusiasm has evolved into concern over the potential for cryptocurrencies to be used as a means for committing or facilitating money laundering, fraud and other financial crimes. We look at the challenges in regulating the sector, how the Cayman Islands is responding, and how the regulators will probably seek to combat money laundering and other financial crimes.

Jalil Asif QC

Rebecca Hume

Pamella Mitchell

The Cayman Islands Embraces Cryptocurrencies

The Cayman Islands is a leading offshore financial centre and has become the jurisdiction of choice for creating investment structures, particularly investment funds and hedge funds. This is mainly because of its tax-neutral status and its innovative and flexible approach to creating the legal vehicles and supporting legislation that facilitates international financial business.[1] The jurisdiction actively maintains its market-leading position by investing in innovation, for example, by facilitating and promoting the infrastructure that allows technology businesses to thrive, including a supportive physical infrastructure and legal regime. In the past year, over 50 blockchain development companies have opened for business from the Cayman Islands, taking advantage of the its special economic zone (SEZ)[2], and these are likely to be just the early adopters.

Cryptocurrencies go hand in hand with blockchain, of course, and the Cayman Islands has been equally quick to welcome companies involved in issuing digital currencies and funds that trade or invest in them. Global growth in initial coin offerings (ICOs) has been phenomenal: In 2016, U.S. $6 million was issued; U.S. $2 billion in 2017; and U.S. $2 billion in the first few months of 2018, a large part of which has been channelled through the Cayman Islands. Similarly, an increasing number of funds that invest in cryptocurrencies are being established in the Cayman Islands, encouraged by the recent announcement that certain exchanges (for example, the CME and CBOE) will allow trading in Bitcoin futures, foreshadowing a broadening of the types of cryptocurrency investments that will be available. In addition, many funds with a primary investment strategy focussed on more traditional market sectors are now looking at cryptocurrencies as a means to generate additional returns, provided that the risk and volatility generated for the fund is kept under manageable control.

"Cryptocurrency trading could easily be captured by existing regulatory regimes if the fund or token exchange (often set up as part of an ICO) allows the conversion of "fiat" cash (i.e., real money) for digital tokens."

Regulation of Funds, ICOs and Cryptocurrencies: The Cayman Islands' Approach

The legal structures typically used for funds can equally be used for funds trading in cryptocurrencies—for example, mutual funds, segregated portfolio companies and the new foundation companies introduced during 2017. In principle, there is no difference in setting up a fund that will trade cryptocurrencies and one that will conduct more traditional business practices. Nevertheless,

the more important question lies in regulation of ICOs and the trading of cryptocurrencies themselves. This is particularly relevant because of the potential for wrongdoers to use them for money laundering, terrorist funding or simply fraud.

"The Cayman Islands' laws require companies carrying out certain activities to operate stringent anti-money laundering procedures."

A fundamental question that will determine how cryptocurrencies are regulated is whether they should be treated as securities, commodities or cash This is an interesting question because they exhibit features of each. The U.S. Securities and Exchange Commission indicated last year that it will treat Bitcoin and other cryptocurrencies as securities that are subject to its regulatory purview and noted that this will be a key area of focus in 2018. On the other hand, the Cayman Islands' Securities Investment Business Law[3] narrowly defines securities subject to that law, which does not cover cryptocurrencies. Thus, the licencing and regulatory requirements of that legislation for engaging in securities-related activities do not apply to Cayman Islands companies carrying on cryptocurrency trading. And although there has been speculation that it will do so, the Cayman Islands' government has not yet given any firm indication that it plans to revise the current system to bring cryptocurrencies within its control.

Cryptocurrency trading could easily be captured by existing regulatory regimes if the fund or token exchange (often set up as part of an ICO) allows the conversion of "fiat" cash (i.e., real money) for digital tokens. This would probably fall under the control of the Cayman Islands' Money Services Law, and would require the fund or exchange to obtain a specific licence from the Cayman Islands Monetary Authority (CIMA). Those involved in setting up and issuing ICOs should therefore be vigilant in ensuring they have properly and comprehensively defined the nature of their business so that it is clear whether or not they are conducting business that potentially could be caught by the Money Services Law.

Trading in cryptocurrencies also raises a number of practical issues that can easily be overlooked, including, for example, how custody of the digital assets will be handled. Due to the risk of hacking, many prudent investment managers will want to move digital tokens to secure cold storage (i.e., offline), probably leading to an increase in self-storage and headaches for those responsible for security and for fund auditors.

By far the most likely area where existing regulation will impact cryptocurrencies is in relation to Know Your Client and other anti-money laundering rules. The Cayman Islands' laws require companies carrying out certain activities to operate stringent anti-money laundering procedures.[4] These obligations are significantly higher than those in the U.S. and at present provide the primary means for protecting cryptocurrency usage and trading from the activities of bad actors.

Additionally, the obligations of those involved in the financial markets under the U.S. Foreign Accounts Tax Compliance Act (and other international agreements to which the Cayman Islands is party) require financial institutions to identify and report on their account holders, and will apply with the same rigour to those involved in buying digital tokens or trading cryptocurrencies.

The Regulatory Road Ahead

While current anti-money laundering laws provide a firm foundation for the regulation of digital currency trading and ICOs, most would agree that they are insufficient on their own to provide fully effective regulation. Although the authorities in the Cayman Islands have not yet moved to address the specific issues being generated by cryptocurrencies, this is not due to inertia or lack of interest; instead, the indications are that the government and the regulator are actively considering how best to formulate controls on a rapidly evolving form of investment. The general expectation is that the Cayman Islands government and CIMA, as the regulator, will soon specifically address regulation in a way that seeks to prevent fraud but at the same time is consistent with, and continues to promote, the Cayman Islands' position as a leading centre for the global financial services industry.

Jalil Asif QC, Rebecca Hume and Pamella Mitchell are attorneys at Kobre & Kim.

Endnotes

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Cryptocurrency Regulation in Australia

By Peter Reeves

The past few years have seen a sharp rise in the creation and use of cryptocurrencies, with companies like Power Ledger and Haven raising millions in their Australian ICOs. This in turn has increased regulatory engagement in Australia. Consistent with many of its international counterparts, the Australian corporate regulator, the Australian Securities and Investments Commission (ASIC), has recently published its view that cryptocurrencies, depending on the rights and utilities attaching to them, may be subject to regulatory oversight and action. This may include where cryptocurrencies are offered to purchasers and investors for the first time through an initial coin offering (ICO). Further, entities seeking to do an ICO in Australia should be aware of financial services, consumer law, taxation and anti-money laundering financing (AML/CTF) regimes which will affect the way entities structure and offer their cryptocurrency as well as regulation affecting new business models. It is important to recognize that regulatory treatment and enforcement will continue to evolve as regulators develop an understanding of the sector, risks to consumers, and the strategies being applied to cryptocurrencies and ICOs.

Peter Reeves

I. Licensing and Marketing

Licensing

Of particular concern to those dealing with cryptocurrencies is whether a cryptocurrency (including those offered during an ICO) constitutes a financial product and therefore may trigger financial services licensing and disclosure requirements. Entities carrying on a financial services business in Australia must hold an Australian financial services license (AFSL) or be exempt. The definitions of financial product or financial service under the Corporations Act 2001 (Cth) (Corporations Act) are broad and ASIC has indicated in an information sheet issued in September 2017, INFO 225 Initial Coin Offerings (Info 225) that cryptocurrency with similar features to existing financial products or securities will trigger the relevant regulatory obligations.

Within Info 225, ASIC indicated the legal status of cryptocurrency is dependent upon the structure of the ICO and the rights attaching to the coins. Depending on the circumstances, cryptocurrencies may constitute interests in managed investment schemes (collective investment vehicles), securities, derivatives or fall into a category of more generally defined financial products, all of which are subject to the Australian financial services regulatory regime. Entities offering such coins will need to comply with the regulatory requirements under the Corporations Act, which generally include disclosure, registration and licensing obligations. An entity which facilitates payments by cryptocurrencies may also be required to hold an AFSL and the operation of a cryptocurrency exchanges may be required to hold an Australian market licence if the coins traded on the exchange constitute financial products.

Importantly, noting the exception of the Chinese and South Korean ban on ICOs, ASIC's regulatory guidance is consistent with the position of other international regulators. For example, the financial regulator in Hong Kong, like ASIC, has also outlined situations where cryptocurrency may be a financial product. ASIC has also recommended that companies wishing to hold an ICO contact its Innovation Hub for informal assistance. This reflects its willingness to build greater investor confidence around cryptocurrency as an asset class. However, there has not yet been a regulated financial product ICO in Australia.

Marketing

ASIC's guidance noting that an ICO may involve an offer of financial products clearly has implications for the marketing of an ICO. Apart from whether the marketing activity itself may cause the ICO to be an offer of a regulated financial product, an offer of a financial product to a retail client (with some exceptions) must be accompanied by a regulated disclosure document (e.g., a product disclosure statement or a prospectus and a financial services guide) that satisfies the content requirements of the Corporations Act and regulatory guidance published by ASIC. Such a disclosure document must set out prescribed information, including the provider's fee structure, to assist a client to decide whether to acquire the cryptocurrency from the provider.

Cross-Border Issues

Entities should note that the Corporations Act may apply regardless of whether the ICO was created and offered from Australia or overseas. Carrying on a financial services business in Australia will require a foreign financial service provider (FFSP) to hold an AFSL, unless relief is granted. Australia has cooperation (passporting) arrangements with regulators in foreign jurisdictions (including the U.S.), which enable FFSPs regulated in those

jurisdictions to provide financial services in Australia without holding an AFSL. However, the passporting relief is currently only available in relation to the provision of services to wholesale clients (i.e., accredited investors), and the FFSP must only provide the services it is authorised to provide in its home jurisdiction.

Further, foreign companies taken to be carrying on a business in Australia, including by issuing cryptocurrency or operating a platform developed using ICO proceeds, may be required to either establish a local presence (i.e., register with ASIC and create a branch) or incorporate a subsidiary. Broadly, the greater the level of system, repetition or continuity associated with an entity's business activities in Australia, the greater the likelihood registration will be required. Generally, a company holding an AFSL will be carrying on a business in Australia and will trigger the requirement.

Promoters should also be aware that should they wish to market their cryptocurrency to Australian residents, and such cryptocurrency is considered a financial product under the Corporations Act, they will not be permitted to market their products unless the requisite licensing and disclosure requirements are met. Generally, an offshore provider may address requests for information, pitch and issue products to an Australian resident if the resident makes the first (unsolicited) approach (i.e., there has been no conduct designed to induce the investor, or that could have been taken to that effect), and the service is provided from outside Australia.

Design and Distribution Obligations and Product Intervention Powers

In response to the 2015 Financial System Inquiry, the Australian government has released an Exposure Draft of Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2017 (the Bill), which may impact on the way cryptocurrencies are structured and ICOs conducted in future. The Bill proposes to introduce new design and distribution obligations in relation to financial products as well as provide ASIC with temporary product intervention powers where there is a risk of significant consumer detriment. This will likely impact businesses seeking to issue cryptocurrency as a financial product. The new arrangements aim to ensure that financial products are targeted to the right people, and where products are inappropriately targeted and sold, empower ASIC to intervene in the distribution of the product to prevent consumer detriment. At the time of writing, ASIC has yet to release guidance on the way it might interpret its powers, but it is open to impact the cryptocurrency sector.

Peter Reeves is a Partner at the firm of Gilbert + Tobin. He can be reached at preeves@gtlaw.com.au.

II. Consumer Law

Even if an ICO is not regulated under the Corporations Act, it may still be subject to other regulation and laws, including Australian consumer laws relating to the offer of services or products. Australian Consumer Law (ACL) prohibits misleading or deceptive conduct in a range of circumstances. Care must be taken in ICO promotional material to ensure that buyers are not misled or deceived. Promoters and sellers are prohibited from engaging in unconscionable conduct and must ensure the coins are fit for their intended purpose.

The protections of the ACL are generally reflected in the Australian Securities and Investments Commission Act 2001 (Cth) ("ASIC Act"), which applies to financial products or services, so should entities be found to be providing financial products or services they will be treated in a similar way.

There can be a range of consequences for failing to comply with the ACL and the ASIC Act, including enforcement by regulators, penalties, injunctions, and compensatory damages.

III. Taxation

The taxation of cryptocurrency in Australia has been an area of much debate, despite recent attempts by the Australian Taxation Office (ATO) to clarify the operation of the tax law. For income tax purposes, the ATO views cryptocurrency as an asset that is held or traded (rather than as money or a foreign currency).

Tax Implications to Investors / Holders of Cryptocurrencies

The tax implications for investors or holders of cryptocurrency depends upon the intended use of that cryptocurrency. The summary below applies to investors who are Australian residents for tax purposes.

Investors in the business of trading cryptocurrencies (including funds) are likely to be subject to the trading stock provisions, much like a supermarket treats its goods for sale as trading stock. The gains and losses on the sale of cryptocurrencies will be taxable to such investors on "revenue account."

Otherwise, the ATO has indicated that cryptocurrency will likely be a capital gains tax (CGT) asset. The gain on its disposal will be subject to CGT. Capital gains may be discounted under the CGT discount provisions, so long as the investor satisfies the conditions for the

discount. There is a looming question in Australia as to whether cryptocurrencies are eligible to be CGT assets (and subject to the CGT discount) as a matter of law, considering most users of cryptocurrency have a profit-making purpose by way of selling their coins or tokens (i.e., they hold the cryptocurrency on revenue account). This matter is unresolved in Australia.

Capital gains or losses on cryptocurrencies that are "personal use" assets are disregarded. This includes cryptocurrencies acquired or kept for personal use or consumption (i.e., to buy goods or services). Capital gains on personal use assets are only disregarded where the asset was acquired for less than A$10,000.

Tax Implications to Issuers of Cryptocurrencies

In the context of an ICO, a coin issuance by an entity that is either an Australian tax resident, or acting through an Australian "permanent establishment," will likely be taxable in Australia. The current corporate tax rate in Australia is between 27.5 percent and 30 percent. If the issued coins are characterised as equity for tax purposes, the ICO proceeds should not be taxable to the issuer, but all future returns to the token holders will be treated as dividends.

Australian Goods and Services Tax (GST)

Following changes of law in 2017, supplies and acquisitions of digital currency are generally disregarded for the purposes of GST.

Other Comments

The ATO has recently announced the creation of a specialist task force to tackle cryptocurrency tax evasion. With the broader regulatory trend around the globe moving from guidance to enforcement, it is likely that the ATO will also begin enforcing tax liabilities more aggressively.

IV. Anti-Money Laundering and Counter-Terrorism Financing

The Australian government recently passed the Anti-Money Laundering and Counter-Terrorism Financing Amendment Act 2017 ("AML/CTF Act"), which will bring cryptocurrencies within the scope of Australia's anti-money laundering regime. The amendments focus on the point of intersection between cryptocurrencies and the regulated financial sector, namely digital currency exchanges and digital wallet providers.

Digital currency exchange providers are now required to register with the Australian Transaction Reports and Analysis Centre (AUSTRAC) in order to operate, with a penalty of up to two years of imprisonment or a fine of up to A$105,000, or both, for failure to register. Registered exchanges will be required to implement know-your-customer processes to adequately verify the identity of their customers, with ongoing obligations to monitor and report suspicious and large transactions. Exchange operators are also required to keep certain records relating to customer identification and transactions for up to seven years. Bringing digital currency exchange providers within the ambit of the AML/CTF framework is intended to help legitimise the use of cryptocurrency while protecting the integrity of the financial system in which it operates.

V. New Business Models

Blockchain

There are currently no specific regulations dealing with blockchain technology in Australia. However, in March 2017, ASIC released guidance in INFO 219: Evaluating Distributed Ledger Technology, outlining their approach to the regulatory issues, which may arise through the implementation of blockchain technology and distributed ledger technology (DLT) solutions more generally. ASIC reaffirmed their "technology neutral" stance in applying the financial services regime and the notion that businesses considering operating market infrastructure or providing financial or consumer credit services using DLT will still be subject to the compliance requirements that currently exist under the applicable licences.

Smart Contracts

Various cryptocurrency networks have implemented "smart contracts" or self-executing contracts. These are permitted in Australia under the Electronic Transactions Act 1999 (Cth) (ETA) and the equivalent Australian state and territory legislation. The ETA provides a legal framework to enable electronic commerce to operate in the same way as paper-based transactions. Under the ETA, self-executing contracts are permitted in Australia, provided they meet all the traditional elements of a legal contract.

VI. 2018 Outlook

The use of cryptocurrencies in new business models and raising funds through ICOs have increased exponentially in the past 18 months. With increasing prevalence comes a tightening of the regulatory framework to protect consumers. This has been seen through developments such as the amendments to the AML/CTF Act bringing digital currency exchange providers under the jurisdiction of AUSTRAC and also ASIC making it clear it will carefully scrutinize ICOs to determine their legality. We anticipate that 2018 will see an increasing level of scrutiny and enforcement activity from various regulators. It is also likely that we will begin to see more institutional activity in the sector over the next year, with the use cases for integrating cryptocurrencies gaining greater legitimacy.

The Public Offering of Coins and Tokens Under Austrian Capital Markets Law

By Stefan Paulmayer

Offering tokens and coins via initial coin offerings (ICOs) and initial token offerings (ITOs) are increasingly popular forms of alternative financing for small companies, including startups. Depending on how tokens or coins are structured, certain regulatory requirements may be triggered under Austrian capital markets law. For instance, a prospectus may be required if the token or coin structure is similar to the structure of a security or investment. Hence, a careful and detailed legal framework of ICOs and ITOs is strongly recommended.

Stefan Paulmayer

1. Introduction

Austria is known for its rather strict financial services and capital market regulation,[1] which may impact on proposed business models of startups and Small and Medium sized Enterprises (SMEs). As a result, smaller companies are constantly looking for new ways to secure financing. A popular form of alternative financing has been the issuance of subordinated loans.[2] With subordinated loans, a company offers to act as a borrower vis-à-vis particular retail clients who act as lender. Although this sort of financing is rather risky for the investor, it is a widely accepted form of financing because the Austrian Act on Alternative Financing Instruments—introduced in 2015 to facilitate access to funding for SMEs—explicitly provides for such instruments.

With the increasing popularity of tokens, coins, blockchain, and virtual currencies, many startup companies over the last 12 months have been exploring ICOs and ITOs as a way to raise funds.[3] One way to raise funds would be to issue subordinated loans that are represented by a token via the blockchain's distributed ledger protocol.

While the ongoing hype for cryptocurrencies has resulted in many ICOs in the Austrian market, coin and token issuers are well advised to structure their ICOs and ITOs in compliance with existing capital markets regulation. This is because the Austrian Financial Market Authority (FMA) generally considers existing regulation to be technic-neutral, meaning that current regulation will apply irrespective of new technologies being employed or underlying a fund-raising campaign.[4]

This article attempts to give readers an overview of applicable regulations under Austrian law that will need to be taken into account when ICOs or ITOs enter Austria's stream of commerce.

2. Types of Tokens and Coins

The following types of tokens and coins are currently being issued in Austria:

i. Utility tokens; and
ii. Investment/equity tokens.

With regard to raising funds, coins that resemble virtual currencies like Bitcoin or Ether are of less practical relevance.

Utility tokens usually refer to tokens that are issued using the Ethereum blockchain technology under the ERC-20 token standard. Utility tokens are commercially similar to vouchers or coupons. The utility token subscribers/buyers are usually granted the right to exchange tokens against the goods or services of the issuer, usually on some form of Blockchain driven platform or online system. Examples include the issuance of Hero token.[5] Utility tokens do not grant the holder any rights similar to investors of debt or equity securities. This means that utility token holders are usually not entitled to repayments of the principal and do not receive any interest payments. Utility tokens also do not confer any voting or similar rights granted to investors of debt or equity securities. Utility tokens have been the predominant form of tokens offered in Austrian ICOs in 2017 and early 2018.

Current market practices, however, show that issuers are exploring ways to structure tokens and coins similar to debt or equity instruments. Investment tokens or equity tokens, for example, are structured similarly to common debt or equity securities. This means that, contrary to utility tokens, holders are granted interest payments rights to cancel the tokens against payment by the issuer or voting rights.

3. The Offering of Utility Tokens

The FMA currently treats utility tokens as "payment instruments" under the Austrian Payment Services Act (PSA). The PSA implements the European Union framework legislation under Directive (EU) 2015/2366 (Payment Services Directive II/PSD II).

Under the PSA, the issuance of payment instruments generally requires the issuer to be licensed as a payment service provider. While the requirements for such license are less cumbersome than licenses for credit institutions, obtaining such license is nonetheless usually not an option for issuers.

There is an exemption from the licensing requirements available for the issuance of payment instruments, provided that these issuances can be used only in a limited way: (i) Instruments allowing the holder to acquire goods or services within a limited network of service providers or within the premises of the issuer; or (ii) instruments that can be used only to acquire a very limited range of goods or services known as the Limited Network Exemption. We expect that most of the currently planned ICOs for utility tokens in Austria are structured to meet the Limited Network Exemption. In order for this exemption to apply, issuers need to ensure that the utility tokens are accepted either by the issuer in exchange for goods or services, or the issuer and a very limited number of service partners cooperating with the issuer.

If the total value of transactions executed exceeds the amount of one million Euros over the preceding 12 months, the issuer, notwithstanding the Limited Network Exemption, must notify the FMA in a document containing a description of the services offered and specifying which exclusion of the Limited Network Exemption the activity fall under.

4. The Offering of Investment / Equity Tokens

4.1 General

Austrian capital markets regulation will apply, if the tokens are structured like debt or equity securities.

4.1.1 Securities

According to § 2 of the Austrian Capital Markets Act (CMA), the public offering of securities requires the publication of a prospectus prior to making the offer. The CMA implements the European Union legislation framework under Directive 2003/71/EC, as amended into Austrian law, known as the Prospectus Directive. The requirements on how a prospectus has to look like and what kind of information must be disclosed is regulated at a European Union level in Regulation 809/2004, as amended (Prospectus Regulation).

Securities within the meaning of the CMA are securities that qualify as transferable securities under Directive 2014/65/EU (MiFID II). The directive covers all classes of securities negotiable on the capital market including:[6]

i. Shares in companies and other securities equivalent to shares in companies, partnerships or other entities, and depositary receipts in respect of shares;

ii. Bonds or other forms of securitized debt, including depositary receipts in respect of such securities; and

iii. Any other securities giving the right to acquire or sell any such transferable securities or giving rise to a cash settlement determined by reference to transferable securities, currencies, interest rates or yields, commodities or other indices or measures.

Prospectus requirements are mitigated somewhat for SMEs that offer securities under the Act on Alternative Financing Instruments (AAFI) (see at 1 above). Generally, a public offer up to 250,000 Euros is exempt from the prospectus requirements, while offers between 250,000 Euros and five million Euros requires only a simplified prospectus under the CMA. A full securities prospectus by an SME under the AAFI is generally only required for offers of five million Euros or more.

4.1.2 Investments

The CMA goes beyond the Prospectus Directive. Traditionally in Austria,[7] in addition to public offerings of transferable securities, the offer of so-called investments also require the prior publication of a prospectus. The prospectus for investments is less cumbersome than the securities prospectus under the Prospectus Regulation but investment prospectuses still require substantial disclosure of the issuer and the instruments offered.

Investments within the meaning of the CMA confer all types of rights and claims of uncertificated securities and are based on the capital investment of a majority of investors in a joint account. These rights and claims can also be based on capital investments on the joint account of the investors and the issuer, which also shares the risks associated with such investments.

An investment may legally be structured in various forms for instance, as uncertificated profit participation right, silent partnership, or any other form of an investment legally conceivable within the four corners of contractual freedom.[8] Common forms of investments are share placements in a limited liability company.[9]

Most alternative financing instruments (see at 4.1 above) that are not transferable securities, such as subordinated loans or uncertificated profit participation rights, are nonetheless investments under the CMA. The prospectus requirement under the CMA is mitigated by certain exemptions under the AAFI: (i) An offer for 100,000 Euros to 1.5 million Euros is exempt from prospectus requirements, and instead requires an informational document replacing the prospectus that has to be prepared and published; (ii) an offer for 1.5 million Euros to five million Euros is subject to a simplified investments prospectus under the CMA; and (iii) only a full investment prospectus is drafted for five million Euros under the CMA is required.

4.1.3 Territorial Aspects

Capital markets requirements under Austrian law, as well as other regulatory requirements apply whenever investment / equity tokens are offered in Austria or to the Austrian market. Issuers will not be exempt from pro-

spectus requirements based solely on their incorporation or seat of management outside of Austria.

4.2 Tokens and Coins as Securities

In previous publications, Paulmayer has argued that, for formalistic reasons, tokens should not be treated as securities.[10] This view can no longer be justified given the latest information provided by the FMA.[11]

The FMA considers tokens and coins as transferable securities provided that they are structured similar to transferable securities as defined in MiFID II (see at 4.1.1 above). This will essentially be the case whenever tokens and coins bear the basic elements of (i) a bond or other debt instruments, such as the repayment of principal or interest payments, or (ii) a share or security similar to shares, such as tokens that provide the holder with dividend payments or voting rights and the like.

One requirement for tokens should be the ability to be traded, which should be expected whenever a token is issued in ERC-20 token format. It remains to be tested before courts whether contractual transfer restrictions could affect the definition of a token as transferable security because the token would no longer be freely transferable. Such an agreement would, however, not prevent holders from factually transferring tokens via platforms or wallets on the blockchain.

4.3 Tokens and Coins as Investments

Tokens qualify as investments whenever the value of those tokens depends on the underlying value of a company or a company's specific project. Such specific projects entail that the token has an intrinsic value and that the token bears elements similar to an investment. This is the case when the token is repayable or redeemable, bears interest payments, grants token holders a voting right in the company or with a view to a specific project, or conveys a similar right. Risks associated with the company or with the project are collectivized, whereas risk collectivization is a key aspect of an instrument being qualified as investment.[12]

Most recently, the FMA has communicated[13] that in case of ICOs and ITOs, instruments that would usually qualify as investments under the CMA (see at 4.1.2 above), such as subordinated loans, may be treated by the FMA as securities (see at 4.1.1 and 4.2 above). The FMA may treat those instruments as securities if the instruments are being represented by tokens. As such, those instruments will become negotiable on the capital market. This may be the case whenever tokens are, for instance, tradeable via token wallets or token platforms. This is a rather restrictive approach that may lead to legal uncertainty for various parties involved in ICOs/ITOs (see 4.4.2 below).

4.4 Legal Consequences of Tokens Being Qualified as Securities Other Than Prospectus Requirements

4.4.1 Positive Consequences

If tokens are structured and qualify as transferable securities, one of the positive consequences for issuers shall be that under the Prospectus Directive and Prospectus Regulation a securities prospectus may be freely passported within the European Economic Area (EEA). This means that securities under a prospectus that have been prepared for and approved by the authorities of one EEA member state may also be offered to the public in the other EEA member states. This is provided that the prospectus has been passported, which is subject to the requirement that a translation of the summary be required in local language.

Such passporting could hypothetically allow issuers of tokens (that qualify as transferable securities) to offer these tokens in other EEA member states without additional burden. To our knowledge, this is currently untested in the EEA market.

4.4.2 Negative Consequences

If tokens qualify as transferable securities, certain ancillary business models or business models connected to ICOs/ITOs may become unsustainable. As a general guideline, issuers should be aware that almost all of the services listed in Annex 1 to Directive 2013/36/EU (Capital Requirements Directive/CRD IV) require a banking license in Austria. This may be significantly more burdensome than expected when compared to home state legislation. For instance, such activities that fall under CRD IV include trading with transferable securities. Furthermore, participating in third party securities issuances or underwriting and placing these securities also require a banking license. Some of these activities are integral to business models of some fintechs or companies that offer support to SMEs or other startups that use ICOs and ITOs. Depending on how the tokens are structured, the ancillary activities of service providers must be vetted against potential licensing requirements under Austrian law.

4.5 Possible Exemptions from Prospectus Requirements

The CMA exempts both securities (see at 4.1.1 above) and investments (see at 4.1.2 above) from prospectus requirements.

In addition to the AAFI issued security and investment exemptions outlined above, other exemptions may apply, but practical relevance in connection with worldwide ICOs/ITOs remains to be seen, *inter alia*:

- Minimum denomination of 100,000 Euros (per token);
- Maximum number of tokens offered within a 12 months period not exceeding 250,000 Euros;

- Offer to qualified investors only; or
- Offer to less than 150 persons per EEA member state.

5. Summary

Depending on their structuring, tokens are usually qualified as either payment instruments (see at 3 above) or securities/investments (see at 4 above) under Austrian law. Issuers and service providers are thus well advised to consider Austrian regulations whenever tokens are offered for sale in Austria or into the Austrian market. Licensing requirements can be avoided if the appropriate business model is properly structured and implemented. Prospectus requirements may apply but may prove advantageous for issuers intending to offer investment/equity tokens in the EEA.

Endnotes

1. *See* Stefan Paulmayer, *Rechtliche Grenzen und praktische Schwierigkeiten bei KMU-Finanzierungen*, 5 Ecolex 362, 362 (2015).
2. *See id.* at 363.
3. *See* Christian Piska and Oliver Völkel, *Kryptowährungen reloaded – auf dem Weg aus dem Bermuda-Dreieck*, 8 Ecolex 816, 817 (2017).
4. *See generally FinTech Navigator*, Austrian Fin. Market Auth., https://www.fma.gv.at/en/cross-sectoral-topics/fintech/fintech-navigator/ (last visited May 23, 2018).
5. *See* HEROcoin, https://www.herocoin.io/.
6. *See generally* Christian Zib et al., Kapitalmarktgesetz: Kommentar § 1 Recital 37 ff (2008) for detailed overview of the securities' definition in the CMA.
7. *See id.* at § 1 Recital 25 f.
8. *See* Susanne Kalss and Martin Oppitz, ÖBA 359 (1994); *see also* Susanne Kalss et al., Kapitalmarktrecht § 11 Recital 18 (2015).
9. *See* Zib, *supra* note 7, at § 1 Recital 25; *see also* Kalss et al., *supra* note 9, at § 11 Recital 17.
10. *See* Stefan Paulmayer, *Initial Coin Offerings (ICOs) und Initial Token Offerings (ITOs) als prospektpflichtiges Angebot nach KMG?*, 11 Zeitschrift Für Finanzmarktrecht 259 (2017).
11. *See FinTech Navigator*, *supra* note 5.
12. *See* Oberster Gerichtshof [OGH] [Supreme Court] Mar. 27, 2012, 4 Ob 184/11d, https://www.ris.bka.gv.at/Dokumente/Justiz/JJT_20120327_OGH0002_0040OB00184_11D0000_000/JJT_20120327_OGH0002_0040OB00184_11D0000_000.pdf (Austria); *see also* Bernd Fletzberger, *Rücktrittsrechet nach KMG beim Erwerb von Secondhand-Polizzen*, 5 Zeitschrift Für Finanzmarktrecht 125 (2012).
13. In non-public communication to the author of this article.

Stefan Paulmayer is an attorney-at-law and works as Senior Manager and head of capital markets for PWC Legal in Vienna, he can be reached at stefan.paulmayer@at.pwc.com or +43 664 883 69 611.

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Cryptocurrencies as Such and the Austrian Capital Markets Law

By Raphael G. Toman

Soon after their first appearance on the public stage, cryptocurrencies triggered immense interest and are being increasingly used for investment and payment purposes. While business models surrounding these instruments have quickly emerged, the Austrian law maker has hardly reacted to these new developments, and it remains partially unresolved to what extent existing regulatory provisions apply to cryptocurrencies as such. The following article provides a quick guideline under Austrian law with regard to the most common issues.

Raphael G. Toman

I. Introduction

Cryptocurrencies fit poorly into the conventional legal concepts in Austrian capital markets law established to date, and it remains a challenge to clearly define what kind of instrument they are from a regulatory perspective. This is, of course, not surprising, as cryptocurrencies were developed as counterparts to "classical" financial instruments. For this reason, the following short article does not try to give an explanation of what cryptocurrencies are under the Austrian capital markets law, as the manifold forms of cryptocurrencies might render it impossible to find a satisfactory solution. Rather, it will establish how they fit into the most commonly used instruments regulated within Austria and refer to the most crucial points when trying to escape the regulatory regime.

II. Cryptocurrencies as "Money"

This article begins by examining whether cryptocurrencies can qualify as money in the narrow sense. This might seem superfluous at a first glance, as money is commonly understood to be a creation of the state legal system.[1] Also, under the prevailing view in the Austrian legal literature, the issuing of money in the narrow sense requires a sovereign act.[2] For this reason, the most common definition of money refers to a means of payment that is recognized by the state and subject to compulsory acceptance.[3] Indeed, within the Republic of Austria, currently only state-issued currencies—most notably the Euro[4]—fall under this definition.

By their very nature, cryptocurrencies are decentralized, meaning that they are neither issued nor controlled by a state but rather by multiple private individuals. Additionally, at least for now, cryptocurrencies do not have to be compulsorily accepted for the exchange of goods. As they meet neither of the abovementioned requirements, they cannot qualify as money in the narrow sense.

One of the consequences of this conclusion is that all regulatory provisions that touch upon the regulation of money in the narrow sense do not apply to cryptocurrencies. Most notably, this is the case for the provision on the foreign exchange and currency business in the Austrian Banking Act § 1 Sec 7 lit a (ABA). According to this provision, any trade with foreign means of payment requires a banking license, which can be very burdensome to acquire and comes with high equity requirements. This provision refers to a foreign means of payment that according to foreign monetary law provisions has been recognized as money in the narrow sense.

Therefore, as long as cryptocurrencies have not been recognized as means of payment on a state level, the exchange of them to a national currency does not require a banking license. While this is the case for the majority of the cryptocurrencies that are currently available, the trade with a minority of cryptocurrencies could trigger a banking license requirement.

For example, on February 20, 2018, the Venezuelan Petro, the world's first national cryptocurrency, became available and had some success in generating revenues.[5] And as it seems for now, it might not stay for long the only one, as other countries have shown some interest, as cryptocurrencies could prove to be an option to circumvent U.S. monetary sanctions.[6] It is likely that the exchange of these cryptocurrencies that function as money in the narrow sense—provided that all the other requirements of the ABA are fulfilled—will require a banking license.

On a final note, Austrian law contains no provision that expressly prohibits the issuing of, and trade in, an alternative currency within Austria other than the Euro. Rather, only the issuing and use of deeds imitating bank notes, denominated in Euro,[7] designated for circulation for the means of payment is forbidden.[8] As cryptocurrencies do not regularly fulfill either requirement, they will not be subject to the corresponding administrative penalty.

III. Cryptocurrencies as "E-Money"

Following European legislation,[9] Austrian law provides for regulation of not only money in the narrow sense, but also e-money, and requires that the issuer thereof be licensed as an e-money-institute (E-Moneylaw § 3 Abs 1). E-money is defined as an electronically—including magnetically—stored monetary value as represented by a claim on the issuer. It has to be issued on receipt of funds for the purpose of making payment transactions,

Raphael G. Toman, LL.M. (NYU) ’17, is currently working at the International Court of Arbitration, ICC, in Paris while finishing his Ph.D. on European capital markets law (MiFID II); he can be reached at raphael.toman@law.nyu.edu.

and has to be accepted by a natural or legal person other than the electronic money issuer (E-Moneylaw § 1 Abs 1).

Looking at the most established types of cryptocurrencies, it seems hard to imagine a type of cryptocurrency that falls under this kind of definition. First of all, the value of cryptocurrencies stems from the willingness of other people who are ready to pay a certain amount of money or exchange certain goods for them. Thus, the value depends on the current exchange rate that is determined at the moment when a transaction occurs, which means that the cryptocurrencies do not store value in them, and thus already the first requirement is missing.[10]

Additionally, cryptocurrencies are regularly—for example at the ICO[11]—exchanged for another cryptocurrency. Such a transaction qualifies as a trade according to Austrian civil law,[12] as one virtual object is exchanged against another one without the involvement of money in the narrow sense, which means that such transactions are also not carried out for the receipt of funds.

But even if a cryptocurrency meets both requirements, its qualification as e-money will depend on whether there is an issuer within the meaning of E-Moneylaw § 1 Abs 1, which means a centralized entity that creates the e-money and against which a claim exists. Some cryptocurrencies lack such a centralized issuer. Bitcoins, for example, are not being issued by a central entity, but rather are created by mining. This process involves the compiling of recent transactions into blocks and trying to solve a computationally difficult puzzle. The participant who first solves the puzzle gets to place the next block and claim the newly released Bitcoin.[13] This participant could be any person taking part in the calculation process, but does not have to be connected to any of the other issuers or to have already participated in the mining process. Therefore, Bitcoins as a whole lack a central entity that serves as an issuer.

One could of course also think about whether this participant acts as an issuer solely for the one Bitcoin it has mined. However, this would not take into consideration the fact that Bitcoins are not created by the participant itself, but rather that the participant is just credited with the Bitcoin for solving the calculation.[14] Additionally, the participant has no means of determining when it solves the calculation; as this happens by chance, it can only increase the possibility by providing more computing power. As the whole process involves therefore a very limited act of will—namely only the decision to start the process, but not where and when the Bitcoin will be created—it seems to be rather far-fetched to qualify a singular participant as an issuer.

While the process of mining for Bitcoins might be rather unique, other cryptocurrencies that have a centralized entity as an issuer are also unlikely to fall under the E-Moneylaw, because it requires that a claim on the issuer exists, meaning that the issuer has to take back the issued cryptocurrency unconditionally at any time in exchange for a national currency. Most cryptocurrencies derive their value, however, from the market value that the community attributes to them in connection with a limited availability of the objects, but the issuer is not obligated to take the issued cryptocurrency back under any conditions. Thus, most cryptocurrencies also lack this requirement and will not fall within the scope of the E-Moneylaw § 1 Abs 1.

IV. Cryptocurrencies and the Requirement for a Banking License

Next, I examine under which conditions cryptocurrencies can qualify as financial instruments according to ABA § 1 Sec 7. If they fall under this provision, transactions and dealings in them for one’s own account or for the account of others would require a banking license, as long as the transaction does not form part of private assets. These instruments entail—apart from foreign currencies already mentioned above—financial futures and options, interest-rate instruments, money market instruments, and transferable securities. Only the latter two merit a closer look in light of the present topic.

Money market instruments are all instruments that can be traded on the money market for securitized assets. The explanatory remarks to the government bill of the ABA provide several examples of what kind of instruments fall under the term of money market instruments: federal treasury bonds, certificates of deposit of the Austrian National Bank, commercial papers, medium term bonds, and similar securitized debt.[15]

The term “money market” is not defined, but is commonly referred to as the market where parties can exchange central bank assets against money market papers or can be transferred as money market loans.[16] The money market is furthermore a market for short-term liquidity procurement instruments, which has the function of liquidity equalization between companies. The instruments traded there are therefore a form of securitized debt, whose primary goal is a short-term supply of liquidity.

Bearing this background in mind, it seems rather unlikely that any kind of cryptocurrency qualifies as a money market instrument. Cryptocurrencies are primarily acquired to either serve as a long-term investment or to be used for the exchange of goods, and not for any short-term supply of liquidity. Additionally, as securitized debt, they would require an issuer, but—as elaborated above—it remains questionable whether such an issuer

exists with regard to some of the cryptocurrencies. Thus, typical cryptocurrencies should—at least for now—not be classified as money market instruments.

V. Cryptocurrencies and License Requirements Under the New Austrian Securities Supervision Act

As of January 3, 2018, the new Austrian Securities Supervision Act (ASSA) entered into force. Although one might legitimately expect that this new act was used as an opportunity to finally resolve the outstanding issues surrounding cryptocurrencies, the Austrian lawmaker used it just to transpose the European Directive 2014/65/EU (MiFID II)—a cornerstone in European capital markets regulation—into Austrian law. It requires, as does the former directive, that any person that receives and transmits orders or offers the service of portfolio management in connection with financial instruments have a license as an investment firm. As is relevant for the present note, financial instruments could be either money market instruments or transferable securities. While the former are fairly similar to the instruments under the ABA, the latter differ, unfortunately, from the securities under the ABA.

Transferable securities are defined in ASSA § 1 Z 5 as those classes of securities which are tradable on the capital market, with the exception of instruments of payment, as is elaborated by several examples. Cryptocurrencies are—not surprisingly—not mentioned, which raises the question whether they fall under the definition.

The first issue in this regard is whether they indeed have to be transferable, as the name implies, or rather tradable, as is explained in the definition. While the first does indicate that the instrument can be transferred under individually negotiated conditions from one person to another, the latter indicates typically plenty supply and demand situations.[17] As cryptocurrencies usually will meet both requirements, this distinction is not further relevant here.

ASSA § 1 Z 5 contains an interesting exception for the present discussion. It provides that instruments of payment do not fall under the definition. Instruments of payment are not only money in the narrow sense; rather they encompass in their broad definition[18] also liquid funds with payment function. Cryptocurrencies should also fall under this definition, if it is their primary function to serve as a payment method, and not, for example, as a long-term investment. Whether this is the case for each individual currency will mostly depend on how it is structured, and in this case a license as investment firm will not be required.

VI. Conclusion

As this article above has shown, cryptocurrencies as such are—if carefully structured—unlikely to be considered subject to the Austrian capital markets law, as has meanwhile been confirmed by the Austrian Financial Markets Authority (FMA), at least with regard to bitcoin.[19] However, this does not mean that any business model that uses cryptocurrencies will not be subject to the Austrian capital market laws in general—rather, it depends on how it is precisely set up in order to make such an assessment.

In this regard it should be noted that at least for now the FMA is rather quick to require intermediaries to have a license as a payment service provider under the Austrian Payment Services Act. Thus, while the first dust has settled on the regulatory framework, many details still remain unclear, but might be taken head on by new European proposals.[20]

Endnotes

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4. Eurogesetz § 1.
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13. Georg Kaes, *Bitcoins: Technische Einleitung*, *in* Bitcoins 1-11 (Helgo Eberwein et al. eds, 2014).
14. *Id*. at 1-11.
15. 369 BlgNR 20. GP 65f.
16. Stephan Karas, Bernd Träxler & Markus Waldherr, § 1 BWG, in BWG, 70 (Dellinger ed., 2016).
17. *See also* Christoph Seggermann, § 1 WAG, in WAG, 43 (Brandl et al. eds., 2015).
18. *See also* Christoph Seggermann, § 1 WAG, in WAG, 46 (Brandl et al. eds., 2015).
19. FMA, Bitcoin, https://www.fma.gv.at/fma-themenfokusse/bitcoin/ (last visited Mar. 31, 2018).
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Regulation of Cryptocurrencies and Initial Coin Offerings in Switzerland: Declared Vision of a 'Crypto Nation'

By Joanna Diane Caytas

I. Overview

The notion of conservative Switzerland identifying as an aggressive, groundbreaking innovation leader in fintech seems inapposite only as long as we ignore what has happened to its storied traditional business model of banking secrecy under the global post-9/11 erosion of financial privacy that resulted in weaponization of extraterritorial reaches of investigations[1] and sanctions.[2] So it comes as little surprise that the notoriously tax-friendly canton of Zug developed a branding strategy to transform itself into a "Crypto Valley" since 2013,[3] a momentum that has not slowed down to date[4] and has resulted in one of the first supportive regulatory guidelines "light" of any major financial center in Europe, somewhat opportunistically breaking ranks with jittery neighbors seeking to curtail proliferation of ICOs which are primarily used to create businesses.[5] Strategically, ICOs are gradually disrupting traditional venture capital funding as hybrid models become *en vogue*, combining smart money and crowd support. Of the world's ten largest ICOs in 2017, four have used Switzerland as their base while over 100 requests for guidance were received by the Financial Market Supervisory Authority (FINMA), the nation's primary regulator, according to a PwC study.[6]

> *"At the moment, amounts at stake in ICOs, even globally, are far too small to present any systemic risk. But that could change with little notice and require expeditious adjustment of national experiments, considering that the number of ICOs exploded in 2017 and investments continue to grow exponentially."*

In response to two legislative requests for evaluation introduced in the lower house of the Swiss Federal Assembly (parliament) in 2013,[7] [8] the Federal Council (the national government) presented a 30-page report on virtual currencies[9] on June 25, 2014 that provides an overview of current issues cryptocurrencies face in all areas of existing Swiss law and, although to a much lesser degree, under past jurisprudence.[10] It also provides an assessment of the principal identifiable legal risks presented by virtual currencies[11] and a first extremely tentative comparative review.[12] In response to the parliamentary inquiries that had triggered them, these 2014 findings of the Federal Council centered primarily on cryptocurrencies but did not yet reflect on the potential of blockchain technology more broadly.

But since 2014, the Swiss Financial Markets Supervisory Authority (FINMA) has initiated a gradual regulatory process intended to clarify when entrepreneurs need to comply with anti-money laundering and securities laws. To this day, its efforts have yielded a "Guidance" document issued September 29, 2017[13] followed by "Guidelines" published February 14, 2018.[14] Although both are not technically regulations, these documents are the principal policy pronouncements of the nation's primary regulator on the subject of cryptocurrencies and Initial Coin Offerings (ICOs)[15] and are intended to facilitate an orderly, legitimate, and growing market.

In mid-2014, and thus prior to the tsunami-like bitcoin boom of 2017-18, the Federal Council's Report did not acknowledge aspirations by Zug to create a "Crypto Valley,"[16] much less a "Crypto Nation."[17] But soon enough, the Swiss financial establishment embraced regular visits to periodic Crypto Finance Conferences at St. Moritz.[18] The conference on January 17-19, 2018 even featured the Swiss Commerce Secretary, Federal Councilor Johann Schneider-Ammann, as keynote speaker.[19] Shortly thereafter, he initiated a federal task force to bridge the chasm of conceptual issues between Zug's Crypto Valley ecosystem and the bricks and mortar of the existing Swiss legal framework, aiming to harmonize priorities for anticipated future regulations.[20]

Its report is expected by end of 2018. Government and markets show substantial interest because blockchain technology holds multiple promises: since it uses distributed ledgers that are verified by means of cryptography, no user can sell or exchange what they do not own.[21] Thus counterparty risk is eliminated, clearing expenses are minimized,[22] and intermediaries become superfluous.[23] Of course, this begs the question why an economy as heavily dependent on its financial services industry as Switzerland's would be so keen to advance technology that aims to eliminate intermediaries (which includes all banks, broker-dealers, asset managers, and institutional investors) and introduce stronger, cost-cutting competition to raising capital, something the finance industry is in dire need of—even if this initiative gives rise to concerns and challenges about legal status, regulation, taxation, cybersecurity, and volatility and speculative bubbles.[24] So, while this might seem like a bizarre attempt by Switzerland, Inc. to re-engineer itself by making one of its economic pillars redundant, the official explanation stated by FINMA's director is the enduring value of innova-

tion leadership,[25] and indeed Switzerland has long been ranked among the world's most innovative nations.[26]

While Switzerland and the U.S. dominate ICOs, both having raised almost the same amount in excess of $550 million,[27] Swiss government policy is to incentivize the ICO market without allowing a "Wild West mentality" to compromise standards and undermine the integrity of financial markets. At the moment, amounts at stake in ICOs, even globally, are far too small to present any systemic risk. But that could change with little notice and require expeditious adjustment of national experiments, considering that the number of ICOs exploded in 2017 and investments continue to grow exponentially.[28] So it is small wonder that FINMA seeks to keep market regulation technology-neutral[29] while the federal Department for International Finance declared its intention to make Switzerland an attractive location for ICOs, opening up the possibility of investing in start-ups to anyone with a smartphone.[30]

"Therefore, the focus of FINMA's Guidelines rests heavily on anti-money laundering and securities regulation as these bodies of law are of greatest direct relevance to ICOs."

2. Interfacing Cryptocurrencies with Current Statutory Law and Regulations

At the time of this writing, no ICO-specific regulation exists yet in Switzerland, nor is there pertinent case law or consistent legal doctrine.[31] That notwithstanding, Swiss regulators (primarily FINMA and the Swiss National Bank) have developed a profound understanding that is reflected and signaled in clear and open-minded guidance.[32] The FINMA Guidelines assess the circumstances of each ICO on its individual merits on a case-by-case basis rather than applying a uniform standard to all of them. Depending on an ICO's purpose and design, it may or may not be subject to regulatory requirements, and not necessarily to the same ones. Current Guidelines differentiate, for now, among three categories of tokens and ICOs.[33]

A. Payment Tokens

Payment tokens are transferable and can serve as present or future means of payment for goods or services or to store or transfer quasi-monetary value. This category comprises any and all cryptocurrencies that do not give rise to claims on their issuer, as central bank-issued notes and ledger accounts do. Under FINMA Guidelines, payment tokens must comply with money laundering regulations, but they will not be treated like financial securities.[34]

B. Utility Tokens

Utility tokens are tokens that provide digital access through a blockchain-based infrastructure to an application or service.[35] They will not qualify as, nor be subject to regulation as, securities so long as their sole purpose is to confer digital access rights.[36]

C. Asset Tokens

Asset tokens represent assets such as a debt or equity claim on the issuer. Such a claim could, for example, arise out of a promise of a share in future company earnings or future capital flows. If they pay dividends or interest or represent rights to earnings streams, with or without claim to repayment of principal, or confer voting rights, or if they are in their economic function analogous to equities, bonds, or derivatives, or other structures capable of securitization that enables physical assets to be traded on the blockchain, such tokens present significant functional analogies to securities. Thus, asset tokens will have to comply with all applicable securities laws and regulations.[37]

D. Hybrid Tokens

Hybrid tokens contain features of more than one of the above-mentioned categories. They are subject to all regulations that apply to at least one of their elements. For example, a utility token with payment token characteristics is subject to anti-money laundering legislation (see below).[38] It is safe to predict that hybrids will quickly move to the center of creative financial and legal engineering[39]—along with related regulatory challenges—because the advancement of blockchain technology with its ability to store

> a public registry of assets and transactions across a shared, trusted, peer-to-peer network, is lauded as one of the most significant technological innovations since the internet. Coupled with the sophistication of software code as a form of communicating information and automating complex instructions, blockchain technology provides a new means of recording information and facilitating the exchange of value in the global economy in a decentralised and immutable way.[40]

That sums up the business model of hybrid tokens and their resulting ICOs, aptly accommodated by the FINMA Guidelines as they aim at incubating their potential without prematurely (or at all) suffocating it with precautionary regulation overkill that is bound to stifle innovation, as the EU, the UK, China, Russia, South Korea, Vietnam,[41] and, partly, the U.S. are doing, driving entrepreneurs overseas,[42] primarily to Switzerland and other offshore financial centers.[43]

3. Regulatory Scheme

Therefore, the focus of FINMA's Guidelines rests heavily on anti-money laundering and securities regulation as these bodies of law are of greatest direct relevance to ICOs. Projects that would fall under the Banking Act[44] that governs deposit taking or the Collective Schemes Investment Act[45] that governs investment fund products are currently considered atypical.[46]

The Anti-Money Laundering Act (AMLA)[47] seeks to protect the financial system in its entirety against risks of money laundering and terrorism financing. Those risks are particularly high in a decentralized ledger-based blockchain system where assets may be transferred anonymously and without regulated intermediaries.[48]

Securities regulation, on the other hand, serves to secure market transparency, a reliable minimum standard of disclosure, and secure trading that is fair and conducive to efficient price formation. Investment decisions require minimum assurances of candor and disincentives to misleading information. The FINMA Guidelines incorporate the breadth and complexity of Swiss securities law and regulation[49] by way of reference, using a very user-friendly formula by applying the aforementioned three-pronged test visualized below.

A. FINMA's Transactional Purpose Matrix

FINMA's treatment of hybrids follows a simple transactional purpose matrix:[50]

	Pre-financing and pre-sale / The token does not yet exist but the claims are tradeable	The token exists
ICO of payment tokens	= Securities ≠ subject to AMLA	≠ Securities = means of payment under AMLA³
ICO of utility tokens⁴		≠ Securities, if exclusively a functioning utility token = Securities, if also or only investment function ≠ means of payment under AMLA
ICO of asset tokens⁴		= Securities ≠ means of payment under AMLA

Credit: FINMA, Guidelines for Enquiries Regarding the Regulatory Framework for Initial Coin Offerings (ICOs) (Feb. 16, 2018), https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/.

B. Principal *Lacunae*

Among the issues not addressed in the FINMA Guidelines is price volatility: because the great majority of ICO projects are at an early stage of development, uncertainties remain high. They include foreign and global political risk centered on unpredictable regulatory actions. Another issue FINMA Guidelines cannot be expected to address, much less resolve, is the uncertainty under current civil law of whether contracts executed through blockchain technology (including "smart contracts") are legally binding in the first place.[51] That is a question controversially debated in common law jurisdictions as well, and it is frequently answered in the negative for "smart contracts," noting that, as our body of law stands, they are neither smart nor contracts.[52]

Another major white spot on the legal map that will likely require technological solutions is the protection of personal data in the blockchain.[53]

4. Summary Outlook

A. Blockchain Goes Mainstream

Little underscores blockchain's momentum more clearly than its spread from tax haven Zug into the highly-taxed establishment centers of Zurich and Geneva with an "innovation park" at Bahnhofstrasse 3[54] after another incubator had unveiled a "blockchain lab" in Geneva.[55] The canton of Zurich has long planned to dedicate the former Dübendorf military airport to becoming a major "blockchain hub."[56] But caution suggests remembering that these initiatives are more testimony to the future of blockchain technology than they are to current models and flavors of cryptocurrencies and ICOs.

B. Uncertainties on Cryptocurrencies Persist

While ICOs reported again a red-hot start into 2018,[57] experts warn about an imminent industry shift away from cryptocurrencies (payment tokens) to security token offerings (STOs), not least because of SEC enforcement actions with regard to ICOs open to U.S. investors.[58] At the same time, positions taken of late by the new head of the People's Bank of China on bitcoin seem to indicate a somewhat positive shift,[59] echoed by the Bank of England's governor and the Financial Stability Board.[60] Markets' exposure to the slightest indicator of major regulators' intent still causes extreme volatility and choppiness of prices of large-cap crypto coins, resulting in entrepreneurs constantly reviewing business models in response to rapidly changing trends.[61]

C. Living Down Switzerland's Tax Evasion Past

While Swiss banks spent much of the last decade trying to rid themselves of a legacy of lucrative accounts used mostly for capital flight and tax evasion, international probes as well as U.S., German, French, and OECD initiatives aimed at greater transparency are far from abating.[62] Here, FINMA's approach fits neatly with the country's pragmatic opportunistic integration of historic strengths with its new public policy of increased transparency and anti-avoidance strategy.[63] This includes strategic encouragement of blockchain technology development in general independently of—and thus untainted by—adverse publicity triggering potentially risky developments

in the fate of cryptocurrencies. Cryptocurrencies proper remain heavily exposed to concerns recently voiced again by the U.S. Treasury Secretary and other G-20 and OECD representatives about money laundering, tax avoidance, and worse.[64] This is, without doubt, the Swiss government's response to findings in the Bloomberg Report of October 2017[65] that "[s]ome worry that the money might be a little too secret." The purpose of regulation is to ensure that the Swiss cryptocurrency industry works with money only where there is a clear record of who is moving traditional currency to cryptocurrency, as the country cannot afford to go back to letting people bury their financial secrets in another black hole that earns unwanted notoriety as it did over the last two decades.[66] Government concerns—expected to be reflected in future regulations—seek to prevent the use of cybercurrencies for illicit activities in light of the fact that Switzerland dominates the market for cross-border management of private wealth.[67]

D. Self-Regulation and Self-Policing

Much like in the legal profession, preservation, maintenance, and public reliance upon self-regulation and self-policing are a central objective for financial industry associations and lobbies. The Financial Market Supervision Act (FINMASA)[68] recognizes in article 7 (3) a longstanding tradition[69] by permitting FINMA to recognize self-regulation as a minimum standard applicable not only to members of self-regulatory organizations (SROs)[70] but generally. Compliance with minimum standards may be enforced either by FINMA or by the SROs[71] which are themselves subject to FINMA supervision.[72] However, to date, no SRO has been recognized to have capabilities of self-policing the blockchain industry.

Many entrepreneurs hold the vision that technology will somehow allow ICOs to become self-policing, perhaps by methods similar to widely used consumer reviews. "It will become an ultra-transparent world if people have to pay more to hide … It is a huge opportunity to clean up the world."[73] The argument goes that any Swiss ICO that would not comply with strict anti-money laundering procedures would see traditional regulated banks turn away its accounts. But this line of reasoning has two major flaws: first, the argument that domestic banks would cease to accept accounts of corporate customers with lax compliance is losing ground as cost and delays of international electronic transfers shrink, not to mention that standards among Swiss banks in screening and monitoring their customers differ quite a bit in reality.

Money laundering has long involved sometimes sharply elevated transaction costs, none of which have deterred the practice. Moreover, growing capitalization of the cryptofinance universe and growing acceptance of tokens may render the need for ICO operators' reliance on traditional banks moot before long. Similarly, it will not be long before traditional national regulation as opposed to global mechanisms will have reached the end of its useful life span with regard to digital technologies, a fact that the G-20 and OECD have been slow to realize. On the other hand, it is this very globalized cooperation of ICO entrepreneurs that is inevitably bound to run afoul of some old-line alliances and geostrategic interests sooner or later.[74]

E. Imminent Regulation

As the Swiss federal task force impaneled to balance the national interest with the visions of cryptofinance entrepreneurs is slated to report to the government by the end of 2018,[75] it remains to be seen how upcoming regulation in its wake will square the circle by, on one hand, intelligently incentivizing innovation[76] and yet, on the other hand, curbing its fallout by upholding or adaptively reshaping existing law on securities regulation, anti-money laundering, sanctions, taxation, and data protection along with other keystones of twentieth-century jurisprudence.

Endnotes

1. Joanna Diane Caytas, Note, *Weaponizing Finance: U.S. and European Options, Tools and Policies*, 23 Colum. J. Eur. L. 441 (2017).
2. *See, e.g.*, Joanna Diane Caytas, *Sanctions, Real and Imaginary: Experiences with Russia in the Ukraine Crisis*, 9 Amsterdam L.F. 26 (2017).
3. Crypto Valley, *Our Story*, Cryptovalley.Swiss (2017), https://cryptovalley.swiss/about-the-association/.
4. *See* Hugo Miller, *Welcome to Crypto Valley*, Bloomberg Businessweek (Oct. 10, 2017), https://www.bloomberg.com/news/articles/2017-10-10/welcome-to-crypto-valley; Jeremy Epstein, *What Switzerland's 'Crypto Valley' Tells Us About the State of Blockchain*, VentureBeat (Sept. 10, 2017), https://venturebeat.com/2017/09/10/what-switzerlands-crypto-valley-tells-us-about-the-state-of-blockchain/.
5. *See* Ralph Atkins, *Switzerland Embraces Cryptocurrency Culture*, Fin. Times (Jan. 25, 2018), https://www.ft.com/content/c2098ef6-ff84-11e7-9650-9c0ad2d7c5b5.
6. Daniel Diemers, *Initial Coin Offerings: A Strategic Perspective: Global and Switzerland*, Crypto Valley (Dec. 21, 2017), https://cryptovalley.swiss/wp-content/uploads/20171221_PwC-S-CVA-ICO-Report_December_final.pdf, further discussed by David Torcasso, *Die grössten ICOs kommen aus der Schweiz* [*The largest ICOs come from Switzerland*], Handelszeitung (Jan. 19, 2018), https://www.handelszeitung.ch/unternehmen/blockchain-die-grossten-icos-kommen-aus-der-schweiz# (providing an overview of the 15 largest ICOs and the planned Telegram ICO intended to raise $1.2 billion based on the end-to-end encrypted messaging platform, as well as discussing national regulators' different views on ICOs as of January 2018, ranging from outright bans in China, South Korea, Vietnam, and Russia, to advising caution in the U.S., UK, EU, Canada, and Australia, to favorable disposition in Switzerland, Gibraltar, Isle of Man, Cayman Islands, Mauritius, Hong Kong, and Singapore—without exception low-tax or no-tax offshore financial centers. Japan, despite 40-60% share in bitcoin trading, took no position on ICOs).
7. National councilor Jean-Christophe Schwaab (parti socialiste, Vaud) requested by 'postulate' 13.3687 of Sept. 9, 2013 that the government should "evaluer les risques de la monnaie en ligne bitcoin" [evaluate the risks of online-currency bitcoin], https://www.parlament.ch/en/ratsbetrieb/suche-curia-vista/geschaeft?AffairId=20133687.

8. National councilor Thomas Weibel (green-liberal party, Zurich) requested on Dec. 5, 2013 by 'postulate' 13.4070 of Dec. 5, 2013 that the government should "Rechtssicherheit für Bitcoin schaffen" [create legal certainty for bitcoin], https://www.parlament.ch/de/ratsbetrieb/suche-curia-vista/geschaeft?AffairId=20134070.

9. Bundesrat (Federal Council), Bericht des Bundesrates zu virtuellen Währungen in Beantwortung der Postulate Schwaab (13.3687) und Weibel (13.4070) vom 25. Juni 2014 [Report of the Federal Council on Virtual Currencies in Response to the Postulates Schwaab (13.3687) and Weibel (13.4070) of June 25, 2014] ("Report"), https://www.news.admin.ch/NSBSubscriber/message/attachments/35361.pdf.

10. *Id*. at 10-18.

11. *Id.* at 18-22.

12. *Id.* at 23-25.

13. FINMA, FINMA Guidance 04/2017 – Regulatory Treatment of Initial Coin Offerings (Sept. 29, 2017), https://www.finma.ch/en/documentation/finma-guidance/#Order=4.

14. FINMA, Guidelines for Enquiries Regarding the Regulatory Framework for Initial Coin Offerings (ICOs) (Feb. 16, 2018), https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/.

15. *Bringing Swiss Order to Initial Coin Offerings,* Fin. Times (Feb. 19, 2018), https://www.ft.com/content/36ef310c-1566-11e8-9e9c-25c814761640.

16. Erich Aschwanden, *Stadt Zug wird weltweit zum Bitcoin-Pionier* [*City of Zug Becomes a World-Wide Bitcoin Pioneer*], Neue Zürcher Zeitung (May 5, 2016), https://www.nzz.ch/schweiz/crypto-valley-zukunftsmodell-oder-marketing-gag-ld.22911.

17. Ralph Atkins, *'Crypto Nation' Switzerland Issues Guidelines to Support Market*, Fin. Times (Feb. 16, 2018), https://www.ft.com/content/737b9634-1303-11e8-8cb6-b9ccc4c4dbbb.

18. Crypto Finance Conference (2018), https://www.crypto-finance-conference.com/en/#.

19. Business ethicists object to governmental support of cryptocurrencies out of concern for their money laundering potential. *See, e.g.*, Peter Seele, *"Krypto-Nation" Schweiz: Ein doppelter Fauxpas?* [*Crypto Nation Switzerland: A Double Faux Pas*?] Inside Paradeplatz (Jan. 24, 2018), https://insideparadeplatz.ch/2018/01/24/krypto-nation-schweiz-ein-doppelter-fauxpas/ (arguing that the very nature of blockchain technology is transparency as opposed to cryptic anonymity, a privilege currently available only to the U.S. government; consequently, sovereign efforts should be geared toward maximization of transparency).

20. *See* Torcasso, *supra* note 6, and in more detail Erich Aschwanden, *Das Bankkonto soll nicht zum Stolperstein für Blockchain-Firmen werden* [*The Bank Account Should Not Turn Into a Stumbling Block for Blockchain Companies*], Neue Zürcher Zeitung (Mar. 10, 2018), https://www.nzz.ch/schweiz/task-force-schlaegt-bruecke-schlagen-zwischen-crypto-valley-und-bundesbern-ld.1364261. There are, of course, considerably more regulatory concerns to be addressed than mere interfacing with banking licenses and bank accounts. *See, e.g.*, Tony Anderson & Luke Scanlon, *Bitcoin, Blockchain & Initial Coin Offerings—A Global Review*, Pinsent Masons (Nov. 2017), https://www.pinsentmasons.com/en/media/publications/bitcoin-blockchain-and-ico/.

21. Joanna Diane Caytas, *Blockchain in the U.S. Regulatory Setting: Evidentiary Use in Vermont, Delaware, and Elsewhere,* Colum. Sci. & Tech. L. Rev. (May 30, 2017), http://stlr.org/2017/05/30/blockchain-in-the-u-s-regulatory-setting-evidentiary-use-in-vermont-delaware-and-elsewhere/.

22. *See* Joanna Diane Caytas, *Developing Blockchain Real-Time Clearing and Settlement in the EU, U.S. and Globally*, Colum. J. Eur. L: Preliminary Reference (June 22, 2016), http://cjel.law.columbia.edu/preliminary-reference/2016/developing-blockchain-real-time-clearing-and-settlement-in-the-eu-u-s-and-globally-2/.

23. Joanna Diane Caytas, *Regulatory Issues and Challenges Presented by Virtual Currencies*, Colum. Bus. L. Rev. (May 30, 2017), https://cblr.columbia.edu/regulatory-issues-and-challenges-presented-by-virtual-currencies/.

24. Diemers, *supra* note 6, at 6.

25. Mark Branson, Technological Change and Innovation in the Financial Sector, Speech to the Business Club Zurich, Zunfthaus Saffran, Zurich (Sept. 10, 2015), FINMA, https://www.finma.ch/de/dokumentation/finma-publikationen/referate-und-artikel/#Order=4.

26. The country tops the World Economic Forum's Global Competitiveness Report (*see* Klaus Schwab, *The Global Competitiveness Report 2016-2017*, World Economic Forum, http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf), the EU's European Innovation Union Scoreboard (*see* European Commission, *European Information Scoreboard 2016*, http://www.knowledgetransferireland.com/About_KTI/Reports-Publications/European-Innovation-Scoreboard-2016.pdf), the Global Innovation Index (*see* https://www.globalinnovationindex.org/), and patent applications in Europe (*see Swiss Lead on Patent Applications in Europe*, SWI Swissinfo, Mar. 3, 2016, https://www.swissinfo.ch/eng/champs_swiss-lead-on-patent-applications-in-europe/41999768).

27. Atkins, *supra* note 5 (discussing ICO market size in Q1-Q3 2017: 1. U.S. ($580m); 2. Switzerland ($550m); 3. Singapore ($184m); 4. Russia ($111m); 5. China ($82m); 6. UK ($67m); 7. Estonia ($63m); 8. Poland ($45m); 9. Costa Rica ($28m); 10. Netherlands ($27m); 11. Slovakia ($23m); 12. Hong Kong ($21m), altogether quite humble amounts on a global scale: total worldwide ICO proceeds rose from $0.8m in 2013 to $4.6 billion in 2017, by way of 430 ICOs in 2018). *See also* Torcasso, *supra* note 6.

28. Diemers, *supra* note 6, at 3.

29. FINMA, Asset Management: Technology-Neutral FINMA Regulations, FINMA (July 2, 2016), https://www.finma.ch/de/news/2016/07/20160701-mm-rs-09-01/.

30. Ralph Atkins, *Switzerland Sets Out Guidelines to Support Initial Coin Offerings,* Fin. Times (Feb. 16, 2018), https://www.ft.com/content/52820f90-1307-11e8-940e-08320fc2a277.

31. FINMA, FINMA Publishes ICO Guidelines, FINMA (Feb. 16, 2018), https://www.finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/. *See also* FINMA Guidance, *supra* note 13, at 2.

32. *See* Atkins, *supra* note 30 (VC investing in ICOs comments on FINMA's guidance as "the most positive thing…seen from anyone" regulator); *see also Bringing Swiss Order to Initial Coin Offerings, supra* note 15.

33. FINMA Guidelines, *supra* note 14, at 3-5. The FINMA Guidelines are vaguely comparable to SEC Chairman Jay Clayton's *Statement on Cryptocurrencies and Initial Coin Offerings*, SEC, (Dec. 11, 2017), https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

34. FINMA Guidelines, *supra* note 14, at 3; Atkins, *supra* note 30.

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36. *See* Iyke Aru, *The Fundamental Principles of Utility Tokens in the Blockchain Ecosystem,* CCN (Mar. 4, 2018), https://www.ccn.com/fundamental-principles-utility-tokens-blockchain-ecosystem/. A similar attitude was taken by Wyoming exempting utility tokens from securities regulation in order to attract ICOs to the state: Josiah Wilmoth, *Wyoming House Unanimously Passes Bill Exempting Utility Tokens from Securities Laws*, CCN (Feb. 19, 2018), https://www.ccn.com/wyoming-house-unanimously-passes-bill-exempting-utility-tokens-securities-laws/.

37. FINMA Guidelines, *supra* note 14, at 3; Atkins, *supra* note 30.

38. Adam Reese, *Swiss Regulator FINMA: AML, Securities Laws to Apply to Some ICOs*, ETHNews (Feb. 16, 2018), https://www.ethnews.com/swiss-regulator-finma-aml-securities-laws-to-apply-to-some-icos; *see also* FINMA, *supra* note 31, at 1-2.

39. *E.g.*, by disrupting traditional VC funding by combining smart money with crowd support, *see* Diemers, *supra* note 6, at 5.

40. Lee Bacon & George Bazinas, "*Smart Contracts*"*: The Next Big Battleground?* Jusletter IT (May 18, 2017), https://www.clydeco.com/insight/article/smart-contracts-the-next-big-battleground.

41. Diemers, *supra* note 6, at 11.

42. *Id.* at 12-14.

43. *See* Atkins, *supra* note 5; Diemers, *supra* note 6, at 11.

44. Bundesgesetz über die Banken und Sparkassen (Bankengesetz, BankG) [Federal Act on Banks and Savings Banks (Banking Act, BA)], SR 952.0, https://www.admin.ch/opc/de/classified-compilation/19340083/index.html. *See also Unofficial Translation of the Swiss Federal Act on Banks and Savings Banks*, KPMG (Feb. 3, 2016), https://home.kpmg.com/ch/en/home/insights/2016/02/federal-law-on-banks-and-savings-banks.html.

45. Bundesgesetz über die Kollektivanlagen (Kollektivanlagengesetz, KAG) [Federal Act on Collective Investment Schemes (Collective Investment Schemes Act, CISA)], SR 951.31, https://www.admin.ch/opc/en/classified-compilation/20052154/index.html.

46. *See* FINMA, *supra* note 31, at 2.

47. Bundesgesetz über die Bekämpfung der Geldwäscherei und der Terrorismusfinanzierung (Geldwäschereigesetz, GwG) [Federal Act on Combating Money Laundering and Terrorist Financing (Anti-Money Laundering Act, AMLA)], SR 955.9, https://www.admin.ch/opc/en/classified-compilation/19970427/index.html.

48. *See* FINMA, *supra* note 31, at 2.

49. *See* Thomas U. Reutter & Annette Weber, *Equity Capital Markets in Switzerland: Regulatory Overview*, Thomson Reuters Practical Law (2018), https://uk.practicallaw.thomsonreuters.com/8-501-2602; Lukas Wyss, Johannes Bürgi & Maurus Winzap, *Structured Finance and Securitization in Switzerland: Overview*, Thomson Reuters Practical Law (2017), https://uk.practicallaw.thomsonreuters.com/2-630-9902; Stephan Werlen & Kaspar Landolt, *Securities Law in Switzerland*, CMS (May 7, 2014), https://cms.law/en/CHE/Publication/Securities-Law-in-Switzerland. FINMA maintains a database of applicable laws and regulations with relevance to capital markets activity: *The Financial Market is Governed by Laws and Ordinances*, FINMA (2018), https://www.finma.ch/en/documentation/legal-basis/laws-and-ordinances/. Below is a list of the principal Swiss legislative and regulatory standards on financial markets and securities currently in force:

Financial market statutes of the Federal Assembly

Bundesgesetz über die Eidgenössische Finanzmarktaufsicht (Finanzmarktaufsichtsgesetz, FINMAG) [Federal Act on the Swiss Financial Market Supervisory Authority (Financial Market Supervision Act, FINMASA)], SR 956.1, https://www.admin.ch/opc/en/classified-compilation/20052624/index.html.

Bundesgesetz über die Banken und Sparkassen (Bankengesetz, BankG) [Federal Act on Banks and Savings Banks (Banking Act, BA)], SR 952.0, *supra* note 44.

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Joanna Diane Caytas is an associate at Schulte Roth & Zabel LLP, where her practice focuses on taxation of investment funds and digital assets; she has published several papers on regulation of blockchain and emerging technologies.

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German Regulation of Cryptocurrencies and ICOs

By Michael Jünemann

In 2017, roughly $3 billion was generated through Initial Coin Offerings (ICOs, also called Token Sales), a figure that is expected to increase to $4 billion by the end of 2018. Through ICOs, businesses (at present, often start-ups and entrepreneurs) issue their very own blockchain-based coins or tokens to investors, which come with a variety rights and obligations. Without investment banks or professional venture capitalists, the entire process is conducted online, sometimes within minutes.[1]

There is no general regulation of crypto-assets in Germany, although a regulatory viewpoint distinguishes between the issuing and trading of tokens.[2] The issuance of Tokens may require specific conduct, including the duty to publish a securities prospectus. The trade of tokens is subject to regulatory questions like the possibility of a bona fide purchase.

1. Cryptocurrency in Germany

The regulation of cryptocurrency has to be performed on a global scale as "national or regional rules would be hard to enforce," according to a director at Germany's central bank.[3] Indeed, a member of the board of Germany's central bank (Deutsche Bundesbank) firmly believes that national rules may struggle to contain a global phenomenon.[4]

> *"By giving the example of a Utility Token, one could say that BaFin generally considers Utility Tokens as not regulated. Nevertheless, no clear statement has been provided yet by BaFin."*

A common approach in Germany is to distinguish between currency token, security token and utility token, of which the legal nature of security token is the most complex.

Trading tokens is not extralegal. Private law applies to the purchase agreement in addition to possible German and/or European regulation. For specific services offered through the different types of tokens as outlined below, permission by the local supervisory authority may be required.

2. ICOs in Germany

ERC20 is a Token Standard published by the Ethereum developers at the end of 2015. ERC20 provides basic functionality for transferring tokens, as well as allowing tokens to be approved so that other members of the chain can use them. Today, the program is standard for the vast majority of ICOs and token sales in Germany. [5]

Michael Jünemann

Similar to an IPO, with the requirement to publish a prospectus, it became customary for ICOs that the issuer publish a white paper, a document used to comprehensively describe the technological design and process of the ICO as well as relevant market data, growth anticipations and requirements for the issue and use of Tokens.

The Federal Financial Supervisory Authority (Bundesanstalt für Finanzdienstleistungsaufsicht-BaFin) checks all relevant documents (white paper, GTC etc.) for classification of an ICO. Depending on the design of the token, the ICO is generally classified as a banking transaction.[6]

2.1 Currency Tokens

The most commonly known token is the currency token or cryptocurrency, such as Bitcoin, Ethereum or Ripple. Currency tokens (sometimes also payment tokens) shall serve as decentralized currency[7] and, as such, may constitute an alternative to national (fiat) currency. In late 2013, BaFin stated that cryptocurrencies constitute "Units of Account" and that thus are classified as financial instruments. Trading financial instruments is subject to special regulatory requirements in Germany and requires permission from BaFin prior to offering services.

2.2 Utility Tokens

The issuance of utility tokens is comparable with the distribution of vouchers which are redeemable against goods and services in the future (in the case of an ICO, this may constitute access to an application or service). Swiss regulator FINMA was the first to make this distinction,[8] followed by BaFin, which refers to utility tokens also as "app tokens."[9] Examples include SVDs (issued by German-based FinTech Savedroid) and filecoin. Purchasing a Savedroid token grants the purchaser the right to receive access to an exclusive beta launch of a self-learning AI algorithm.[10] Purchasing a Filecoin token provides the right to store data in a decentralized cloud.[11]

In a recently published advisory letter on the classification and regulation of tokens or cryptocurrencies, BaFin provided no general answer as to whether a token

qualifies as a security under German law.[12] BaFin further communicated that "the mere labelling of a Token, for instance, as a 'Utility Token,' is not relevant to the outcome of the legal analysis," meaning regulation cannot be circumvented by a mere change of label.[13] This means, however, that BaFin itself suggests there must be some unregulated types of tokens. By giving the example of a utility token, one could say that BaFin generally considers utility tokens as not regulated. Nevertheless, no clear statement has been provided yet by BaFin.

Utility tokens are also often tradeable, but are limited in their issued quantity and validity period.[14] The scenario may be considered the same as trading a rare ticket (for example, a ticket for a concert).

2.3 Security Tokens

By issuing security tokens, often also referred to as "equity," "asset" or "investment tokens," the issuer promises some sort of revenue. Possible revenue could be a share in future company earnings or future capital flows. In contrast to an Initial Public Offering (IPO), the purchaser does not obtain any company shares. Instead, the promised revenue is in the form of a commercial stake, interest or similar. The issuance of classic company shares requires strong certification (i.e., notarization), which makes it hard to circulate company shares through an ICO.[15]

A security token, depending on its structure, could be classified and thus be regulated as a regulated security (according to the German Securities Trading Act–*WpHG* and German Security Prospectus Act -*WpPG*) or as a capital investment (according to the German Capital Investment Act–*VermAnlG*).

Michael heads the German Banking & Finance practice of Bird & Bird LLP in Frankfurt and is a member of the international Banking & Finance practice group. He works with clients across a large variety of sectors including Financial Services, Payment Services, e-commerce, FinTech, InsureTech, RegTech, Energy & Utilities, Telecommunications and Media. During his years of practice, Michael advised Mastercard on the effective lobbying efforts in the course of new anti-money laundering laws in Germany and Europe and advised Germany's bank bailout fund on the development of interim and final stabilization measures for WestLB AG in accordance with the Financial Market Stabilisation Act, including the formation of the first German "bad bank."

2.3.1 Classification as Security

The German Securities Trading Act, based on the European Markets in Financial Instruments Directive (MiFID and its revised version, MiFID2), provides three defining criteria for securities: standardization, transferability and negotiability.

Standardization means that every token has the same features such that every token is interchangeable. The interchangeability could be a problem if the issuer offers tokens with different terms, volume or price with each new contract. Generally, tokens are issued to the same base value so that they are standardized in the view of the German legislator.

Negotiability is the essence of transferable securities within MiFID and therefore also within the German Securities Trading Act.[16] Transferability and negotiability are at times hard to separate from one another. One might say the transfer of a token is necessarily preceded by a negotiation. This would conclude that transferability and negotiability go hand-in-hand. Some scholars interpret negotiability in a more narrow sense. From their perspective, the mere possibility of trading tokens on a platform does not qualify as negotiability. Instead, "they tend to stress that acquisition of securities based on good faith must be possible, or that equivalent security mechanisms need to be in place to protect investors *erga omnes*, and not only vis-à-vis their contractual party, from insecure links in the chain of ownership."[17]

"Security tokens come with specific rights (e.g., a profit sharing agreement). If this specific right was transferred to another party, the security token would probably automatically follow under German law."

According to a BaFin advisory letter, "trading platforms for cryptocurrencies can, in principle, be deemed financial or capital markets within the meaning of the definition of a security."[18] This view is over-simplified because (in agreement with BaFin's viewpoint) utility tokens are equally tradeable as security tokens. The classification and specific design of the token defines its regulation. The classification of the market on which the relevant tokens are traded is connected to the token's classification and potential regulation. A market on which only utility tokens are traded should not qualify as a financial or capital market under this interpretation.

2.3.2 Classification as Capital Investment

A group of people planning to purchase tokens could be classified as a company constituted under civil law, and the purchase could therefore be classified as a regulated capital investment. Nevertheless, a classification as

capital investment is rather unlikely, given that the different purchasers do not invest their money jointly. Instead, each one invests for himself and no pooling of money occurs. Every investor decides for himself, so there is no investment decision by a third party. The investment decision by a third party is compulsory for such a classification.

In light of this, a classification as capital investment is rather unlikely. The possibility however remains if the above requirements are met.

2.4 Donation Coins

BaFin recently introduced donation coins as an additional category to the classification of tokens given by the economy (currency, utility and security tokens).

> *"The European Commission recently launched the EU Blockchain Observatory and Forum with the support of the European Parliament."*

Donation coins are tokens without any rights or obligations, and they customarily are not tradable. BaFin generally considers this type of token as comparable to a donation, which usually entails no further financial regulatory requirements.[19]

3. Hybrid Tokens

Hybrid tokens comprise elements of one or more categories of tokens. These cases require an assessment as to which aspects of the token are regulated as security tokens and which as utility tokens, etc., in order to determine if a specific feature of the token is regulated or not. However, the purchaser's sole expectation of profit is not enough to define a utility token as a security token.[20]

Hybrid tokens are the most common form of tokens. The distinction between security tokens and utility tokens in particular, however, is difficult due to their tradability.

4. Potential Bona Fide Purchase of Token?

Within German law, a bona fide purchase of securities is possible in certain cases. Bona fide regulations do apply if required by law. The sole characteristic as a data packet does not qualify as subject to bona fide regulations, as there is no property on data under German law.[21]

Security tokens come with specific rights (e.g., a profit sharing agreement). If this specific right was transferred to another party, the security token would probably automatically follow under German law. However, not even these cases would qualify as bona fide purchases. As any and all tokens are issued by using blockchain technology that uses a proof of stake concept, a bona fide purchase, even though theoretically imaginable for some scholars, is technically impossible.

5. What to Expect

Cryptocurrency and ICOs are not extralegal within Germany. The existing law partly covers certain areas of cryptocurrencies and ICOs. Nevertheless, it remains unclear when issuers need to obtain permission in order to perform an ICO or when certain regulatory systems (like the consumer protection system) apply to the trade of tokens.

BaFin's advisory letter serves as more of a summary of existing regulations than helpful, new advice. The different possibilities of the design of tokens also makes it difficult to cover every aspect. The main aspects are regulated already, however, and therefore a notification outlining which law is relevant in different situations may be enough to help regulate cryptocurrencies and ICOs in Germany in a satisfying manner.

BaFin remains skeptical in relation to ICOs, and renewed its warning during a recently conducted congress (BaFinTech 2018) and further expanded on its motives for the consumer warning it issued, dated November 9, 2017.[22]

BaFin observes market developments and determines any option for regulation, whether national, European or international. During the recent BaFinTech Workshop, BaFin referred to European and international regulatory attempts such as the Financial Stability Board Chair's letter to G20 Finance Ministers and Central Bank Governors dated 18 March 2018.[23] This letter suggests that crypto-assets "do not pose risks to global financial stability at this time. […] even at their recent peak, their combined global market value was less than 1% of global GDP."[24]

The European Commission recently launched the EU Blockchain Observatory and Forum with the support of the European Parliament.[25] This new Forum is set to play an active part in the cultivation of blockchain technology and its applications. It seeks to build expertise, gather information, monitor and analyze trends and addresses the challenges and socioeconomic potential of blockchain. The idea is to promote cross-border cooperation within Europe and involve technologists, industry, citizens and public authorities.

Constructed in an open forum, it is likely the results and findings may support an effort to overcome various national regulatory attempts and create a unified regulation through the European legislator.[26]

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International Section Diversity Policy

The International Section is committed to diversity in its membership, officers, Executive Committee, Chapters, and Committees. Diversity is an inclusive concept, encompassing gender, race, color, ethnic origin, national origin, religion, sexual orientation, age and disability.

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We endorse the statement of the Association as applied to our Section that we are a richer and more effective Section because of diversity, as it increases our Section's strengths, capabilities and adaptability. Through increased diversity, our Section can more effectively address societal and member needs with the varied perspectives, experiences, knowledge, information and understanding inherent in a diverse membership.

December 15, 2011

Regulation of Cryptocurrencies and Initial Coin Offerings in Poland—Ambivalence at Its Best

By Joanna Diane Caytas

I. Overview

No cryptocurrency-specific legislation or regulation whatsoever exists in Poland to date.[1] But much like in many other countries, the legal and regulatory situation in this country of 40 million with regard to cryptocurrencies and ICOs is rife with skepticism, euphoria, crime, popular fascination, investor interest,[2] and dire warnings by the financial establishment; in short, a feverish climate of uncertainty, mass greed,[3] and political, legislative and regulatory factionalism. Torn between resentment for unprecedented and superficially irrational creation of wealth by stellar returns, recognition of powerlessness of any nation state to quash or at least regulate runaway technology, and the even greater fear of embarrassment that would follow coming down on the wrong side of history[4] against a potential wave of the future, reactions of the Polish government *de facto* run the gamut of positions taken anywhere, while clandestine attempts were made to prepare for a "death knell campaign" in the event cryptocurrencies were to exhibit exploitable vulnerabilities such as a sustained drop in prices or the discovery of major fraud and market manipulation. As in many other countries, memories of the Dutch Tulip Mania[5] were invoked.[6] To no avail: to date, Poland ranks as the eighth-largest marketplace for cryptocurrencies and ICOs around the world.[7] Clarity existed pretty much from the outset only with regard to taxation of any ICO- or cryptocurrency-trading related income,[8] although technicalities about accounting and reporting were initially unclear.[9] In any event, long-standing calls for regulation become increasingly louder[10] as the government clearly hopes to join effective international, or at least EU-wide, action.

II. Regulatory Structure

A. Regulators

The Ministry of Finance (Ministerstwo Finansów) provided an informal policy directive in a public statement of its spokesperson Szymon Wozniak, who stated on December 18, 2013 at a conference at the Warsaw School of Economics that the Ministry of Finance did not consider bitcoin illegal and also did not wish to hinder its development. That notwithstanding, it did not deem bitcoin legal tender or "electronic money" within the meaning of EU directives.[11]

1. National Bank of Poland—Narodowy Bank Polski (NBP)

The central bank regulates and refinances licensed financial institutions, but while the payment-services aspect of cryptofinance overlaps with banks, a banking license is not required in Poland for either mining, trading or brokering cryptocurrencies. It is, however, its considerable interpretive leeway that is not shackled to *stare decisis* that permits NBP to assert jurisdiction in more ways than just by advising caution and discouraging investment.[12] It may be expected that NBP, like many institutional actors, will emphasize the point that blockchain technology does not need bitcoin, or any cryptocurrency, for that matter, to build efficient and secure transaction systems and platforms, while currency-related implementations are just a few practical applications of its use.[13]

Joanna Diane Caytas

On July 7, 2017, NBP and the Financial Supervision Authority (KNF) issued a joint comment on virtual "currencies,"[14] stating that virtual currencies: (1) are not issued or guaranteed by the central bank, (2) are not money, i.e., they are neither legal tender nor currency, (3) cannot be used to pay tax liabilities, (4) do not meet the criterion of universal acceptability in shopping and service points, (5) are not electronic money, (6) are not payment services (in legal terms), (7) are not financial instruments (in legal terms). They also noted that trading virtual currencies in Poland does not violate national or EU law; however, ownership of virtual "currencies" involves many risks: (i) risk related to the possibility of loss of funds due to theft, (ii) risk related to lack of guarantee, (iii) risk of lack of universal acceptability, (iv) potential fraud risk, (v) risk of price volatility. Due to these risks, NBP and KNF caution against investment in virtual currencies. NBP and KNF recognize that purchase, ownership and sale of virtual currencies by entities supervised by KNF (such as banks) would be burdened with high risk and would not ensure a stable and prudential management of the financial institution. Financial institutions should therefore be cautious about engaging and cooperating with entities trading in virtual currency.[15] NBP apparently remains ambivalent about the European Central Bank's view that traditional financial sector regulation does not apply to cryptocurrencies, since they do not involve traditional financial actors.[16] Legislative and executive opinions in the EU have differed sharply from

that position relatively early on[17] and, with the benefit of hindsight, rightfully so.

"Significantly, the scope of MLD4 was extended to include digital currencies and provides for close observation of beneficial owners of business entities with a view to tax evasion, further subjecting them to severe penalties and fines for non-compliance."

2. Financial Supervision Authority—Komisja Nadzoru Finansowego (KNF)

Established by the Financial Markets Supervision Act,[18] the Authority (Commission) consists of a chairman (appointed by the Prime Minister for a five-year term), two deputy chairpersons (appointed by the Prime Minister at the chairman's request) and five members (the Minister of Finance or his representative, the Minister for the Economy or his representative, the Minister responsible for social security or his representative, the President of the NBP or a board member delegated by him, and a representative of the President of the Republic). The Commission is tasked with the supervision of banks, insurance companies, capital markets, pension schemes and electronic money transmitters.

3. General Inspector of Financial Information (GIFI)—Generalny Inspektorat Informacji Finansowej (GIIF)

Operating since June 23, 2001 under the Ministry of Finance, GIFI is the Financial Intelligence Unit (FIU) of Poland and a member of the global Egmont Group and of MONEYVAL.[19] Its tasks include investigations to combat financial crimes including money laundering and terrorism finance.[20]

4. Ministry of Digital Affairs—Ministerstwo Cyfryzacji

The Ministry of Digital Affairs was established in 2015[21] and is tasked with the development of broadband infrastructure, support for the development of online content and electronic services, and promotion of digital awareness.

5. Office of Competition and Consumer Protection—Urzad Ochrony Konkurencji i Konsumentów (UOKiK)

The Office was established through a 2007 statute.[22] It is constituted by decree of the Council of Ministers[23] and tasked with antitrust enforcement and consumer protection matters. Misleading advertising and consumer fraud would come under the agency's jurisdiction.

B. Regulations

The subject matter of cryptocurrencies is governed by EU law as well as by Polish national law (which must not conflict with minimum standards set by the former, although it may impose supplementary requirements and legislate in matters not addressed by EU law).

1. Money Laundering Standards

a. 4th Money Laundering Directive (MLD4)[24]

Significantly, the scope of MLD4 was extended to include digital currencies and provides for close observation of beneficial owners of business entities with a view to tax evasion, further subjecting them to severe penalties and fines for non-compliance. It forms part of the EC's action plan for combating terrorist financing. MLD4 brings digital currency exchange platforms and custodian wallet providers within the scope of AML and CTF regulation, requiring them to perform customer due diligence and report suspicious transactions.[25]

b. Payment Services Directive (PSD)

The Payment Services Directive created new regulated activities in the payment ecosphere, such as issuing and acquiring payment instruments, money remittance and providing IT-based payment consent mechanisms applicable to electronic and mobile payment service providers.[26] But especially as technology evolves at a dizzying pace, it becomes increasingly difficult to tell whether an activity is subject to regulation or outside its scope. For example, BNP and KNF consider tokens/coins structured as utility tokens outside the scope of payment services regulations.

c. Electronic Money Institutions Directive

E-money was further regulated by a targeted directive that builds on the foundation of PSD.[27] It allows e-money institutions to engage in a wider range of payment-related activities to better compete with payment institutions and banks on payments. But e-money institutions, such as payment institutions, must safeguard funds received in exchange for e-money. More detailed rules were created on the terms and conditions applicable to e-money, such as issuance, redemption and interest (if and when that aspect should ever become a consideration again).[28]

"However, different tax issues are presented by the creation or generation of the original cryptocurrency, which is done by 'mining.'"

d. Securities Law and Regulation

To the extent that coins/tokens are considered securities, trading thereof will be deemed regulated trading. Where tokens express or represent regulated assets, trading of such assets may eventually be deemed regulated

activity subject to licensing or other regulatory requirements. As of February 2017, Poland officially recognized the trading and mining of virtual currencies as "official economic activity," according to the Central Statistical Office of Poland (Główny Urzad Statystyczny, GUS).[29]

Poland does not have a statutory or jurisprudential equivalent to the *Howey*[30] doctrine with a comparably sweeping definition ("a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party"[31]) that captures pretty much everything involving other people's money as an "investment" and thus subjects it to securities regulation and registration. The Polish Securities and Exchange Commission (formerly Komisja Papierów Wartociowych i Giełd) was merged into KNF in 2006.

Self-regulation of the crypto industry, as it starts to emerge in Japan,[32] has not shown indications of developing in Poland yet.

e. Crowdfunding

Crowdfunding is currently not regulated in Poland. So far, KNF has issued favorable opinions regarding crowdfunding projects, subject to observance of certain minimum standards.[33]

f. Taxation

Somewhat unsurprisingly, although the legal status of bitcoin remained quite shaky, Poland has always sought to tax bitcoin profits.[34] But virtual currencies had to be treated differently by different tax regimes, depending on whether the decision concerns sales tax (VAT) or income tax.[35]

The Polish VAT Act[36] provides in art. 5(1)(1) that paid delivery of goods or of paid services within Polish territory forms the basis of value-added taxation of sales. Thus, payment for taxable activity is a condition of taxation. Trading in cryptocurrencies involves exchange of conventional currency against virtual currency units. There, the taxable amount equals the differential between the intermediary's purchase price and its sales price received from customers. But the VAT Act's art. 43(1)(7) provides that transactions, including intermediation, in currencies, bank notes and coins used as legal tender are exempt from VAT. Therefore, the question arose whether virtual currencies—to date not regulated by law and neither issued nor supervised by any government body—could be considered as "means of payment" within the meaning of the VAT Act. If so, cryptocurrency transactions would be exempt from VAT.

Cryptocurrencies have already been the subject of consideration by the European Union bodies. The VAT exemption for currency transactions was introduced in Poland by way of implementation of the EU's VAT directive.[37] In its *Hedqvist* decision,[38] the ECJ ruled that bitcoin "cannot be characterised as 'tangible property' within the meaning of Article 14 of the VAT Directive, given that … that virtual currency has no purpose other than to be a means of payment." The Court found that it would be unacceptable to restrict the provision of the Directive to transactions in traditional currencies, as this would partially deprive the directive of effectiveness. Thus, transactions involving the exchange of traditional currency against bitcoin units (also, of course, *per analogiam*, other cryptocurrencies) and *vice versa* are exempt from tax within the meaning of the EU VAT directive.

In light of controlling ECJ jurisprudence presented in applications for individual interpretation (equivalent to an advance ruling), the Director of National Tax Information in Poland found the positions taken by the applicants to be correct.[39] In the cases in question, the sole purpose of virtual currencies was the function of payment means, and therefore cryptocurrency trading is exempt from VAT. This position appeared in three tax interpretations of October 3, 2017 concerning bitcoin, litecoin and ether. In this scenario, virtual currency units are similar in function to non-cash money. Furthermore, value is solely determined by supply and demand on virtual exchange websites that establish their exchange rate in relation to traditional currencies. At the same time, cryptocurrencies are increasingly used to pay for goods and services, accepted in stores and, in some countries, even by government agencies.[40] Therefore, exchange of virtual into traditional currencies and *vice versa* involves the same kind of spread between purchase and sale price as a forex transaction. Both are exempt from taxation of sale of goods and services in Poland, and thus from VAT.

However, different tax issues are presented by the creation or generation of the original cryptocurrency, which is done by "mining." Because virtual currency units are generated in this fashion "out of thin air" and then marketed and sold for a price determined by the seller as part of its business strategy, then, as a judgment of the Łódz Provincial Administrative Court has held, this activity should be deemed to be providing a service—which would render it taxable under the VAT Act. Poland's Supreme Administrative Court[41] has held that, while the introduction of virtual currency units to the market does not constitute delivery of goods within the meaning of the VAT Act, it is a paid service, because the seller receives a specific price from the buyer. Thus, the basic difference between the two situations is how cryptocurrency is used. In the case of trading existing units, VAT Act art. 43(1)(7) applies,[42] because in such transactions they act as a carrier of money. But if freshly "mined" currency units are first "issued" into the primary market, this transaction is treated as providing a paid service that is taxable under the VAT Act without regard to exemptions otherwise available if currency units are sold for consideration in trading as opposed to issuance transactions.[43] One may or may not find the notion persuasive that min-

ing constitutes a service but brokerage does not, but the economic purpose is to avoid taxing the circulation of even quasi-currency, thus forcing its value to evaporate over time.

In another decision, the Supreme Administrative Court held that, as for income taxation, it is undisputed that both income derived from mining as well as from trading is subject to regular income tax.[44] Relatively strict and complex demands apply to documentation under the Personal Income Tax Act (PIT Act), art. 10(1)(3) and (7).[45] Thus, bitcoin trading profits may be taxed as income at a rate of up to 32 percent.[46]

III. Management by Rumor

One phenomenon observed in Central and Eastern Europe quite frequently also played a role in the cryptocurrency arena: management by rumor and denial. For example, several Polish media outlets recently reported on an alleged project of a national cryptocurrency[47] (similar to Estonia or Venezuela[48]) that could supplement or, in due course, even supplant the zloty. The dPLN, "digital zloty," to be pegged one-to-one to the national currency in an effort to retain the security of blockchain technology without volatility risks inherent in unregulated cryptocurrencies, was a brainchild of the Polish Accelerator of Blockchain Technology (Polski Akcelerator Technologii Blockchain) under the patronage of the Ministry of Digital Affairs.[49] After the accelerator's announcement of its successful creation in principle of this cryptocurrency made international and domestic news, the Ministry of Digital Affairs promptly disavowed the project, withdrew its patronage, and issued a statement that financial instruments and currencies, including cryptocurrencies, lay outside the jurisdiction of the Ministry of Digital Affairs.[50]

While the vision of a national cryptocurrency would dovetail with plans probably welcomed by almost all regulators worldwide to gradually eliminate cash,[51] and blockchain-based payment platforms such as Ripple offering payments in zloty are indeed about to be launched imminently in Poland by Banco Santander, Europe's largest bank,[52] and while the potential value of blockchain technology for purposes other than finance is widely recognized in Poland,[53] sensationalist media buzz is deliberately generated from time to time, even in instances where the outcome is entirely obvious to finance professionals. Especially statements likely to be noted abroad are still frequently made primarily for the consumption of a domestic audience.[54] Regulators have promptly and repeatedly denied plans for a national cryptocurrency.[55]

Other rumors about Poland's involvement in a national cryptocurrency were spread by Venezuelan Minister of Oil and Mining, Vielma Mora, claiming that Poland would somehow endorse Venezuela's crude-oil-backed petro,[56] the world's first state cryptocurrency. These rumors were emphatically denied as well.[57] Not least in consideration of U.S. opposition to the regime of Nicolás Maduro and of a range of strict sanctions in force that ultimately resulted in President Trump banning U.S. persons from transacting the petro by executive order[58] (and Russia promptly announcing its convertibility into rubles the same day[59]), the petro had already been refuted by Poland one month earlier,[60] although it turns out that reasons for this step were considerably more complex and well-founded.[61]

A. Technology's Thus Far Unfulfilled Hope for an Anti-Defamation League

We are reminded of Lord Bacon's classic transliteration of Plutarch: *[a]udacter calumniare, semper aliquid haeret*—slander boldly, something always sticks.[62] Nobody knows this better than leading officials of the financial establishment: following the example of extensive diatribes by JPMorgan Chase Chairman Jamie Dimon,[63] KNF Chairman Marek Chrzanowski compared Bitcoin to the Dutch Tulip Mania of 1637[64] and Prime Minister Mateusz Morawiecki compared it to a 2012 local shadow banking pyramid scheme named Amber Gold[65] that may have caused some U.S. $40 million in losses, a rather insignificant amount that nonetheless created great publicity.

"Polish law requires disclosure of sponsored content. That did not happen in this video. Polish law does not prohibit investment of funds of lawful origin in cryptocurrencies. NBP had therefore no basis or justification to sponsor defamatory content against cryptocurrencies in general in the first place."

Independence from government control of purportedly independent central banks and monetary policy was among the key motivating factors driving early investment in cryptocurrency technology. It also explains covert action to recapture control by discrediting private, disintermediated currencies that might threaten government control of payment methods. Since President Nixon's 1971 abandonment of the Bretton Woods gold standard, the argument that cryptocurrencies are not backed by anything other than market participants' willingness to pay has lost any persuasive power since the very same can be said about fiat money, except that major governments' and central banks' capacity to create emergency liquidity still by far outranks cryptocurrencies' ability to generate emergency liquidity, as global management of the 2008 financial crisis has demonstrated. But this diagnosis presents only a temporary snapshot, and shows only a gradual difference. By its very structure and nature, sovereign fiat money is no more "covered"

or "backed" by intrinsic value than cryptocurrencies are: if bitcoin is a "fraud," then so is the U.S. dollar, the euro, the yen, the renminbi, the Swiss franc, the ruble, not to speak of other, less internationalized currencies. Since international law had to abandon the fiction that a sovereign debtor cannot, by definition, become insolvent, and since a Chairman of the Joint Chiefs of Staff, Admiral Mike Mullen, publicly identified debt as "the biggest threat to U.S. national security"[66] while OECD found the European public debt situation to pose even greater risks to the global economy than current U.S. debt levels,[67] the biggest remaining issue is the inability of governments to sanction, freeze and block crypto payments which, after all, do not rely on SWIFT or dollarization.[68]

Poland has seen a barrage of commonplace but unsubstantiated grumblings about potential risks involving hypothetical risks that we know also from regulatory comments in other countries, mostly focused on perceived threat scenarios arising out of anonymity,[69] lack of traceability, downside potential, and the general risks of hype that arises out of the lemming psychology of "dumb money": when homemakers, retirees and celebrities flock to an asset and laypeople start pledging their homes and cars to "get in on this wave of the future," it is usually the last safe moment to exit a bubbly market.[70] And certainly, regulatory skepticism around the world is not without merit as new products and markets generally tend to be rife with crime until regulation and enforcement catch up in due course.[71]

Also familiar among the tools for expressing establishment disapproval is the cancellation of account relationships by major banks for companies active in the cryptocurrencies market.[72]

Another classic, however, is the creation of the appearance of sovereign political risk targeted to destroy the market: repeated ruminations by the Polish government about the "possibility" of a unilateral ban of cryptocurrencies in Poland[73] stand almost no chance of successful implementation in a relatively small country with open borders and convertible currency that is surrounded by neighbors who show no inclination to join such a ban.

B. NBP's Excursion into Fiction

A truly unique cock-and-bull story right out of slapstick, however, is the street ballad of NBP's commissioning and funding out of taxpayer money to the tune of 90,000 zloty (~U.S. $27,000)[74] a piece of defamatory "fake news" against bitcoin promoted by Facebook and Google advertising—and then getting caught[75] and having to admit it.[76]

NBP commissioned a Polish youtuber, Marcin Dubiel, to produce a video titled *Straciłem wszystkie pieniadze?!* [*I Lost All the Money?!]*.[77] It shows a young man investing all his worldly possessions into cryptocurrency, only to be embarrassed at a dinner date when he finds himself unable to settle the restaurant bill using cryptocurrency. The woman leaves, highly annoyed, after settling the bill in cash. The video ends with the young man learning that his money has disappeared into a fraud scheme while an evil Dubiel, in Scrooge McDuck pose, laughingly counts his illicit profits—in legal tender, nothing crypto about his loot.

Polish law requires disclosure of sponsored content. That did not happen in this video. Polish law does not prohibit investment of funds of lawful origin in cryptocurrencies. NBP had therefore no basis or justification to sponsor defamatory content against cryptocurrencies in general in the first place.[78] No public explanation has been provided by NBP to date. Circumstances of the publication did not even leave NBP the expectable argument that the video had been commissioned "for the shelf," to be released as a public warning in the event of a market crash in cryptocurrencies, since no such event had taken place prior to its release on December 8, 2017—or since. The odd commentator has voiced understanding for NBP acting under some sort of *parens patriae* theory to warn against sudden egregious fluctuations in value.[79]

This narrative is all the more bizarre since it was the same NBP that registered a slew of trademarks with relevance to the cryptocurrency market, such as *PL coin*, *Poland coin*, *Pol coin* and *Pola coin*.[80] One might call it a classical hedge.

IV. Regulatory Developments

Few doubt that a wave of fairly comprehensive regulation of cryptocurrencies and ICOs is imminent in Poland,[81] independent of, and supplementary to, any EU-wide standards.[82] Of course, as in the vast majority of other countries, and aside from basics such as extension of anti-money-laundering standards and securities laws, considerable uncertainty continues to exist about specifics of future crypto-related regulation.[83] Definitional issues—what constitutes currency?, what is cryptocurrency?—required some debate[84] but have largely been answered.

Recently, the Sejm enacted a legislative update to anti-money-laundering standards[85] which now also apply to crypto-platforms of all stripes, pretty much in lockstep with contemporaneous SEC enforcement action in the U.S.[86]

A. Act on Counteracting Money Laundering and Terrorism Financing

The Act,[87] adopted with near-unanimity,[88] was intended supersede existing legislation dating back to 2000 in order to increase the effectiveness of Polish anti-money laundering provisions and to implement the EU's MLD4.[89] It also presented the first statutory definition of a virtual or digital currency.

The Act does not mention cryptocurrencies specifically but defines in art. 2 (12) "obligated institutions" as

> entities conducting economic activity consisting in the provision of services in the scope of:
> (a) exchanges between virtual currencies and legal tender
> (b) exchanges between virtual currencies
> (c) brokering services referred to in (a) or (b)
> (d) keeping accounts enumerated in art. 2 (17) (e).

Accounts referenced in (d) are further defined in art. 2 (17) (e) as "an electronic collection of identification data that provide authorized individuals the possibility of using virtual currency units, including transactions to exchange them." The Act also defines "virtual currency" in art. 2 (26) and characterizes it in art. 2 (27) as one of the variants of "property value." Virtual currency is understood to be a "digital mapping of values" that "is exchangeable in the course of trade for legal means of payment and accepted as a medium of exchange, and may also be electronically stored or transferred, or may be subject to electronic commerce."

"Virtual currency" is a digital representation of value that is not legal tender issued by the NBP, foreign central banks or other public administration bodies; or an international settlement unit established by an international organization and accepted by individual countries belonging to or cooperating with this organization; or electronic money within the meaning of the Act of August 19, 2011 on Payment Services; or a financial instrument within the meaning of the Act of July 29, 2005 on Trading in Financial Instruments; or a bill of exchange or a check. Furthermore, "virtual currency" also needs to be exchangeable in the course of trade for legal tender and accepted as a medium of exchange and may also be electronically stored or transferred or may be subject to electronic commerce.

The Act extends the status of obligated institutions also to "entities conducting business activity consisting in the provision of virtual currency exchange services. " This means that obligated institutions, including virtual currency exchanges and entities that maintain portfolios of these currencies, must apply financial security measures to their clients in accordance with the Act to enable monitoring with a view to detection and reporting of suspicious transactions potentially related to money laundering and terrorist financing. Obligated institutions may use "enhanced security measures" in cases of "greater risk of money laundering or terrorist financing." Greater risk is indicated by symptoms that include "the customer's use of products or services conducive to anonymity or impeding identification." The application of these provisions is subject to verification by GIFI.

Joanna Diane Caytas is an associate at Schulte Roth & Zabel LLP, where her practice focuses on taxation of investment funds and digital assets; she has published several papers on regulation of blockchain and emerging technologies.

Besides that, the Act sets tasks for the Financial Security Committee, establishes mechanisms to prepare a national risk assessment for money laundering and terrorist financing, defines duties of obligated institutions including implementation of financial security measures, creates and sets an operational framework of a Beneficial Ownership Central Registry,[90] establishes rules for GIFI governing information gathering, information sharing and data protection as needed to fulfill its statutory obligations, and it regulates cooperation between GIFI, foreign FUIs and Europol. It also contains provisions on enforcement action, specifically on suspension of transactions and blocking of accounts, on restrictive measures against individuals, groups and entities, as well as on control of obligated institutions and a set of administrative sanctions to be imposed on obligated institutions that fail to comply with obligations imposed by the Act.

B. Act on Payment Services

This Act[91] provides in art. 150 for penalties in case of unauthorized provision of payment services or of "electronic money." A violation carries fines of up to 5 million zloty (~U.S. $1.5 million) or up to two years imprisonment or both. The same penalty faces whosoever advertises or offers to act without a license as "payment services," "issuing electronic money," "payment institution," "payment services office," an "electronic money institution" or being "a branch of a foreign payment institution."

To date, Poland knows no ban on conducting business, including intermediary services for trading, in cryptocurrencies. Transacting or holding virtual currencies is not a violation of Polish or EU law. However, cryptocurrency exchanges that are not themselves licensed to perform payment services must cooperate with one or more financial institutions regulated and supervised by KNF. Virtual stock exchanges must register, typically as LLCs or corporations recorded in the National Court Register (Krajowy Rejestr S dowy, KRS), or, if they represent other organizational structures, in the Commercial Activity Register (Evidencja Działalnosci Gospodarczej, EDG).

According to the Act's art. 6, cryptocurrency exchanges do not come under its purview. The services they provide also do not come under the provisions of the Act on Trading in Financial Instruments.[92] But the growing popularity of cryptocurrency ownership creates competitive pressures on traditional banks and they could adversely affect profitability for the entire banking sector over time.[93] Thus, and because of potential risks for statutory

deposit insurance, it remains doubtful whether crypto markets will receive support from government institutions with regard to exercise of discretion or statutory interpretation or policy adaptations, not to mention potential bailouts in the event of a dramatic market downturn, with or without regard to their systemic relevance.

On January 9, 2018, the Council of Ministers adopted draft legislation by the Minister of Finance on amending the Act on Payment Services[94] that represents a fundamental overhaul in light of the new Act on Counteracting Money Laundering and Terrorism Financing.

V. Conclusion

Legal treatment of cryptocurrencies in Poland follows a familiar pattern of distanced observation, popular enthusiasm, threat perception by the establishment, embarrassing fumbles and hedges, followed by vigorous and rigorous regulation and, ultimately, triumphant taxation. We know that an idea or product has reached maturity when the tax man has turned into a stakeholder, rooting for it.

As for regulatory treatment, the parameters are more complex: Poland has turned into one of the world's crypto markets without having significant regulatory weight independent of the EU. The objective of AML legislation is primarily to avoid U.S. and EU pressure while its market of 40 million is too large to define itself as a niche player like Estonia. Poland has substantial human resources in the digital sphere, and not insignificant entrepreneurial potential, even if it has not left important marks in innovation technology yet. But just as the Warsaw Stock Exchange remains one of the world's fastest-growing and most successful, the largest in CEE, with investors as international as issuers, the same is likely to be true of its virtual exchanges where Poland punches well above its weight in cryptocurrencies. Consequently, and absent a major systemic meltdown in the crypto market, regulatory emphasis will have to be on providing a supportive operating environment while maintaining European standards of policing market integrity. The pace of regulation will likely continue to increase throughout 2018 and beyond, as international standards emerge and blockchain fintech business models evolve further.

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President

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Executive Director

South Korea

The International Section held its first Asian Regional Meeting in Seoul, South Korea, on April 23-24, 2018, hosting more than 100 attendees from various countries around the globe.

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International Section Seasonal Meeting – Registration Form

Montreal | October 24 – 26, 2018

I. REGISTRANT INFORMATION

Name____

Company/Law Firm ___________________________________

Address____

City ___________________________ State _____________

Zip _______________ Country ________________________

Phone ______________ E-mail address__________________

Name of spouse or guest ______________________________

❑ First-time attendee of a Section meeting?

❑ I am a speaker on program #__________

II. REGISTRATION FEES

Fees are denoted in U.S. dollars

	EARLY BIRD until August 31	Standard Sept. 1
NYSBA Member Attorney	$995	$1095
Non-NYSBA Member Attorney	$1195	$1295
Associates	$795	$895
Federal Govt Employees & NFP Sector	$795	$895
Spouse/Guest	$695	$695

Spouse/Guest fee Includes: Welcome Reception and dinner, Thursday reception & dinner, Friday cocktail reception and Gala dinner; as well as applicable transportation.

III. CHOOSE YOUR EVENTS

Please choose one program in each time slot:

Wednesday, October 24

❑ Plenary Session ONE ❑ Plenary Session TWO

Thursday, October 25

❑ Panel 1 ❑ Panel 2 ❑ Panel 3
❑ Plenary Session THREE ❑ Lunch
❑ Panel 4 ❑ Panel 5 ❑ Panel 6
❑ Panel 7 ❑ Panel 8 ❑ Panel 9
❑ Panel 10 ❑ Panel 11 ❑ Panel 12

Friday, October 26

❑ Panel 13 ❑ Panel 14 ❑ Panel 15
❑ Panel 16 ❑ Panel 17 ❑ Panel 18
❑ Lunch ❑ Plenary Session FOUR
❑ Panel 19 ❑ Panel 20 ❑ Panel 21
❑ Panel 22 ❑ Panel 23 ❑ Panel 24

Please indicate social functions you plan to attend:

Wednesday, Oct. 24 ❑ President's Reception & Dinner – InterContinental

Thursday, Oct. 25 ❑ Cocktail Reception and Dinner – L'Auberge

Friday, Oct. 26 ❑ Gala Reception and Dinner – InterContinental

❑ I/we will require group transportation to all events (included).

IV. DIETARY RESTRICTIONS/ALLERGIES

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V. PAYMENT INFORMATION

Payment for registration fees will be accepted by credit card or wire transfer.* Please include the name of the credit card holder if it is different from the registered attorney.

❑ Charge $ _____________ to:
❑ American Express ❑ MasterCard ❑ Visa

Expiration date___________________________

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*Please email tbardwell@nysba.org for wire transfer instructions.

Online registration will be available beginning the week of July 2, 2018 but will be available for non-discounted registration rates only.

www.nysba.org/montreal2018

VI. EMERGENCY CONTACT

Name____________________________________

Phone___________________________________

Email ___________________________________

Attorney Registration fees include:

Programming and costs associated with programming, coffee breaks, attorneys' lunches Thursday and Friday, cocktail receptions, dinners on Wednesday, Thursday and Friday, as well as transportation to offsite evening events and NY MCLE credit.

Cancellation Notice:

Notice of cancellation must be received by October 5, 2018 in order to obtain a refund of fees.

Email or Fax this form to:

Tiffany Bardwell
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One Elk Street, Albany, New York 12207

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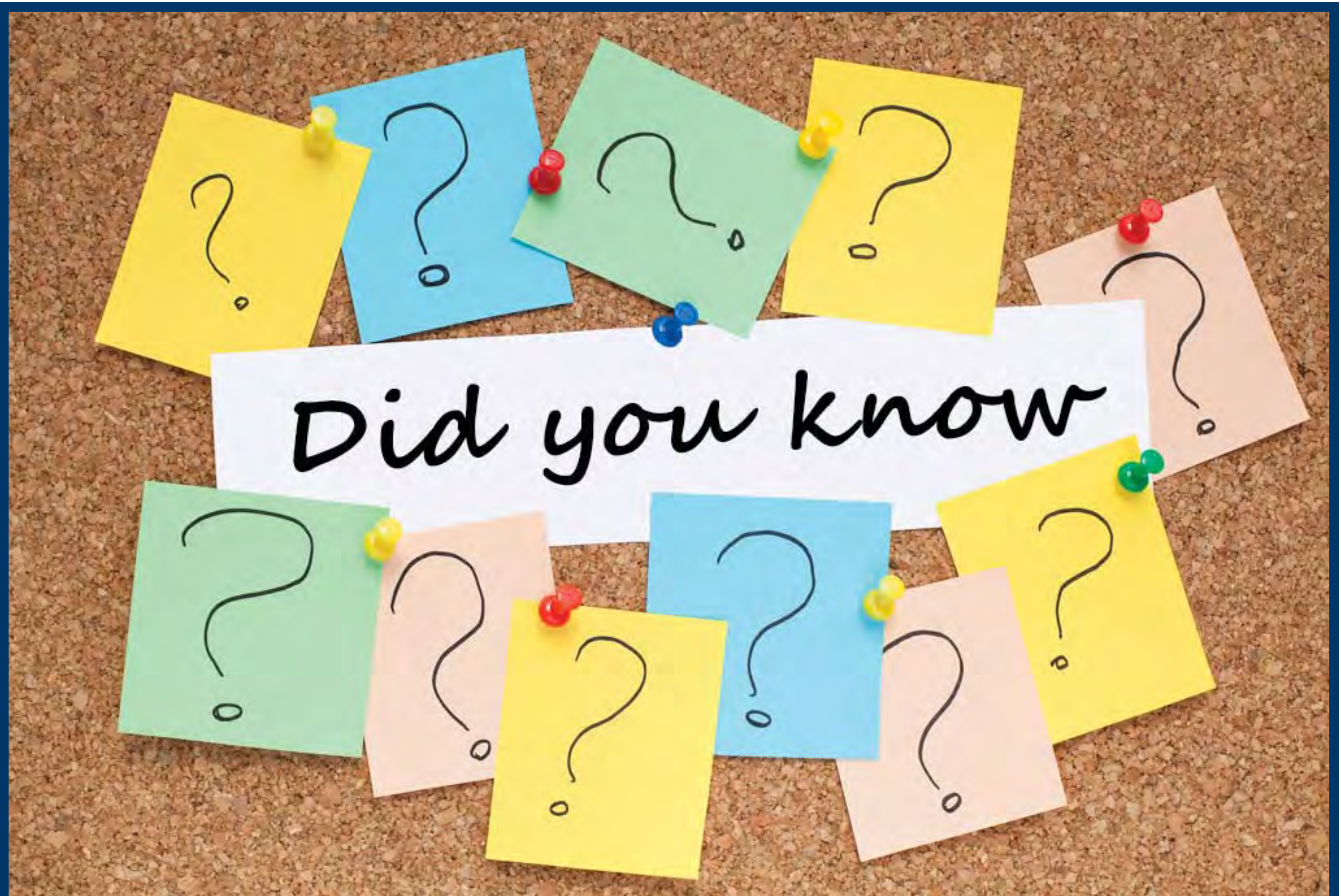

Did You Know?

The International Section gained nearly 200 new members so far in 2018!

In addition to U.S. members, we have gained members in Australia, Austria, Brazil, Canada, China, Czech Republic, Denmark, Dominican Republic, Egypt, England, France, Germany, Hong Kong, Hungary, India, Italy, Japan, Kuwait, Luxembourg, Singapore, South Korea, Spain, Switzerland, and the United Kingdom.

The Brazil Chapter of the NYSBA International Section

By Gerald Ferguson

The Brazil Chapter of the NYSBA International Section regularly organizes breakfast meetings to discuss issues that are important to American and Brazilian lawyers, always with speakers from both countries.

On March 27, our breakfast meeting was about the regulation of crypto assets and Initial Coin Offerings (ICOs) in the U.S. and Brazil. The chapter had the support of WeWork, a global company that provides workspaces to technology companies and other startups and entrepreneurs, and which has offices in São Paulo. WeWork graciously offered space and infrastructure for the event, which was hosted by TozziniFreire, a Brazilian law firm, and Vortx DTVM, a fund and corporate trust services fintech.

Gerald Ferguson

Gerald Ferguson of Baker & Hostetler (New York) spoke via Skype to a crowd of about 30 lawyers, investors and tech enthusiasts in São Paulo. In his presentation, Mr. Ferguson detailed the latest developments on this issue in the U.S. and answered several questions from the audience. Carlos Mauricio Mirandola, Co-chair of the Brazil Chapter and CCO/CRO at Vortx DTVM, served as moderator, and Rodrigo Vieira of TozziniFreire spoke on developments in Brazilian law related to the issues raised in Mr. Ferguson's presentation.

Jay Himes, the senior vice chair for Chapters, said: "This meeting provides a good blueprint for how, through the use of Skype and infrastructure support from companies such as WeWork, Chapters can collaborate with lawyers based in New York to provide informative and useful content at Chapter meetings."

Please find some pictures of the event on this page.

A founding partner of Baker & Hostetler's Privacy and Data Protection team, Mr. Ferguson is a regular contributor to Baker & Hostetler's Data Privacy Monitor blog and has authored numerous published articles.

French Chapter Latest News and Plans for 2018

By Chapter Chair François Berbinau

1. Reactivating the Chapter Through a Steering Committee

Using the momentum created by the Seasonal Meeting of the International Section held in Paris in October 2016, we are attempting to reinvigorate the French Chapter and increase its activities. To that end, in the Spring of 2017 we created a Steering Committee of the Chapter composed from a mix of French and U.S. attorneys practicing in Paris, as well as an in-house compliance specialist of the banking sector.

Benoît Charrière Bournazel (who also chairs the Paris Bar Association's "Paris-New York Committee"), Lara Kroop Delamarre (former DOJ in California and now working at Cohen Gresser in Paris), Sophie Levy (a French-U.S. citizen and attorney with experience both in New York at Allen & Overy and at the U.N. and now a litigator with Clifford Chance's Paris practice), Charles Merveilleux du Vignaux (a Columbia alumnus and also a litigator at Clifford Chance), Nathalie Riez (formerly Managing Director, Head of Compliance for France, Belgium and the Netherlands at JP Morgan) and François Berbinau (Chapter Chair) have been active in organizing a first event, which will serve as a basis for developing the Chapter's activities.

2. Launching the First Event Organized by the Steering Committee

While meeting on a regular basis since March 2017, our Steering Committee has decided to work on setting up a first event, with the objective of presenting the work and ambitions of our Chapter to a group of approximately 35 colleagues (already members of the International Section or possible recruits) in order for them to help us understand what would make the Chapter successful (increase the number of participants and events) and promote a larger event in 2018.

This first dinner of the Chapter took place on October 18, 2017, at the Cercle France-Amériques, a beautiful venue known to those of the Executive Committee of the Section who participated in the dinner held there during the 2016 Paris Seasonal Meeting.

Attendance was as expected and we shared a very warm moment with our guests, who came at the invitation of one of the Steering Committee's members. Our invited guests showed great interest in our initiative. The crowd was of mixed nationalities, background, and age, including legal practitioners, members of international organizations, law professors and in-house counsel.

3. The Outcome of This First Event and Plans for 2018

François Berbinau

This first dinner helped us spread the news to a potentially larger crowd than the mere attendees, who expressed their interest in participating in the development of the Chapter and provided us with very useful information about the type of Chapter activities they were looking for and how to create something new while delivering opportunities (events, international exchange, networking) in a manner that will be unique.

We understand from the feedback we have received at this first dinner that attendees were interested in participating in:

- breakfasts organized to discuss a legal topic of practical interest presented by a small panel of specialists;
- dinners with special guests, not necessarily from the legal community, but who will be willing to share her/his international (preferably French/U.S.) experience in her/his field of business/expertise,
- joint events with other European Chapters.

Now that we have gathered this information, our next Steering Committee meeting will be dedicated to deciding on our next event and setting things in motion.

4. Collaboration with New York and Other Chapters

Obviously, the work of our Chapter and its Steering Committee only makes sense if it is aimed at developing international relationships and networking, not just among ourselves in France but also across Europe and of course with the Section in New York and especially the members of its Executive Committee.

Therefore, we welcome any opportunity to meet with our friends from other Chapters and from New York who, when making plans to come to Paris, even on a short business visit, should never hesitate to reach out to us. We will always be happy to take them out for lunch or dinner, and we could also manage to have them participate in one of our events to come. If we can be of help while you are staying in Paris, please let us know.

François Berbinau, BFPL avocats, Paris, France

United States Rethinks Its Exiting TPP as Remaining 11 Countries Sign the New Agreement, Which Includes Significant Investment Protections

By Joaquin P. Terceño and Daniel Allen

Following his election as U.S. President, Donald Trump followed through on a campaign promise and in January 2017 withdrew the United States from the Trans-Pacific Partnership Agreement (TPPA), a wide-ranging investment agreement with 11 other countries.[1] Those 11 countries—Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam—spent the last year renegotiating the agreement without the United States. The new agreement, renamed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPATPP), was signed on March 8, 2018. The agreement covers regions accounting for approximately 14 percent of global GDP and includes roughly 500 million people.

The United States, meanwhile, seems to be reconsidering its initial withdrawal. According to press reports, 25 Republican U.S. Senators recently wrote a letter to President Trump requesting that the United States rejoin the trade agreement.[2] President Trump himself said recently that he would consider rejoining the agreement, although he qualified doing so on the United States being able to get a "substantially better deal."[3] The Trump administration's 2018 Trade Policy Agenda, released February 28, stated in relation to the 11 CPATPP countries (the "Member States") that: "In 2018, the Trump administration will continue efforts to build stronger, better, and fairer trading relationships with these countries."[4] Whether the United States could revise the agreement now that it has been signed remains to be seen.

The TPPA aimed to create a free trade area covering much of the Pacific Rim. The CPATPP reflects revisions to the original TPP that the United States rejected under President Trump.[5] However, with certain exceptions, the CPATPP's content does not deviate significantly from what had been agreed in the TPPA, the provisions of which are incorporated by reference into the CPATPP.[6]

A number of provisions of the TPPA, ranging from copyright terms to the dates that commitments will commence, are suspended with effect from the date of entry into force of the CPATPP.[7] These provisions could be reinstated if all the Member States were to agree. As discussed below, certain of the suspended provisions relate to foreign investment protections. Such investment protections in international treaties have become a touch-

Joaquin P. Terceño

Daniel Allen

point for the North American Free Trade Agreement (NAFTA) negotiations in which the United States is currently engaged with CPATPP Member States Canada and Mexico. It remains to be seen whether the United States would accept the investment protections in the CPATPP as a condition of its rejoining the agreement.

Despite the suspended investment protection provisions, the CPATPP will offer significant protections to investments by nationals or companies from one Member State in the territory of another Member State. The CPATPP's chapter on investment protection[8] (the "Investment Chapter") will: (*i*) guarantee important protections to investments made by those nationals or companies; and (*ii*) contain investor-State dispute settlement (ISDS) provisions entitling investors to submit disputes with Member States to binding international arbitration. In sum, the CPATPP provides investment protections similar to those found in many bilateral investment treaties and other investment-protection agreements. However, as detailed below, there will be some important differences.

I. Substantive Protections

The Investment Chapter includes the following substantive investment protections (subject to the exceptions flagged in the next section):

Minimum standard of treatment. Each Member State will guarantee covered investments a minimum standard of treatment in accordance with customary international law. This includes: (i) fair and equitable treatment, including the obligation not to deny justice in legal proceedings

in accordance with the principle of due process embodied in the principal legal systems of the world; and (ii) full protection and security, which requires each Member State to provide the level of police protection required under customary international law.

The CPATPP provides that the fact that government action may be merely inconsistent with an investor's "expectations" does not breach this standard. The text also expressly provides that the fact that a subsidy or grant has not been issued, renewed or maintained, or has been modified or reduced, by a Member State, in and of itself does not breach this standard. Further, the original TPPA provision applying the minimum standard of treatment obligation to the provision of financial services has been suspended in the CPATPP.

National and Most-Favored-Nation (MFN) treatment. Each Member State will guarantee investors of another Member State and covered investments treatment no less favorable than the treatment it accords, in like circumstances, to its investors and their investments in its territory or to investors of any other state (i.e., a Member State or a non-Member State) and their investments. This protection will cover the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments in its territory. The text expressly provides that MFN treatment does not encompass ISDS procedures, including those in the Investment Chapter.

Free transfer of funds relating to a covered investment. Each Member State will be required to permit all fund transfers relating to a covered investment to be made freely and without delay into and out of its territory. Transfers relating to a covered investment shall be permitted to be made in a freely usable currency at the market rate of exchange prevailing at the time of transfer.

Prohibition on expropriation without compensation. The Member States will agree not to expropriate or nationalize covered investments directly through formal transfer of title or outright seizure of a covered investment, or indirectly through measures that have an effect equivalent to expropriation or nationalization, except: (i) for a public purpose; (ii) in a non-discriminatory manner; (iii) on payment of prompt, adequate, and effective compensation; and (iv) in accordance with due process of law. The CPATPP specifies that non-discriminatory regulatory actions by a Member State that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations, except in rare circumstances. The Investment Chapter does not clarify what qualifies as a "rare" circumstance.

II. Exceptions to Investment Protection Under the CPATPP

The CPATPP's investment protections are subject to several exceptions.

First, the national treatment and MFN treatment standards will not apply to non-conforming measures maintained by a Member State. Each Member State was required to provide a list of such measures as a Schedule to Annex I of the TPPA. Annex I, together with its Schedules, incorporated into and made part of the CPATPP. Member States may amend the non-conforming measures listed in their respective Schedules, provided the amendment does not decrease the conformity of the measure with the national treatment or MFN treatment standards, as it existed immediately before the amendment, or Articles 9.9 (Performance Requirements) or 9.10 (Senior Management and Board of Directors).

Second, Member States will have the freedom to adopt appropriate measures to ensure that investment activity in their territories is undertaken in a manner sensitive to their environmental, health or other regulatory objectives, provided that such measures are not otherwise inconsistent with the Investment Chapter, meaning that they do not otherwise constitute a breach of the obligations under the Investment Chapter.

Third, a denial of benefits clause is included. It provides that a Member State may deny the benefits of the Investment Chapter to an investor that is an enterprise of another Member State and to any investments made by that investor, if the enterprise: (*i*) is owned or controlled either by a person of a non-Member State or of the denying Member State; and (*ii*) has no substantial business activities in the territory of any Member State other than the denying Member State. The Member State may also deny such benefits to an investor that is an enterprise and to investments of that investor if persons of a nonparty control the enterprise and if extending investment protections to that investment or investor would circumvent or violate measures prohibiting transactions with that enterprise, e.g., as a result of economic sanctions. In addition, the CPATPP provides that a Member State may deny the benefits of the ISDS section with respect to claims challenging any of its tobacco control measures.

III. The ISDS Provisions

Investors will be able to enforce the Investment Chapter's protection against a Member State by submitting a dispute to binding international arbitration provided it is not resolved within six months through consultation and negotiation with the Member State.

One noteworthy change from the TPPA is that the CPATPP Investment Chapter's ISDS provisions do not include disputes regarding alleged breaches of any investment authorization (i.e., an authorization that a Member State's foreign investment authority grants to an investor of another CPATPP Member State or a covered investment) or investment agreement (i.e., a written agreement between a central government authority of a Member State and an investor of another Member State or covered investment which the investor or covered investment relies upon to establish or acquire a covered investment). In other words, breaches of these agreements, while remaining a potential basis for a breach of contract claim in domestic courts, will not be subject to the ISDS provisions in the CPATPP, and thus cannot be the basis for a claim under the CPATPP (unless the breach could be shown to violate an existing obligation under the agreement). While the TPPA provided for such protection, the relevant provisions will be suspended upon entry into force of the CPATPP, and thus these protections will not be available to foreign investors unless all of the CPATPP Member States agree at some later date to reinstate them.

The Investment Chapter will offer investors the option of both institutional and ad hoc arbitration. For instance, an investor may submit a dispute to ICSID arbitration if both the Respondent State and the investor's home State are parties to the ICSID Convention (i.e., all Member States, except Vietnam and Mexico). Alternatively, an investor may submit a dispute to arbitration under the ICSID Additional Facility Rules if either the Respondent State or the investor's home State is a party to the ICSID Convention; the UNCITRAL Arbitration Rules; or any other arbitration institution or rules agreed by the disputing parties.

"President Trump has not made clear what he would consider to be a better deal for the United States than that reflected in the original TPP, or what his administration's position is on the newly agreed CPATPP."

The Investment Chapter also prescribes some specific rules for ISDS procedures.

First, the ISDS provisions expressly provide that the governing law of any arbitration shall be the CPATPP and applicable rules of international law.

Second, the Investment Chapter addresses the risk of multiple proceedings under the CPATPP, and other treaties concluded between one or more of the Member States, e.g., the NAFTA, to which Canada and Mexico are parties. The notice of arbitration in a CPATPP dispute will be required to be accompanied by a written waiver of any right to initiate or continue proceedings before any court or administrative tribunal of a Member State, or any other dispute settlement procedures, with respect to any measure alleged to constitute a breach of an obligation under the Investment Chapter. In addition, Chile, Mexico, Peru, and Vietnam each have expressly precluded an investor who has commenced proceedings before a court or administrative tribunal in its territory from submitting a dispute to ISDS under the Investment Chapter.

Third, an investor's ability to bring a claim under the Investment Chapter will be subject to a limitation period. An investor will be unable to bring a claim if more than three years and six months have elapsed from the date on which the claimant first acquired or should have acquired both knowledge of the alleged breach and knowledge that the investor had incurred loss or damage. This provision is similar to the three-year limitation period that currently applies to claims under NAFTA.

Fourth, the CPATPP provides for the establishment of a Commission with the power, among other things, to issue interpretations of the CPATPP's provisions. The Commission's role is similar to the role of the Free Trade Commission established under current Article 2001 of NAFTA. The Commission established under the CPATPP will meet at the Minister or Senior Official level, as mutually determined, and each Member State will be responsible for the composition of its delegation to the Commission. An interpretation issued by the Commission will be binding on a CPATPP tribunal, and the tribunal's award must be consistent with the Commission's decisions.

Fifth, the CPATPP includes a Code of Conduct for arbitrators. Before the CPATPP's entry into force, the Member States are to provide guidance on the application of the Code of Conduct for Dispute Settlement Proceedings under Chapter 28 (Dispute Settlement) of the CPATPP to arbitrators selected to serve on CPATPP tribunals. Arbitrators will be required to comply with such guidance in addition to the applicable arbitral rules regarding independence and impartiality.

Sixth, the Investment Chapter expressly provides that the burden of proving all elements of a claim submitted under the Investment Chapter lies with the investor, "consistent with general principles of international law applicable to international arbitration."

Seventh, the ISDS provisions contain a number of procedural options, several of which are modeled on the 2012 U.S. Model Bilateral Investment Treaty. These include:

- **Expedited procedure for jurisdictional objections.** If, within 45 days of the constitution of a tribunal under the CPATPP, the Respondent State requests that the tribunal decide a jurisdictional objection on an expedited basis, the tribunal shall suspend any proceedings on the merits and issue a decision or award on the objection(s) no later than 150 days after the date of such a request.

- **Transparency.** All hearings are to be open to the public and certain documents that have been submitted to a CPATPP tribunal (including pleadings, memorials, written submissions, and briefs) shall be made available to the public. A CPATPP tribunal's orders, awards, and decisions shall also be made available to the public.

- **Written comments.** At the request of a disputing party, a CPATPP tribunal must transmit its proposed decision or award to the disputing parties before issuing a decision or award on liability. The disputing parties will have 60 days to submit written comments to the tribunal concerning any aspect of the proposed decision or award. A CPATPP tribunal must consider any such comments and issue its decision or award no later than 45 days after the expiration of the 60-day period.

***Amicus curiae* submissions.** After consultation with the disputing parties, a CPATPP tribunal may accept and consider written *amicus curiae* submissions from any person or entity that has a significant interest in the proceedings.

President Trump has not made clear what he would consider to be a better deal for the United States than that reflected in the original TPP, or what his administration's position is on the newly-agreed CPATPP. Given that the CPATPP includes some of the same investment protections that the United States is reportedly trying to remove from a renegotiated NAFTA, and that the CPATPP Member States have successfully finalized their own deal without the United States, it is unclear whether the United States will agree to accept the CPATPP as is or attempt to open negotiations to revise it yet again. More importantly, it remains unknown how the Member States will respond to any such attempt.

Endnotes

1. *See* https://ustr.gov/about-us/policy-offices/press-office/press-releases/2017/january/US-Withdraws-From-TPP.
2. *See* http://www.businessinsider.com/trump-reverse-tpp-trade-decision-senators-say-2018-2.
3. *See* https://www.cnbc.com/2018/01/25/trump-says-he-would-reconsider-trans-pacific-partnership-trade-deal.html.
4. 2018 Trade Policy Agenda and 2017 Annual Report, Chapter I, Section 3.b., *available at* https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2018/2018-trade-policy-agenda-and-2017.
5. The text of the CPATPP can be found here: https://www.mfat.govt.nz/en/trade/free-trade-agreements/free-trade-agreements-concluded-but-not-in-force/cptpp/comprehensive-and-progressive-agreement-for-trans-pacific-partnership-text/.
6. Articles 30.4 (Accession), 30.5 (Entry into Force), 30.6 (Withdrawal) and 30.8 (Authentic Texts) are expressly excluded. CPATPP, Article 1.1.
7. CPATPP, Article 2 and Annex.
8. Chapter 9 of the TPPA, incorporated by reference into the CPATPP subject to the suspension of certain provisions (CPATPP, Articles 1.1, 2 and Annex).

Joaquin P. Terceño is with Freshfields Bruckhaus Deringer's in Tokyo, Japan. He can be reached at joaquin.terceno@freshfields.com.

Daniel Allen, also with Freshfields Bruckhaus Deringer's in Tokyo, Japan, can be reached at daniel.allen@freshfields.com.

International Section Staff Contacts

Section Committees/Executive Committee/All Events
Tiffany Bardwell, Section Services & Meetings Department
518/487-5675
tbardwell@nysba.org

CLE Department Sponsored Programs
Sally Bratten, Esq., CLE Program Attorney
518/487-5550
sbratten@nysba.org

Online Communities
Brandon Vogel, Social Media and Web Content Manager
518/487-5644
bvogel@nysba.org

New York International Law Review/International Law Practicum/New York International Chapter News
Simone Smith, Section Publications Coordinator
518/487-5671
ssmith@nysba.org

Canadian Issuers Focused on Legalized Marijuana, but Keep an Eye on the United States

By Gordon N. Cameron

In January 2018, one of Canada's largest public companies, with a market capitalization topping C$7 billion, was a company focused solely on producing, distributing and selling both medical and recreational marijuana. The legalization and regulation of marijuana in many different forms (medicinal, recreational, oils, and other applications) in Canada has changed rapidly since 2014 and with it so have the valuations of so-called "pot companies" in Canada. But with billion-dollar companies trading millions of shares daily up North, how will Canadian and U.S. investors and other market participants cope with a vastly different and complex marijuana regime down South?

Background: Canada

In 2001, medical marijuana was legalized in Canada. The possessing, producing and selling of cannabis had been illegal in Canada for generations. While local law enforcement often took a lax perspective on enforcement of personal possession in the years leading up to 2001, it was the case of *R. v. Parker*[1] that started a sea-change in the approach Canada took to marijuana regulation.

> *"In October 2015, Justin Trudeau, leader of the Liberal Party, was elected Prime Minister on a promise to legalize marijuana."*

The 2000 *Parker* case was the landmark decision that first invalidated the total prohibition of cannabis in Canada. Terry Parker was an epileptic who could only alleviate his suffering by recourse to cannabis. The court found that the blanket prohibition on cannabis under federal law was unconstitutional as it did not contain any exemption for medical use. However, striking down cannabis prohibitions was suspended for one year to allow the federal government (which regulates drugs and is responsible for criminal laws in Canada) to amend marijuana laws to make them constitutional.

In response, the government of Jean Chretien established rules in 2001 for eligible patients to get access to medical cannabis through the Medical Marijuana Access Program and even allowed patients to grow their own limited personal use supply. The system was problematic, for while patients could receive and grow small amounts of marijuana, ultimately, governments were not enjoying any tax revenues. Moreover, certain problems associated with medical cannabis use policies continued, such as keeping the drug industry illegal and unregulated. The system made for a monopolized market with high barriers to entry, which, it was argued, in turn led to increased violence, organized crime and the diversion of government resources toward prosecuting drug users (i.e. non-violent crimes).

Gordon N. Cameron

In 2014, the Medical Marijuana Access Program was replaced by the Marijuana for Medical Purposes Regulations (MMPR) by the Conservative Government of Stephen Harper. Under the MMPR, legal medical cannabis production is permitted by licensed producers whom Health Canada licenses and regulates. Health Canada maintains a public database of licensees and patients. Patients wishing to fulfill a medical cannabis prescription must register with, and order from, a licensed producer of their choice. To receive a prescription for medical cannabis, a patient must obtain a medical document from a health care practitioner and obtain an *Authorization to Possess* from Health Canada. Ordering via the internet and sealed delivery became a primary way of ordering and distributing licensed medical marijuana in Canada.

Initially, in 2014 a few dozen entities were granted a license under the MMPR. With a governmental seal of approval for medical marijuana companies, many entrepreneurs felt it was now time to test the market. In fact, the first marijuana company to go public in Canada received its MMPR license on January 27, 2014, and was listed on the TSX Venture Exchange four months later. The pot rush had begun.

In October 2015, Justin Trudeau, leader of the Liberal Party, was elected Prime Minister on a promise to legalize marijuana. Acting fast on his promise, he commissioned an extensive study on the legalization of marijuana and promised a joint federal-provincial approach to legalization. The final report was published November 30, 2016, and the Liberal Party tabled bill C-45, An Act Respecting Cannabis, which was put forward to Parliament on April

13, 2017, with the intent of legalizing recreational use of cannabis by July 1, 2018.

Currently, most provinces are preparing to adopt a model of marijuana sale and distribution based on the way alcohol is distributed, taxed and sold in many provinces in Canada. This is done primarily through government-run stores or through licensed providers on the internet, with the potential for some private business sellers to be licensed and permitted in the future. Marijuana sales will be prohibited to minors and will be taxed with the tax revenue split between the federal and provincial governments.

Background: The United States

The legalization of medical and recreational marijuana in the United States has taken a vastly different and more perilous route. At the federal level, the use and possession of cannabis remain illegal for any purpose as it has since 1970.[2] The medical use of cannabis, upon the recommendation of a doctor, is allowed in the majority of states under state law. Under federal law, the federal Justice Department is prohibited from prosecuting individuals who use cannabis in jurisdictions where there are comprehensive state medical use cannabis laws and usage is done in accordance with such laws. As of this writing, Cannabis use has been, at a state level, legalized in nine jurisdictions, most recently California. The commercial distribution of cannabis is allowed in all states where cannabis has been legalized. Prior to January 2018, the Cole Memorandum, drafted under the Obama Administration, provided some protection to individuals possessing or using recreational cannabis against the enforcement of federal law in states that had legalized it.[3] However, the Cole Memo was rescinded in early 2018 by the Trump Administration.

> *"In Canada, with the rapid movement toward legalization, the CSA, and the stock exchanges have been able to keep pace with the changing landscape."*

While marijuana stores are now commonplace in states like Colorado and California, such businesses face a number of challenges when it comes to regulatory and legal compliance, banking, distribution, employment and other areas vital to the survival and growth of any business. Online distribution (especially across state lines) is fraught with both fraud and legal risk. This has meant U.S. businesses have had a difficult time scaling up and hampered the development of large companies that can take market share.

Meanwhile, Up North…

Legal compliance, banking, distribution, employment and online distribution for marijuana companies are hardly an issue in Canada, as many of these issues are resolved or in the process of being resolved based on the legalization regime. The walls are down, and the floodgates have opened Canadian businesses to a rush of two types of "green." Presumably, after July 1, 2018, marijuana business in Canada will face few substantive legal challenges and, as long as they comply with the new federal/provincial legalized cannabis regulatory regime, they will be able to sell their product much like a manufacturer or distributor of alcohol or over-the-counter pharmaceuticals anywhere in Canada. While there are certainly going to be growing pains in this new business environment, it is apparent that companies can quickly scale up and are prepared to enter into new markets both domestically (new products such as cannabis-infused drinks and make-up) and internationally by expanding into (and entering into supplier agreements with) other countries where cannabis is legal, quasi-legal or compliance is minimal. But not the United States.

Issues for Canadian Public Companies With U.S. Marijuana-Related Activities

It is increasingly clear that Canadian public companies and investors on both sides of the border will continue to have problematic access to a broader legal and substantive business market for marijuana companies in the United States. In October 2016, the Canadian Securities Administrators (CSA), an organization of all provincial securities commissions/regulators, issued specific guidance to Canadian public companies relating to their U.S. marijuana-related activities.[3] In Canada, with the rapid movement toward legalization, the CSA, and the stock exchanges have been able to keep pace with the changing landscape. A landscape that, in a matter of three years, saw newly licensed medical marijuana companies listed on the junior TSX Venture exchange, to a point in 2018 where the TSX has numerous large marijuana companies with clear plans for exploiting and penetrating the newly legalized market in Canada. With the date for legalization set (July 1, 2018) many Canadian listed companies are actively planning for the new era. However, for such companies that also had marijuana-related activities or operations in the United States, the landscape, with regard to legalization, has become problematic.

The CSA took notice that U.S. federal guidance (the Cole Memo) was subject to change, rescission or alteration by the Trump Administration at any time and they decided to get out ahead of it. The CSA recognized that Canadian listed companies with business dealings or operations in the United States may find themselves conducting an il-

legal activity (in the U.S.) and that would create a *material risk* for investors in such companies. In Canada, securities regimes are primarily disclosure-based, with requirements for timely and accurate disclosure of information.

It is the view of the CSA, and an important principle for all Canadian public companies, that an issuer's disclosure fairly presents all material facts and risks so that investors can make informed investment decisions. On October 16, 2017, the CSA issued Staff Notice 51-352 with the specific purpose of highlighting disclosure expectations for issuers that currently have, or are in the process of developing, marijuana-related activities in the United States where such activity has been authorized within a state regulatory framework (such issuers are called "U.S. Marijuana Issuers"). The CSA noted their disclosure-based approach is premised on the assumption that marijuana-related activities are "conducted in compliance with the current laws and regulations of a U.S. state where such activities are legal, and the understanding that a U.S. federal government forbearance approach to the enforcement of federal laws remains in place."

The CSA outlined general disclose standards for all issuers with U.S. marijuana-related activities, including the obligation to: describe the nature of the issuer's involvement in the U.S. marijuana industry, explain that marijuana remains illegal under federal U.S. law, describe how the issuer activities are conducted in a manner consistent with U.S. federal enforcement, and mandate discussion of an issuer's ability to access public and private capital in order to support continued operations.

The Notice then went on to describe more specific disclosure requirements for three categories of issuers:

- U.S. marijuana issuers with direct involvement in cultivation or distribution (by an issuer, or a subsidiary controlled by the issuer)
- U.S. marijuana issuers with indirect involvement in cultivation or distribution (where an issuer has a non-controlling investment in an entity involved in the U.S. marijuana industry); and
- U.S. marijuana issuers with ancillary involvement (where goods or services are provided to the U.S. marijuana industry).

The notice indicated that Canadian stock exchanges will apply their own listing requirements with regard to U.S. marijuana-related activities and that the CSA would continue to reexamine their views in the event the U.S. federal government changed its approach. The Toronto Stock Exchange (TSX) released a notice on the same day as the CSA, reminding issuers that all listed issuers, pursuant to TSX rules, must take care to ensure the business of listed issuers is conducted with integrity and in the best interests of shareholder and market participants.[4] The TSX (which includes the TSX Venture Exchange) specified that issuers with U.S. marijuana business activities that violate U.S. federal law are *not* in compliance with TSX listing requirements. It is interesting to note, however, that not all Canadian exchanges took the same approach. The Canadian Securities Exchange has been more permissive on this issue, and thus became a repository for a number of so-called U.S. marijuana issuers in Canada. On January 12, 2018, the CSA announced (in light of the Cole Memo recession) that it would consider whether the disclosure-based approach discussed above remains appropriate.[5]

The Future

While public markets, and those who regulate them, have had to cope with changes and new developments at break-neck speeds in the past (for example, the ".com boom" of the early 2000s) it is difficult to recall a situation since the end of Prohibition in the 1930s where the rapid legalization of a previously illegal activity in one jurisdiction has created such a conflict of laws and divergent approaches to a booming business activity. Exasperating the issue, much like it did during the era of Prohibition, is an 8,891 km border, not to mention the over $600 billion of annual trade and millions of daily trades of inter-listed companies between two countries. While it is likely that many countries will follow the path of Canada (and the Canadian public markets) with regard to the legalization and regulation of medical and recreational marijuana, it seems that it is two steps forward and one step back in the United States. Perhaps it is fitting that on the same day in January 2018 that it was reported that the U.S. Treasury Department was reviewing its Obama era regulations allowing banks to serve marijuana businesses in the United States, the Bank of Montreal (Canada's oldest bank) announced it was a lead underwriter on a financing for the largest public marijuana company in Canada.

Endnotes

1. *R v. Parker* (2000), 49 O.R.(3d) 481 (Ontario Court of Appeal).
2. *Comprehensive Drug Abuse Prevention and Control Act of 1970*, Pub. L. No. 91-513, 84 Stat. 1236 (Oct. 27, 1970).
3. *United States Department of Justice* memorandum August 29, 2013 by United States Deputy Attorney General James M. Cole.
4. TSX Staff Notice 2017-0009, October 16, 2017.
5. CSA Press Release issued January 12, 2018.

Gordon Cameron is a principal in the New York office of Stikeman Elliott LLP.

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Why Blackrock's 2018 CEO Letter Matters to Your Company

By Azish Filabi, Theano Manolopoulou and Julee Milham

Titled *A Sense of Purpose,*[1] the annual letter by the chief executive at Blackrock, the world's biggest investor, to chief executives at S&P 500 companies and large European corporations took media by storm. The letter encourages CEOs to create a clear long-term strategy that articulates not only a path to financial performance but also a positive contribution to society. As co-chairs of the NYSBA International Section's Committee on Social Finance and Enterprise (formerly the Committee on International Microfinance and Financial Inclusion), we reviewed the letter with great interest, as these priorities impact the work of our committee members.

Azish Filabi

Theano Manolopoulou

Julee Milham

All companies, public and private, should heed Larry Fink's advice for the following reasons.

1. A New Model for Corporate Governance

BlackRock recognizes that most of the public has a long-term investing perspective, often saving for retirement or a rainy day. Most companies, however, manage their business with short-term interests in mind despite the interests of their owners and shareholders. This emphasis on the short-term, as Fink says in his letter, "sacrifice[s] investments in employee development, innovation, and capital expenditures that are necessary for long-term growth." This skewed dynamic has become even more pronounced given the shift towards greater use of index funds. As a fiduciary to the long-term investing public, BlackRock believes that the responsibility of asset managers "to engage and vote is more important than ever […]. This responsibility goes beyond casting proxy votes at annual meetings–it means investing the time and resources necessary to foster long-term value." Public companies should consider disclosing to their investors their strategy to drive sustainable, long-term growth.

2. Engaging with Shareholders

The letter calls for a new model of shareholder engagement, under which companies will engage in a year-long discussion with their shareholders on how to create long-term value. Companies are encouraged to submit to their shareholders a strategic framework for long-term value creation.

This emphasis on long-term value creation is consistent with academic research that shows that more ethical companies have better financial performance in the long run. Profits aside, Fink makes an even stronger point–it's the right thing to do. "The time has come for a new model of shareholder engagement—one that strengthens and deepens communication between shareholders and the companies that they own."

3. The Role of the Board

In Fink's appeal, the role of the board is vital in promoting this change. Directors should be able to demonstrate to the investors that they understand and buy into their company's strategic growth plan. The board should be able to explain to shareholders how major legislative or regulatory changes will impact a company's balance sheet as well as long-term growth. Public companies should, therefore, explore ways to demonstrate their directors' overall engagement on these issues.

4. Promoting Diversity in the Boardroom

In line with previous letters to CEOs, Fink's letter emphasizes the importance of a diverse board. In his words, diverse boards "are less likely to succumb to groupthink or miss new threats to a company's business model," and "are better able to identify opportunities to promote long-term growth." Public companies should, therefore, increase efforts to foster diversity in their boardroom.

5. Environmental, Social, and Governance (ESG) Issues

Fink deems this heterogeneous board vital not only to conveying and carrying out a company's business mission but to answering those queries that reflect values of its participants. Company investors, consumers, and local communities have an increasing interest in how a company affects and addresses larger collective concerns; they want to know what businesses are doing to practice principled management and improve environmental, social, and broader governance conditions. Companies should explore new ways to make these goals a component of their investment practices.

Judith Samuelson of the Aspen Institute, an international nonprofit and nonpartisan think tank, warns against a misinterpretation of Fink's missive as a call to "new social initiatives," as described by *New York Times* writer Andrew Ross Sorkin.[2] Rather, Fink calls for fundamental and foundational change from the ground up in the operation and decision-making of companies, a change that acknowledges people's morphing expectations as well as the unintended ripple effects on stakeholders. Samuelson proposes businesses ask themselves three clarifying questions: What is our goal and purpose as a company? Where are we most vulnerable? and Are we a good neighbor? She exhorts companies to "conduct their business as though they, themselves, are on the other end of the pipe, live on the other side of the wall, are the counterparty in the contract."[3]

Traditionally, factoring such broader concerns into company practice could lead that company to be accused of (and punished for) a failure to maximize shareholder profit. Recent years have brought the advent of benefit corporations which expressly permit companies by statute to consider the interests of other stakeholders. Fink's clarion call both reflects and supports a new definition of basic corporate responsibility.

About the Committee on Social Finance and Enterprise

Our Committee was launched under the name Committee on International Microfinance and Financial Inclusion in 2012 with a goal to support the expansion of microfinance and other methods of financial inclusion via both commercial and non-profit sectors. Since then, our work has expanded significantly, exploring areas such as virtual currencies, benefit corporations, and UNCITRAL's focus on simplified legal entities and small and medium enterprise development. Initially, our work was focused on microfinance, particularly as it related to consumer protection issues. Over time, it expanded to track the industry, as institutional investors, notably North American and European development finance institutions, pension funds and endowments played a leading role in the development of impact investing, with an initial focus on private equity, venture capital, and green infrastructure. As a result, we are re-branding the Committee with a new name: **Committee on Social Finance and Enterprise (SoFie)**. We had several discussions with some of our members, and much discussion among the co-chairs to find what we think captures the depth and breadth of our work and interests. The new title has been approved by the Executive Committee, and a corresponding mission statement will be posted on the NYSBA International Section website soon.

Endnotes

1. The full text of the letter is available on BlackRock's website: https://www.blackrock.com/corporate/en-us/investor-relations/larry-fink-ceo-letter.
2. See Andrew R. Skorkin, BlackRock's Message: Contribute to Society, or Risk Losing Our Support, New York Times 2018, *available* at: https://www.nytimes.com/2018/01/15/business/dealbook/blackrock-laurence-fink-letter.html.
3. See Judith Samuelson, Larry Fink's letter to CEOs is about more than "social initiatives," Quartz at Work 2018, *available* at: https://work.qz.com/1182544/larry-finks-letter-to-ceos-is-about-more-than-social-initiatives/?utm_source=THE+B+TEAM+COMMUNITY&utm_campaign=740cc92212-EMAIL_CAMPAIGN_2018_01_31&utm_medium=email&utm_term=0_95125a86a3-740cc92212-118326741.

Azish Filabi is Executive Director of Ethical Systems. Through research and collaboration with the best academics in the field, she dedicates her time to helping businesses measure and promote ethical behavior and culture in their organizations. She is also an Adjunct Professor at the NYU Stern School of Business. She writes and frequently speaks on business ethics and compliance. Previously, she was as an Assistant VP, Ethics Officer, and lawyer at the Federal Reserve Bank of NY. She was also an Associate at the NYC-based law firm Curtis, Mallet-Prevost, Colt & Mosle, LLP. She is active in the NY State Bar Association as an Officer in the International Section and co-founded the Committee on Social Finance and Enterprise.

Theano Manolopoulou practices law with Bracewell LLP in Houston, where she advises clients on cross-border structured and corporate finance transactions with a focus on the energy industry. She is admitted to practice in New York, Texas and Athens (Greece) and registered as a European lawyer with the Solicitors Regulatory Authority in England and Wales. Prior to joining Bracewell, Theano gained experience practicing law with another AmLaw100 law firm in New York, London, and Houston. She dedicates time to pro bono legal advocacy work and thought leadership in the social finance and impact investing space. She has been very active with the International Section of the New York State Bar Association for several years, where she serves as a member of the Executive Committee and a co-chair of the Committee on Social Finance and Enterprise.

Julee Milham is a sole practitioner in St. Pete Beach, Florida, where she practices business, intellectual property, and entertainment law, working with individual, small enterprise, and corporate clients. She is AV-rated by Martindale Hubbell and board certified in Intellectual Property Law. She is an appointed member of the Florida Bar's Intellectual Property Certification Committee and Chair Emeritus of its Entertainment, Arts, and Sports Law Section. She is admitted to the Roll of Solicitors for England and Wales (non-practicing) as well as a number of state and federal bars. Julee co-founded and co-chairs NYSBA's Committee on Social Finance and Enterprise.

Orphan Drug Approval Route Under Ecuadorian Legislation

By David A. Maldonado

Orphan drugs are pharmaceutical agents that have been developed specifically for the diagnosis, prevention, and treatment of rare conditions and diseases, sometimes life-threatening (also referred to as Orphan Diseases).[1]

Orphan Diseases represent socio-health problems that are detected in a small number of people and require orphan drugs as part of their treatment.[2] A rare or orphan disease is defined as a disease with a low occurrence rate in the population. The rate is so minimal that often there are no treatments for the disease in hand and, most of the time, the disease is extremely difficult to diagnose because of its low occurrence and the reduced research that is done by practicing physicians.[3] In Europe, for example, an orphan or rare disease is classified as one that affects 1 in every 2,000 citizens.[4]

Thus, the role of orphan drugs in the pharmaceutical industry is very peculiar, given that there is little interest in researching and developing orphan drugs because there is a limited market for them. This means that the cost of developing them is unlikely to be offset by their eventual sale to the public.[5] Consequently, the development of an orphan drug can be a financial risk that a pharmaceutical company is not willing to take.[6] Hence, it is important for legislatures to create some incentive that will stimulate pharmaceuticals to develop orphan drugs.

Many countries, including the United States, Japan and members of the European Union, have created incentives such as accelerated approval pathways, or priority review designations, market exclusivity or even tax breaks, which all contribute to easier and faster approvals in comparison to more common drugs.[7] These incentives have encouraged the development of orphan drugs, as developing orphan drugs becomes less expensive and the market return more prosperous.

For these countries, having a less complicated and accelerated approval route is a matter of public policy in the sense that medical advances are being generated by offsetting the high cost of research and development.[8] For example, given that orphan drugs are for rare diseases, countries have eased the requirement for clinical trials. This means that at a clinical trial in phase III, where a common drug is required to be tested on 1000 patients, for an orphan drug the requirement would be a test on 100 patients. Also considering that it is improbable to find 1000 patients with a rare disease the easing of requirements allows for the reduction of cost and accelerated approval process.

Thanks to more flexible approval routes the public gets the benefit of the development of cures for rare diseases, as well as access to these cures.[9] Orphan drugs can be placed in the market faster and at a lower cost thanks to incentives such as the aforementioned.[10]

David A. Maldonado

Currently, there are groups consisting of pharmaceuticals, doctors, and lawyers who oppose the approval of orphan drugs by a fast and flexible route. Their position states that clinical trials are not complete, usually due to the lack of patients available for testing, and thus these medicines carry a high risk when placed on the market, due to their complexity.[11] They further argue that fast-track approval could lead to repercussions in terms of quality, efficacy, and safety.[12]

Close Attention must be paid to such groups as they may be owners and vendors of competing orphan drugs themselves. Hence, their opposition to a fast track approval route in orphan drugs may be motivated by a desire to stay on the market with little or minimal competition, thereby allowing them to continue to generate high sales but providing patients with little or no options.

Currently, Ecuador's legislation does not have specific regulations for the approval of orphan drugs. The only path available for approval is that of general and common drugs.[13] This means that there is no differentiation within Ecuador's laws between orphan drugs and common drugs, and therefore there is no fast track approval route.[14] Ecuador's current laws do not take into account the urgency of placing orphan drugs in the market for the treatment of rare and serious diseases among Ecuadorians.

However, there is a practical solution within Ecuadorian legislation that may serve as a fast track for approval for orphan drugs. This route is called Homologation.

Article 30 of the Regulations Code for purposes of obtaining Sanitary Registration, Control and Surveillance of Biological Medicines for Human Use and Consumption (Regulations for the Registration of Biological Drug), was issued by Ministerial Agreement No. 3344 on May 17, 2013. It was published in the Official Gazette No. 21 on June 24, 2013, regarding the granting of Sanitary Registrations via Homologation. It provides the following:

> The National Health Authority, through the [National Agency for Health Regulation, Control, and Surveillance] (ARCSA), or whoever exercises its powers, shall grant the Certificate of Health Registration for imported biological medicinal products for human use and consumption through Homologation…[15]

Article 31 continues:

> For purposes of Health Registry of these drugs, approval shall mean the official recognition of Sanitary Registration issued by Health Authorities of the countries whose drug regulatory agencies have been qualified by the Pan American Health Organization (PAHO) / World Health Organization (WHO) Authorities Regional Reference, as well as those Sanitary Registrations issued by Health Authorities in the United States, Canada, Australia, Japan, for the centralized registration of the European Medicines Agency (EMA) process and the Ministry of Food and Drug Safety of the Republic of Korea.
>
> Approval shall also include the official recognition of Sanitary Registrations issued by countries whose biological drugs, exclusively vaccines, have been prequalified by the Pan American Health Organization (PAHO) / World Health Organization (WHO).[16]

As stated in Article 32:

> Health Registration approvals will be granted to all biological medicines for human use and consumption, which have been registered by the countries mentioned in the previous article, provided they have specific regulations for this effect.[17]

This means that Ecuador accepts and acknowledges the approval of drugs in the countries and organizations mentioned in Article 31, including the World Health Organization (WHO), United States, Japan, and South Korea through its Ministry of Food and Drug Safety, etc., without placing any condition that they should be approved via the traditional route or flexible route. In this sense, it can be interpreted that if the United States or the Republic of Korea have approved an orphan drug, then according to Ecuadorian law, it can be approved in Ecuador via homologation, and as such, orphan drugs can benefit from the incentives created in other countries.

In addition, the rule, correctly, also requires a post-registration control in Article 34 (10), which provides the following:

> Once the Certificate of Sanitary Registration of biological medicines for human use and consumption has been issued through Homologation, the dossier with all the documentation will be sent automatically to the unit responsible for carrying out the post-registration control of medicines, so that it is included within its planning for this effect.[18]

Thus, it is clear that the risk of a drug, whether orphan or traditional, in the Ecuadorian market could be reduced in a timely manner by requiring adequate drug control.

If this is not the case, judges should draft opinions and clarify the approval or non-approval of orphan drugs via the existing Homologation Regulation. Their intervention would solidify or clarify this incentive in order for international pharmacists and laboratories to introduce orphan medicinal products for rare diseases in the Ecuadorian market and allow Ecuadorians access to them.

If judges agree that homologation is not the right way, then legislators should take into consideration the importance of creating a regulation that would make it easier to introduce orphan drugs into the country. New legislation could serve as an incentive for laboratories to develop these drugs, without being forced to deal with the economic weight, thereby contributing to fair and democratic access to health for all Ecuadorians, regardless of the disease they face.

David A. Maldonado,
Partner at Maldonado Leon Abogados,
Quito, Ecuador.

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The Past, Present and Possible Future of the Spanish Renewable Energy Arbitration Saga

By Clifford J. Hendel and María Antonia Pérez

Introduction

It is not easy to write about, and even harder to make predictions as to future developments involving, a topic that is a moving target. This is especially true where the movement is in fits and starts, with occasional lengthy periods of stability or inactivity followed by bursts of frenetic and often unanticipated developments.

The Spanish renewable energy arbitration saga (currently involving nearly 40 investment treaty arbitrations against the country claiming some U.S. $9 billion in total) is such a moving target: a fascinating, complicated and ever-evolving situation bringing into focus a number of important and timely issues of policy and threads of public discourse.

As such, the topic is difficult to write about, especially in traditional print form where the time lag between preparing a piece and its actual publication can be significant. And this all the more in an area in which recent weeks and months have been particularly active and the coming weeks and months will surely be even more so. With the caveat, then, that this article speaks only as of May 25, 2018, the following serves as an introduction to the three-dimensional chess game that this series of claims has become.

We start with the relevant background, then summarize the final awards that have been issued to date, and finally turn to some potentially game-changing issues that have arisen which might restrict or prevent enforcement of the awards already rendered and/or limit or preclude further awards in favor of investors.

Background

Until three or four years ago, the Energy Charter Treaty (ECT)—a multilateral treaty for the protection of foreign investment and the promotion of international trade and competition in the energy sector—and arbitration based on it as well as similar multilateral or bilateral investment treaties, were virtually unknown in Spain.

Investment arbitration itself was a rarefied specialty, known only to a handful of intrepid companies and a small cadre of advisors. The few Spanish practitioners who had any exposure typically involved claims brought by Spanish entities against recalcitrant states such as Venezuela and Argentina. For so long as ECT and other

Clifford J. Hendel **María Antonia Pérez**

investment arbitration against Spain was limited to one or two exceptional cases, the Spanish press paid little or no attention to the issue, and the Spanish public remained blithely ignorant. To that point, the recently raging debate over the pros and cons of the arbitration-based investor-state dispute resolution system (ISDS) drew little attention in Spain.

All of this has changed due to Spain's regulation, and then re-regulation, of the renewable energy sector.

In the past two decades, Spain adopted a clear and concerted policy favorable to the development of renewable energies of all types. The lynchpin of the then-government's Renewable Energy Plan 2005-2010 was a series of incentives for long-term investment, which included a generous guaranteed feed-in tariff. The policy worked: investment in Spanish renewable energies grew spectacularly, and Spain as a country, along with a number of Spanish companies, became leaders in the field.

The policy, it seems, may have worked too well. The amount of investment attracted was excessive. Long-term maintenance of the feed-in tariff and the generous remuneration system turned out to be a practical impossibility causing government officials to conclude, after the financial crisis of 2008 hit, that the country could not afford to maintain the remuneration system in place. For a variety of reasons, a gaping "tariff deficit" had opened, with revenues generated by electricity sales being vastly outweighed by the associated costs. As a result, starting in 2010, Spanish governments changed course and implemented a bevy of legal and regulatory measures, limiting

payments to renewable investors and investments in an effort to reduce and (finally) eliminate the tariff deficit.

An essential and highly controversial aspect of the reforms was the implementation of a new remuneration scheme for electricity generation, based on assuring "reasonable profitability" (linked to the yield of Spanish government bonds) for renewable plants.

Countless challenges to these measures have been filed in the Spanish courts by domestic investors. But the Spanish Supreme Court's jurisprudence in the area seems to cast a cloak of immunity on the State in its regulatory activity, essentially concluding that sophisticated investors should be aware of the inherent regulatory risk involved in their investments. In so doing, the court has shut the door on their claims, so long as a reasonable return was provided and subsidies or benefits already granted were not required to be returned.

The recourse of foreign investors, though, is not limited to the Spanish courts; they are entitled to arbitrate under the ISDS system. So, what began as a trickle in late 2011 with a still-pending ECT claim brought under the UNCITRAL rules by a series of international investors in the Spanish photovoltaic sector has now become a barrage involving the whole range of renewable energies. At last report, nearly 40 ECT cases have been brought against Spain, the vast majority under ICSID, with a handful being administered by the Stockholm Chamber of Commerce (SCC), in addition to the initial UNCITRAL claim (the ECT contemplates these three alternatives).

Awards Issued to Date

International arbitrations take time, and investment arbitrations—frequently bifurcating jurisdictional issues and/or permitting the appearance of public or public interest entities as amici curiae—tend to take longer than commercial cases. As of this writing, only five of the nearly 40 cases have reached a final award.

This trickle will soon become a torrent. A handful of the older cases are on the verge of an award. Reportedly, two or three merits hearings are currently being held each month, so a significant and growing number of cases are nearly ready for judgment. Moreover, there have been recent developments at the European level which cast a large cloud on the future of the saga. So now is a good time to take stock of the state of play.

Final awards have been issued and are in the public domain in the following five cases: *Charanne* (SCC, January 2016); *Isolux* (SCC, July 2016); *Eiser* (ICSID, May 2017); *NovEnergía* (SCC, February 2018) and *Masdar* (ICSID, May 2018).

In all five cases, and surely in those remaining to be decided, the key issue on the merits involves the meaning and application under the ECT of the concept of "fair and equitable treatment" (FET), and its constituent element: "legitimate expectations." Both *Charanne* and *Isolux* (each by majority decision over a forceful dissent) rejected the investors' claims, the former arising from relatively limited reforms implemented in 2010 and the latter from the more significant changes implemented between 2012 and 2014. *Eiser, NovEnergía* and *Masdar,* on the other hand, found forcefully (and unanimously) for the investors challenging the 2012-2014 reforms.

A close review of the voluminous awards in these five cases suggests that they may not be as irreconcilable as certain Spanish press headlines (especially those just following the issuance of the third and fourth awards) have suggested. Rather, they can be understood to apply a similar (or, at least, substantially similar) conceptual framework to very different investors and investments, or at least to investors and investments that were viewed quite differently by the respective tribunals.

Thus, what may have appeared, on first impression, as fundamentally irreconcilable may, with the passage of time and the accumulation of further awards, be revealed as quite the opposite: comprehensible and predictable.

Charanne

The investors in Charanne acquired control of the owner of 34 photovoltaic (PV) plants in Spain in 2009. The regulatory changes enacted in 2010 eliminated regulated tariffs for such plants after 30 years of operation, limited operating hours and hours entitled to retribution in the period 2011-2013 and made other changes reducing plant profitability. The investors alleged that the changes reduced the profitability of their plants by some 10 percent.

The SCC Tribunal concluded that, although the economic and financial consequences of the reduction in profitability were significant, they did not justify a conclusion that the value of the investment had been destroyed so as to constitute indirect expropriation. The Tribunal (by majority) further concluded that the commitments of regulatory stability contained in the underlying 2007 legislation were not sufficiently targeted or specific to substantiate legitimate expectations that its provisions would not be modified.

Isolux[1]

Isolux involved a challenge to the 2012-2014 changes by claimants who made their investment decision and indirect investment in 117 entities (thus stepping into

the latter's' shoes), each owning a PV plant in Spain. According to the award, in prior litigation the investor's parent company had submitted an expert report to the Spanish Supreme Court indicating an expected rate of return of some 6 percent on its investment, less than the "reasonable" rate of some 7 percent provided by the new regulation.

The SCC Tribunal concluded that the claimant could not have had a legitimate expectation at the time of its investment.[2] Moreover, that the regulatory framework would not materially, or even fundamentally, change, since (i) in the years prior to the investment, the regulatory framework had already been modified on various occasions, (ii) the Spanish Supreme Court had established clearly that, insofar as national law was concerned there were no obstacles to the modification of the regulatory regime, with a reasonable investor presumed to have knowledge of this situation; and (iii) the claimant was perfectly aware of the referenced Spanish case law.

This last element was of particular importance because the claimant's ultimate parent company had unsuccessfully challenged one of the 2010 measures before the Spanish courts. The challenge resulted in a September 2012 decision of the Supreme Court[3] which concluded that the regulatory changes were permitted so long as they respected a reasonable rate of return. The Court noted that "A party who decides to invest in a country which, according to it, lacks legal certainty, cannot later complain that it was not provided such certainty." The majority also echoed the *Charanne* finding that the legislative commitments were insufficiently targeted and specific to form the basis for legitimate expectations of essential stability.

Eiser

Eiser involved a challenge by UK and Luxembourg-based claimants who made their investment decision and investment in a series of concentrated solar power plants (CSP) in Spain in 2007. The claimants alleged that the regulatory changes from 2012-2014 constituted "a complete value destruction" of their investment because some Euro 125 million was reduced in value to a mere Euro 4 million, thereby (as indeed found by the Tribunal) "stripping claimants of virtually all of the value of their investment."

The ICSID Tribunal noted that the changes to the PV regulatory regime at issue were far more "dramatic," "sweeping" and "drastic" in terms of their impact on the economic value of the claimants' assets and interests than those at issue in *Charanne*, and created a "totally different" and "unprecedented" regulatory regime. The Tribunal concurred with the claimant that the consequence of the "total and unreasonable" change in the regulatory regime was the virtual destruction of their investment.

NovEnergía

In *NovEnergía*, a SCC panel found in favor of a Luxembourg investor in several Spanish PV plants. As in *Eiser*, the Tribunal distinguished *Charanne* as having only addressed the more limited regulatory changes of 2010 and *Isolux* as involving an investment made at a much later stage (2012) when a reasonable investor would not have legitimately maintained an expectation of regulatory stability.

Departing, to some extent, from *Charanne* and its rather strict requirement that legitimate expectations be based on specific, focused assurances or undertakings, the *NovEnergía* Tribunal indicated that legitimate expectations "arise naturally from undertakings and assurances given by the state, whether or not specifically targeted to the investor or included in contractual stabilization clauses."

Departing, to some extent, from *Eiser*, the *NovEnergía* Tribunal further indicated that the FET standard protected against more than changes that actually destroyed the investment or deprived the investor of the investment's value. Instead, a "balancing exercise" was required, in which destruction of value is only one factor, i.e., the fact that a "healthy profit" was still being made after the "radical, drastic and unexpected" changes was not a bar to the claim where the investor's legitimate expectation and reliance had been that no such change would be implemented, and where the change caused "quantifiable prejudice" to the investor.

Masdar

Finally, in *Masdar*, an ICSID panel found in favor of a UAE-owned Dutch investor with a 40 percent stake in a number of Spanish CSP plants, holding that the recent regulatory changes (those at issue in the *Eiser* and *NovEnergía* cases) violated the ECT's fair and equitable treatment standard. The panel awarded damages of Euro 64.5 million.

Beyond confirming the apparent trend commenced in *Eiser* and *NovEnergía* towards unanimous findings in favor of investors challenging the 2013-2014 regulations as FET violations, the award is of interest for three reasons. First, in its emphatic finding that the maintenance of the 2007 remuneration regime for the plants in question had been the subject of specific assurances amply sufficient to create legally protected legitimate expectations

under the ECT. It noted, "It would be difficult to conceive a more specific commitment than a Resolution issued by Spain addressed specifically to each of the Operating Companies, confirming that each of the Plants qualified under the RD661/2007 economic regime for their cooperation lifetime" and observed that there was "not any indication at the time when Claimant was making its investment that there was the slightest possibility that the RD661/2007 regime…would be swept away by the Disputed Measures, or that any reasonable investor might foresee that they might be." Second, for the split between the majority and dissent as to whether discounted cash flow (DCF) or an asset-based valuation (ABV) is the more appropriate method to assess the fair market value of the investments in question for purposes of assessing damages. And third, and perhaps most importantly, for its summary dismissal (and perhaps, rather restrictive or literal application) of the *Achmea* decision discussed below, stating that *Achmea* "had no bearing upon the present case" since it "cannot be applied to multilateral treaties, such as the ECT, to which the EU itself is a party."

Jurisdictional Objections

In each of the cases discussed, Spain, generally, with the European Commission's participation as amicus curiae, raised a series of jurisdictional objections which (as in certain parallel Italian cases) were uniformly, and rather summarily, dismissed. Were it not for the recent developments discussed below, they would require only a passing reference (if that) in this article.

Specifically, in *NovEnergía*, Spain argued first that the Tribunal lacked jurisdiction under the ECT since NovEnergía was not "an investor of another Contracting Party." That is, because both Spain and claimant's home state, Luxembourg, were EU member states, and because the EU was itself a party to the ECT, the dispute was essentially one within a single ECT contracting party, the EU, and not between one contracting party and an investor of another contracting party.

This objection was rejected. The Tribunal refused to read into the ECT the jurisdictional limitations suggested by Spain. As long as the investor hailed from another contracting state, ECT's jurisdictional requirements were satisfied.

Spain also contended (in an argument first developed by the European Commission) that the ECT contained an "implicit disconnection clause," according to which the ECT would not apply between EU member states, but only with respect to third states. However, the Tribunal saw no basis for such an implicit clause in the "clear" terms of the ECT.

The Tribunal also rejected a set of further arguments based on EU law. According to Spain, for instance, EU law prevailed over and displaced any other law (including the ECT) due to a "principle of primacy" in intra-EU legal relations, which thus barred the Tribunal from upholding jurisdiction over investor's claims. Spain also asserted that the Tribunal was barred from addressing questions of EU law, as EU courts have exclusive jurisdiction over such questions. These objections were also readily dismissed. The Tribunal concluded that the claim was based on the ECT and not on EU law, that the ECT gives the Tribunal exclusive jurisdiction, and that there is no conflict between ECT investor protections and EU law, which would require a ruling by the CJEU.

Europe Comes to Spain's Defense

On the (sole) basis of the first four final awards discussed above, Spain's position appeared rather bleak. As mentioned, it had prevailed (by majority) only in cases challenging early, less drastic regulatory changes (*Charanne*) or involving investments made when the handwriting of impending change was clearly on the wall (*Isolux*) and the negative consequences to the investment were limited. On the other hand, it had lost (unanimously) in the two cases challenging the more radical changes, which were the subject of the vast majority of the pending cases, one where the changes had produced devastating consequences on the investment (*Eiser*), the other where the impact of the changes was much less drastic, allowing the investor a healthy profit (*NovEnergía*).

Speculation in the market was that Spain would be likely to lose the large majority of the pending cases, the facts and circumstances of which were understood to echo more closely *NovEnergía* and *Eiser* than *Charanne* and *Isolux*. Rumors of the possibility of settling the claims (pending the results of annulment proceedings, ongoing in the case of *Eiser* and anticipated in the case of *NovEnergía*) began to circulate. And this notwithstanding the delicate political problem that might arise from settling an ECT claim with an international (non-Spanish) investor when a Spanish investor, without recourse to ISDS, has (under established Spanish case law) no effective recourse against the same measures. (The more recent *Masdar* case highlights this last point: there, the foreign investor with access to the ECT procured an award protecting its 40 percent investment, whereas its Spanish joint venture partner has no effective recourse for its 60 percent investment.)

But, with the help of the EU (the Commission and Court of Justice of the European Union (CJEU), respectively), Spain has recently received two lifelines that could be game-changers. The effect is to put into possible

doubt the ability of the investors in *Eiser* and *NovEnergía* to enforce their awards (assuming the annulment actions are rejected) and potentially even tilt the scales towards Spain in the still-pending cases and any yet to be filed.

State Aid

The first European lifeline thrown to Spain is one based on concepts of unlawful state aid. This line of thought is predicated on the Commission's efforts currently on appeal to the CJEU to defeat enforcement of an ICSID award under an intra-EU BIT in the *Micula* case on the ground that paying the award would violate EU law as constituting new, un-notified and thus illegal state aid in violation of EU law.

Based on its *Micula* strategy, the Commission in a controversial decision (Decision 2017/C442) issued in November 2017 found that the 2012-2014 reforms were compatible with EU law, and specifically referring to the *Eiser* decision issued some months prior, essentially prohibited Spain from paying compensation under the award on the grounds that this (unless approved by the Commission) would constitute new un-notified and thus illegal state aid.

The decision repeated the Commission's position that intra-EU investor-state arbitration is contrary to EU law. Thus the ECT is inapplicable to investors from EU member states with disputes against other member states and observed that the decision itself is part of EU law and therefore binding on arbitral tribunals applying EU law. In this scenario its validity can only be challenged before European courts.

The decision went even further, concluding as a matter of substance that there was and could be no FET violation in *Eiser* or any other case alleging legitimate expectations based on the 2007 Spanish remuneration regime since that regime involved un-notified, and thus illegal, state aid and "no investor could have, as a matter of fact, a legitimate expectation stemming from illegal state aid."

Pending an ultimate decision by the CJEU, this lifeline to Spain risks undermining the ICSID system of automatic recognition and enforcement of ICSID awards within the EU and, as a result, may render non-EU jurisdictions (such as the United States and in particular, New York) the key battleground for enforcement purposes.

Incompatibility of BIT (and ECT?) Arbitration With EU Law

A second and potentially even stronger lifeline was handed to Spain in early March 2018 by the CJEU in the case of *Achmea v. the Slovak Republic*, in which it finally and definitively confirmed the Commission's view that clauses in BITs providing for arbitration were contrary to EU law since the arbitral tribunals established cannot be considered courts or tribunals of a member state within the meaning of the Lisbon Treaty and, as such, have no power to refer questions to the CJEU. In making this decision the CJEU declined to follow the (non-binding) contrary view of the EU's Advocate General advisory opinion issued some months prior and aligned itself with the views expressed by a majority of EU member states (particularly those being on the receiving end of arbitration claims).

The CJEU thus concluded that ISDS, as contemplated in intra-EU BITs, was incompatible with EU law as it deprived courts within the judicial system of the EU from deciding questions of EU law, with the possibility of referring questions of EU law to the CJEU (as the German court before which the claimant was seeking to enforce the award had done), if necessary.

This decision, infallible because it is final, not final because it is infallible, probably raises more questions than it answers, especially insofar as the Spanish renewable cases (based on the ECT, not on BITs) are concerned. These include whether

- The decision should be understood to be applicable only to BITs (at issue in *Achmea*), or also to multilateral treaties such as the ECT, to which the EU is party and thus arguably can be deemed to have accepted the ECT's arbitration mechanism;
- In the absence of any temporal discussion in the decision, it should be understood to require that ongoing intra-EU BIT cases be discontinued (or alternatively, whether it should be understood to apply only to newly-filed cases);
- And to what extent the decision should be applicable in the case of intra-EU ICSID disputes, where ICSID's self-contained/automatic recognition and enforcement regime precludes by definition the review or involvement of domestic (EU) courts upon which Achmea was fundamentally predicated; and
- In the case of BIT proceedings seated outside the EU, Tribunals should or will pay any attention to *Achmea* and EU law generally.

The coming months will be indicative of how tribunals in ongoing cases view the relevance of Achmea. It would not be surprising to find different views taken in different cases, with the nature of the arbitration (ICSID/SCC/UNCITRAL) and the seat potentially pushing tribunals in different directions. As for recognition and

enforcement, the EU would seem now to be off-limits; award creditors will focus on non-EU jurisdictions to seize assets with which to satisfy their claims. Indeed, press reports indicate that the Swedish court hearing Spain's action to set-aside the *NovEnergía* award has granted Spain's request for a temporary stay of any potential enforcement of the award in Sweden (presumably in light of the state aid and/or *Achmea* issues).

In all events, what is clear is that, when Spain most needed it, both the EU Commission and the CJEU threw it a lifeline. In so doing, however, these institutions have rendered problematic the satisfaction of existing awards. They have also made the process more expensive as the proper structuring of claims has become more complex, and, more unlikely and possibly even pyrrhic the obtaining of further awards in the dozens of ECT cases that remain to be decided.

Conclusion

After a slow start, the saga involving upwards of three dozen investment treaty claims against Spain has accelerated in recent months. After two initial losses by investors, the two subsequent final awards had evened the score and appeared to augur well for the remaining claimants (and badly for Spain). But the recent action by the EU Commission and the decision by the CJEU cast a large cloud of uncertainty as to the enforceability of awards eventually issued in favor of the investors in these two cases, and may–notwithstanding the *Masdar* Tribunal's forceful assertion to the contrary, at least insofar as ECT claims are concerned–also impact the outcome of the still-pending cases and the prospects for any to-be-filed cases.

Surely by the time this piece is printed and in the hands of the reader, the situation will have evolved further, perhaps much further. Some investors, frustrated by the apparent obstacles to enforcement posed by the recent EU actions, may consider selling their claims to entities with more patience and more stomach for what could still, post-award, be a long and grueling battle. On the other hand, certain investors who have stayed on the sidelines during recent years, might be sufficiently heartened by the seeming favorable trend in the awards to file claims now, betting that the recent EU law obstacles will be able to be circumvented and will only delay, but not defeat, the ability to both bring a successful claim against Spain, but also to enforce it. The state aid and *Achmea*-related issues will be trotted out before each and every body hearing annulment or enforcement actions. There is no reason to expect that all decisions in this regard will be of a piece: for example, annulment and enforcement decisions involving CIADI awards may well come to different conclusions than those involving SCC awards in arbitrations seated in Europe where enforcement is sought in the EU.

Hopefully, this article will have permitted the reader a useful background (as of May 25, 2018) against which to measure future developments. So, stay tuned and keep your seatbelt buckled—there could be substantial turbulence ahead!

Author's note: This article draws, to a certain extent, on some of the principal author's previously published materials on the topic, including "Squaring the Circle: Reconciling the Conflicting Awards in the *Eiser* and *Isolux* Spanish Renewable Cases (Part I)," Kluwer Arbitration Blog, July 2017; "Squaring the Circle: Reconciling the Conflicting Awards in the *Eiser* and *Isolux* Spanish Renewable Cases (Part II)," Kluwer Arbitration Blog, July 2017; "Before the Other Shoe Drops," EFILA Blog, September 2015; "Before the Other Shoe Drops (II): The First ICSID Final Award in the Spanish Renewable Energy Arbitration Saga Finds for the Investors—Crossing the Line?," EFILA Blog, May 2017; and the chapter *The Energy Charter Treaty*, The Investment Treaty Arbitration Review, 1st Edition, March 2016.

Endnotes

1. In many respects, a companion case to *Charanne*, brought by related investors—parts of the group of companies controlled by the Spanish construction group of the same name, now the subject of insolvency proceedings—with the same counsel, and the same co-arbitrators named by each party.
2. Determined by the majority to be October 2012, as Spain had argued, instead of June 2012, as claimant had argued.
3. Per above, the court determined the date of the investment to be October 2012.

Clifford J. Hendel, Hendel- IDR, Madrid, Spain and Maria Antonia Perez, Araoz & Rueda Abogados, Madrid, Spain

Intra-EU BITs Arbitration Clause Ruled to Be Against EU Law by the Court of Justice of the European Union

By Alessandro Benedetti and Iacopo De Totero

A recent decision[1] of the Court of Justice of the European Union (CJEU) ruled that the arbitration clause contained in Bilateral Investments Treaties (BITs) concluded between Member States (MS) is not compatible with European Union (EU) law. BITs are agreements between two countries affording protection to investments made by investors from one contracting state in the territory of the other. One of the main features of such a regime of protection is to be found in the recourse to international arbitration given to the investors against state expropriation.

The first BIT dates back to 1959. After two decades there were already hundreds of BITs, and the current number of BITs in force is estimated to be around 3,000. BITs have proven to be effective instruments in fostering foreign investments. Just two years before the first BIT appeared, several European Countries (Belgium, France, Italy, Luxembourg, the Netherlands and West Germany) signed the Treaty of Rome creating the European Economic Community (ECC). It was indeed the first step toward an ongoing complex process of integration that today includes 28 Member States (27 at the end of Brexit) under the name of the EU.

BITs and the EU are diverse phenomena. The former are two-party treaties aiming at fostering international investments in the territories of contracting states. The latter is something far more ambitious, which cannot be adequately defined in just a few sentences. However, the institution of a single market within the EU borders, where investors can operate under a common framework of rules, certainly shares something with the BIT phenomenon. In other words, both the BIT and the EU are aimed at fostering international investments. But, while the EU has a much broader scope, the aforementioned aspect is indeed the sole purpose of the BIT.

Even the way in which that aim is pursued differs significantly. BITs are rather simple instruments, which contain just a few provisions. In contrast, the EU is based on two primary treaties: The Treaty on the European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU). The relevant principles of the internal market are contained in the latter treaty, but they are enriched by a whole bunch of different sources such as EU regulations, directives transposed into national laws by member states and decisions. The internal market is based on the principles of free movement of goods (Part. 3, Title II, TFEU) persons, services, and capital (Part. 3, Title IV, TFEU). It also includes, amongst many other things, the principle of non-discrimination (article 18, TFEU) and a common set of rules provided on competition (Part. 3, Title VII, TFEU).

When compared to the structure of BITs, the architecture set up by the EU appears to be extremely sophisticated. Regardless, and despite all of the aforementioned differences, is it possible for BITs to coexist with the EU? More precisely, are BITs concluded between member states (intra-EU BITs) compatible with EU law?

Although there is no shared view about it, the preponderance of evidence indicate that they are not. Supporting this view is the fact that the EU Commission took a stand against their compatibility. Further, the opinion of the Advocate General who argued for their compatibility was recently overturned by the CJEU.[2] But what are the grounds for the inconsistency of BITs with EU law?

The position of the EU Commission dates back to 2015.[3] Over the years it raised various grounds that support incompatibility. These are summarized as follows:

- The principle of *lex posterior derogate priori* contained in article 59 of the 1969 Vienna Convention on the Law of Treaties;[4]
- Article 351 of TFEU requiring member states to undertake actions against any inconsistencies arising concerning EU law and previous treaties;[5]
- EU law primacy over national laws.[6] Since international treaties enter into force through ratification of national laws, EU law shall also prevail over international treaties;
- The principle of non-discrimination pursuant to article 18 of TFEU;[7]
- The fact that BITs may be interpreted as being a violation of state aid rules under EU law;[8] and
- BITs conflict with the exclusive jurisdiction the CJEU has in interpreting EU law. In fact, no preliminary ruling from the CJEU can be sought by arbitral tribunals.[9]

It has also been argued that EU law provides investors with protection that ought to be considered equivalent to the one afforded by BITs.[10] Consequently, there would be no need for intra-EU BITs. However, such grounds conflict with the assumption that intra-EU BITs violate the principle of non-discrimination contained in article 18 TFEU. Only one of these assumptions can be true. In other words, if it is true that the recourse to arbitration provided under BITs represents an advantage susceptible to violate the EU principle of non-discrimination, then the degree of protection EU law affords investors has to be lower than the one provided by BITs.

Some of these arguments were recently brought before the CJEU in the case *Achmea* v. *Slovakia*.[11] The case relates to a BIT concluded between the Kingdom of the Netherlands and former Czechoslovakia. The Republic of

Slovakia succeeded after the dissolution of Czechoslovakia in 1993.

The liberalization of Slovakia's sickness insurance market of 2004 induced the Dutch company Achmea B.V. (Achmea) to set up a subsidiary there. In 2006 the aforementioned liberalization was partly reversed through the introduction of certain limitations.

For such reasons, Achmea started an arbitration proceeding against the Republic of Slovakia under the BIT in order to obtain compensation for the damage suffered due to Slovakia's reform of 2006. With its award, the Arbitral Tribunal ordered Slovakia to pay damages of approximately 22.1 million Euro.

The Republic of Slovakia brought an action before the German Federal Court[12] for setting off an intra-EU BIT related arbitral award. According to the arguments raised by Slovakia, the arbitration clause contained in intra-EU BITs is against EU law since it conflicts with articles 18, 267 and 344 of the TFEU and, thus with the principles of non-discrimination and supremacy of EU law.

Although the CJEU ruled in favor of the incompatibility, it is interesting to notice that both the German Court's request[13] for the CJEU's interpretative intervention and the opinion[14] of the Advocate General seem to conclude that intra-EU BITs arbitration clause is compatible with EU law.

Quite interestingly, the CJEU ruling left out any reasoning about the alleged violation of article 18 TFEU. Indeed, the decision seems built around the CJEU's own role. EU Treaties confer on the CJEU the role of gatekeeper of the EU legal system's autonomy and EU law interpretation. In other words, it is through the work of the court that the aim of uniform application of EU law within the European Union is reached. The CJEU decision is largely based on the fact that arbitral tribunals are not jurisdictional authorities within the meaning of article 267 TFEU. As a consequence, no arbitral panel can make a reference to the CJEU for a preliminary ruling. Therefore, intra-EU BITs arbitration clauses risk undermining the uniform application of EU law and for such reason conflict with EU law.

The CJEU conclusion appears reasonable but may be built on defective grounds. It is true that arbitral tribunals cannot be considered to be judicial authorities under article 267. Thereby they are precluded from making references to the CJEU. The reasoning as to why they should apply EU law in a dispute arisen under a BIT is therefore obscure.

In fact, BITs generally provide independent and autonomous frameworks where the scope of any concept involved is properly defined. Due to this kind of structure arbitral tribunals called to apply BITs shall not apply any other substantive law provisions than those contained therein. Moreover, it is true that member states' laws may become applicable in case the seat of arbitration is located within their territories, but these are laws of procedural nature.

The CJEU surprisingly affirms[15] that arbitral panels under BITs may be called to apply member states' substantive laws which are now largely based on EU law. This reasoning is not convincing. In fact, substantive national laws of member states may perhaps become relevant only in proceedings where enforcement or setting aside are sought. Indeed, in such scenarios, member states laws are susceptible to becoming essential. However, it cannot be forgotten that the aforementioned proceedings' jurisdiction always belongs to jurisdictional authorities within the meaning of article 267 TFEU. In other words, if the EU law's supremacy really is at stake, either the enforcement or the setting aside authority can refer to the CJEU for a preliminary ruling.

Some may argue that the CJEU decision only refers to the particular arbitration clause contained in the BIT between the Kingdom of the Netherlands and the Republic of Slovakia and it is of no use with regards to arbitration clauses contained in other intra-EU BITs. However, BITs structures are generally the same, and the reference to arbitration as a dispute settling measure is contained in every BIT. Further, the reasoning of the CJEU is not based on the particularities of the specific case and seems to be wide enough to be applied to all intra-EU BITs.

Endnotes

1. *Achmea* v. *Slovakia* CJEU decision of 6 March 2018. In http://curia.europa.eu/juris/document/document.jsf?text=&docid=199968&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=354883, visited on 30 March 2018.
2. Advocate General Opinions are not binding. The role of Advocate General's reasoned submissions is to inform the court with independent legal solutions.
3. Commission asks Member States to terminate their intra-EU bilateral investment treatise. European Commission Press release of 18 June 2015. At http://europa.eu/rapid/press-release_IP-15-5198_en.htm?locale=EN, visited on 30 March 2018.
4. *Achmea* v. *Slovakia,* L. Ilie and L. Le Bars, *What is the Future of Intra-EU BITs*?, in Kluwer Arbitration Blog, January 21st, 2018, http://arbitrationblog.kluwerarbitration.com/2018/01/21/future-intra-eu-bits/, visited on 30 March 2018.
5. *See supra*.
6. *See supra*.
7. *Binder v. Czech Republic; see supra*.
8. *Micula v. Romania; see supra*.
9. Articles 267 and 344 TFEU. *See* n.1.
10. *See* n.1.
11. C-284/16.
12. *Bundesgerichtshof*.
13. *See* paras from 1 to 23 of the CJEU decision.
14. Opinion of Advocate General Wathelet delivered on 19 September 2017, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A62016CC0284, visited on 30 March 2018.
15. Paras. 42 and 58 of the CJEU decision.

Alessandro Benedetti, BLB Studio Legale, Roma, Italy

Iacopo De Totero, BLB Studio Legale—Benedetti Loruso Benedetti, Milan, Italy

Protecting Personal Data: Companies Not in Compliance With EU Regulations Face Serious Penalties

By François Berbinau

On May 25, 2018, regulation n°2016/679, called "General Data Protection Regulation" (the "Regulation"), issued by the European Parliament and the Council of the European Union (EU) on April 27, 2016, became effective. And it appears that a large number of companies will not have taken the necessary steps to be in compliance despite the very severe penalties involved.

In the current digital world, any company, regardless of its size or business sector, is regarded as a controller of personal data processing. Therefore, each company must comply with the new European data privacy legal framework and constantly maintain such compliance under penalty of sanctions which could put it at risk.

1. The Company: A Controller of Data Processing

According to the Regulation, personal data means "any information relating to an identified or identifiable individual."[1]

To ensure the same protection of personal data all over the EU, the Regulation provides a strict frame of data processing.

Personal data processing means "*any operation or set of operations which is performed on personal data or on sets of personal data, whether or not by automated means.*"[2]

Hence, this definition refers to the following operations on personal data:

- procurement;
- storage;
- modification;
- reading;
- use;
- transfer;
- cross-referencing ;
- removal.

In fact, any company whose clients are individuals has information on them such as their names, contact details, purchase history, reports from the customer service, list of outstanding invoices, etc.

Moreover, any company with employees gathers information such as curriculum vitae, cover letters, contact details, social security numbers, banking information, diplomas, recordings of video surveillance, pay slips, professional assessments, disciplinary records, dismissal letters, etc.

François Berbinau

In addition, when implementing a contract executed by two companies, one or both of them may obtain various pieces of information regarding several individuals, such as employees of its co-contracting party.

Thus, all of this processing of personal data relating to European citizens will have to be compliant with the new Regulation, which guarantees the protection of these data subjects.

2. A New Unified Legal Framework Applicable in All EU Member States

This new legal environment includes two distinct sets of rules: the general rules applicable to all personal data processing (2.1.) and the specific rules in case these data are transferred to an international organization or a country outside of the EU (2.2.).

2.1. General Rules Applicable to Any Personal Data Processing

The Regulation unifies the legal framework across the EU and establishes a common set of principles relating to the processing of personal data.[3]

According to the Regulation, personal data that are collected must:

- Be lawful, fair and transparent;
- Have explicit and legitimate purposes;
- Be adequate, relevant and limited to what is necessary;
- Be accurate and kept up to date;
- Be kept in a form which permits identification of data subjects;
- Be kept for a limited term according to purposes;
- Enjoy an appropriate security.

Compliance with all these principles has to be guaranteed by the controller of data processing, who must be able to produce proof of such compliance.

In order to ensure that these guarantees will be duly respected, the European legislator has issued a significant number of obligations that each company is expected to meet.

"Penalties provided in case of non-compliance with the Regulation are of three kinds: administrative (3.1.), civil (3.2.), and criminal (3.3.), and these are cumulative."

Hence, to ensure that its contemplated processing of data is lawful before it starts implementing it, the company must:[4]

- Verify that such processing is necessary for the performance of a contract, or in order to comply with a legal obligation, protect the vital interests of the data subject, or perform a task carried out in the public interest;
- Obtain the unambiguous consent of the data subject.[5]

During and after the processing of data, the Regulation grants the data subject a series of rights: a right of access,[6] a right to rectification,[7] a right to be forgotten,[8] a right to the restriction of processing,[9] a right to data portability,[10] and a right to object.[11]

To guarantee these rights, the company[12] and its controller's representative are also subject to the following obligations:

- Guaranteeing data protection by design and by default;[13]
- Keeping a record of processing activities;[14]
- Actively cooperating with the supervisory authority of the state in which they have their registered main office or the main center of their activities in the EU;[15]
- Guaranteeing an effective and up to date security of data processing in view of new technical developments;[16]
- Notifying any personal data breach to the supervisory authority not later than 72 hours after becoming aware of it.[17]

When processing of personal data is jointly implemented by several companies, these companies are jointly liable in case of non-compliance of their obligations by one of them.[18]

Moreover, regarding subcontractors, though they are subject to the same obligations, the principal remains in charge of controlling that its subcontractor respects all of its obligations.

2.2. Specific Rules in Case of a Transfer of Personal Data Out of the EU

For the transfer of personal data to an international organization or a non-member state, in addition to those already outlined, additional obligations apply in order to guarantee the protection of European data subjects everywhere in the world.[19]

These specific rules also apply to subsequent transfers of personal data between organizations or countries outside of the EU.

Therefore, a transfer of personal data may be allowed only:

- If the European Commission affirmed, by way of a decision, that the recipient country or the recipient organization ensures an adequate level of protection;[20] or
- If in the absence of a decision of the Commission, the company has provided appropriate safeguards, and if data subjects have opposable rights and effective legal remedies.[21]

In the latter case, the appropriate safeguards may be ensured by:

- A legally binding and enforceable instrument between public authorities or bodies;[22]
- Binding corporate rules approved by a supervisor authority before the transmission of data;[23]
- Standard data protection clauses adopted by the Commission or by a supervisory authority;[24]
- A code of conduct established by a representative body of the stakeholders of a certain line of business and approved by the European Commission;[25]
- A certification mechanism established by an approved certification body.[26]

If the company issuing the personal data chooses to respect a code of conduct or to use a certification mechanism, the recipient company located in a non-member state must make a compelling and enforceable commitment "to apply the appropriate safeguards, including as regards data subjects' rights."

3. Severe Penalties in Case of Noncompliance

Penalties provided in case of non-compliance with the Regulation are of three kinds: administrative (3.1.), civil (3.2.), and criminal (3.3.) and these are cumulative.

3.1. Administrative Penalties

As it is already the case under the currently applicable rules that were replaced by the Regulation as of May 25, 2018, in case of non-compliance, the company may be subject to a financial penalty.

However, the penalty provided in the Regulation is significantly increased compared to the previous rules. The new administrative fine may reach as much as 20 million Euros or 4 percent of the relevant company's global annual turnover of the previous year,[27] whichever is highest.

Furthermore, although it is not a penalty strictly speaking, in case of a serious breach of personal data processing, the company responsible will be subject to an obligation that can be particularly harmful since it must inform all the data subjects concerned of the existence of this breach.[28]

"The purpose of the DPO is to advise the company and to monitor the processing of personal data to ensure its compliance."

This obligation to report such breach to the victims is likely to seriously affect the corporate image of the company across the EU and, consequently, to have significant repercussions on its business development.

3.2. Civil Penalties

In addition to administrative penalties, the Regulation allows civil actions against companies in case of non-compliance.

First, the Regulation opens the possibility for any data subject to introduce a civil action to obtain compensation for the prejudice suffered as a result of the non-compliance.[29]

Second, the Regulation also opens the possibility for associations dedicated to the protection of data subjects' rights to introduce a class action against non-compliant companies.[30]

3.3. Criminal Penalties

Finally, the Regulation does not prevent EU member states from prosecuting companies in case of non-compliance.

In this respect, current French criminal law remains applicable after May 25, 2018, subject to any amendment in the meantime and afterward.

It provides for penalties in case of a non-compliance with the protection of personal data which may amount, as far as individual perpetrators are concerned, to a maximum of five years imprisonment and/or a 300,000 Euros fine,[31] the latter maximum amount being multiplied by five if the perpetrator is a company.[32]

Consequently, a company that does not respect its obligation under the Regulation will possibly face a criminal fine representing 1.5 million Euros. Such penalty may be cumulated with any administrative and/or civil sanctions mentioned described in section 3.1. and 3.2. above.

4. What Should a Company Do to Ensure Compliance of Personal Data Processing Under the Regulation?

As of May 25, 2018, any company in the EU must have processing of personal data in compliance with the Regulation.

In order to ensure timely compliance, companies are recommended to conduct a legal/technical audit, in particular on all its existing contracts, to determine the number and scope of personal data processing operated by the company.

Depending on the results of the audit, it might be necessary to conduct legal and technical adjustments for all of the company's personal data processing to comply with the Regulations.

To ensure compliance of implemented solutions, the Regulation provides the development of certifications and codes of conduct to help companies better understand the proposed solutions.[33]

Throughout the company's life, it has to permanently ensure that personal data processing complies with the Regulation and actively cooperate with the supervisory authority.

Consequently, the company should seriously consider appointing a Data Protection Officer (DPO), as provided by the Regulation. The purpose of the DPO is to advise the company and to monitor the processing of personal data to ensure its compliance.[34]

The DPO, notably an individual with sound legal and technical knowledge, will be able to facilitate discussions between the company and the supervisory authority as well as the technical experts.

Endnotes

1. Article 4 of the Regulation on definitions, point 1.
2. Article 4 of the Regulation on definitions, point 2.
3. Article 5 of the Regulation regarding principles relating to the processing of personal data.
4. Article 6 of the Regulation regarding lawfulness of processing.
5. Articles 7 and 8 of the Regulation regarding the conditions for consent.
6. Article 15 of the Regulation regarding the right of access by the data subject.
7. Article 16 of the Regulation regarding the right to rectification.
8. Article 17 of the Regulation regarding the right to erasure.
9. Article 18 of the Regulation regarding the right to restriction of processing.
10. Article 20 of the Regulation regarding the right to data portability.
11. Article 21 of the Regulation regarding the right to object.
12. Article 24 of the Regulation regarding the responsibility of the controller.
13. Article 25 of the Regulation regarding data protection by design and by default.
14. Article 30 of the Regulation regarding records of processing activities.
15. Article 31 of the Regulation regarding cooperation with the supervisory authority.
16. Article 32 of the Regulation regarding security of processing.
17. Article 33 of the Regulation regarding notification of a personal data breach to the supervisory authority.
18. Article 26 of the Regulation regarding joint controllers.
19. Chapter V of the Regulation regarding transfers of personal data to non-member states or international organizations.
20. Article 45 of the Regulation regarding transfers on the basis of an adequacy decision.
21. Article 46 of the Regulation regarding transfers subject to appropriate safeguards.
22. Article 46 of the Regulation, point 2, a.
23. Article 46 of the Regulation, point 2, b.
24. Article 46 of the Regulation, point 2, c and d.
25. Article 46 of the Regulation, point 2, e.
26. Article 46 of the Regulation, point 2, f.
27. Article 83 of the Regulation regarding general conditions for imposing administrative fines.
28. Article 34 of the Regulation regarding communication of a personal data breach to the data subject.
29. Article 82 of the Regulation regarding the right to compensation and liability.
30. Article 80 of the Regulation regarding representation of data subjects.
31. Articles 226-16 to 226-24 of the French criminal code.
32. Article 121-2 of the French criminal code.
33. Articles 40 to 43 of the Regulation about codes of conduct and certification.
34. Articles 37 to 39 of the Regulation about Data Protection Officer.

François Berbinau, BFPL avocats, Paris, France

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Italian Supreme Court Gives the Green Light to Foreign Judgments Granting Punitive Damages

By Stefania Boscarolli

On July 5, 2017, the Italian Supreme Court (*Corte di Cassazione*) issued Opinion No. 16601/17 on the enforceability, in Italy, of foreign civil judgments granting punitive damages.[1]

Prior to this decision being issued, Italian courts had declined recognition of such judgments on the grounds that they were against public policy. The reason lies in the traditional view that, under the Italian tort system, damages do not aim at punishing the tortfeasor but rather at compensating the victim for a loss.

Stefania Boscarolli

Now, in a landmark case, the Supreme Court established an important rule of law acknowledging the compatibility between punitive damages and tort cases in Italy.

Background

Underlying Lawsuit: *Duffy, III v. Nosa, Inc.*

The issue stems from an underlying suit brought by a motorcyclist for injuries sustained during a motocross race. The motorcyclist, claiming a defective helmet, started legal proceedings in the United States against Nosa, Inc. (Nosa), the Florida-based retailer and importer; Helmet House, Inc., the U.S. distributor, and Axo Sport, S.p.A. (Axo), the Italian manufacturer. Nosa made a timely demand upon Axo to defend it, which the Italian company ignored, although participating in the proceedings. Nosa settled the case paying the motorcyclist $1 million, inclusive of punitive damages, while Axo settled for $50,000.

U.S. Indemnity Action: *Nosa, Inc. v. Axo Sport, S.p.A*

Subsequently, Nosa brought a third-party indemnity action against Axo. The Florida 17th Circuit Court for Broward County that heard the case ordered Axo to indemnify and hold Nosa harmless for the entire settlement amount, as well as $329,419.60 pre-judgment statutory interest, and $106,717.27 in costs and attorney's fees (for a total of $1,436,136.87), plus 11 percent annual interest.[2]

The judge further granted Nosa costs and attorney's fees in the amount of $106,500 (including $15,000, prevailing party taxable costs, $1,500, proposal of settlement costs, and $90,000 attorney's fees), bearing an interest rate of 8 percent a year.[3]

The Florida District Court of Appeal affirmed, and on October 13, 2010, ordered Axo to pay legal costs and attorney's fees for the appellate proceedings, in the amount of $9,000, plus 6 percent annual interest.[4]

Italian Lawsuit: *Nosa, Inc. v. Axo Sport, S.p.A*

In an attempt to collect damages from the Italian manufacturer, Nosa sought to enforce the three judgments in front of the Appellate Court in Venice. Axo defended on the ground that the U.S. opinions violated Italian public policy because they awarded punitive damages. On January 3, 2014, the Appellate Court ruled in favor of Nosa and granted recognition of the judgments.

Axo appealed to the Italian Supreme Court, whose First Division heard the case. With Ordinance No. 9978/2016,[5] the justices prompted the Joint Divisions (*Sezioni Unite*) to answer the issue whether public policy barred enforcement of foreign civil judgments granting punitive damages.

Among other grounds of appeal, Axo contended the Appellate Court erred in enforcing the judgments that included punitive damages, for they violated public policy. In support of its position, Axo cited Supreme Court cases, Cass. Civ., Sez. I, 8 febbraio 2012, n. 1781 (It.), and Cass. Civ., Sez. III, 19 gennaio 2007, n. 1183 (It.), which held that the idea of punishment falls outside the scope of tort damages. Axo maintained that Italian case law is settled in holding there is no room for punishment in civil matters, where the primary scope of damages is to make the injured whole. Axo further argued that the foreign decisions failed to convey they were based on a settlement that included punitive damages.

However, the Supreme Court found the argument was based on a hypothetical, non-existing, situation involving an order against Axo to pay the motorcyclist punitive damages. The Court held the Venetian judges, in examining the settlement and all its underlying facts, rightfully considered the victim's request for punitive

damages and ruled the amount did not ultimately involve them. Therefore, the Court rejected Axo's attempt to infer punitive damages solely from the fact that the U.S. opinions did not specify the type of damages.

Further, it refused to examine the reasonableness of the conclusion the U.S. courts reached under foreign law. The Court's authority is, in fact, limited to analyzing the effects that the foreign decision has within the Italian legal system.[6] The justices thus affirmed the lower court's holding that, based on the foreign judge's analysis of the settlement's reasonableness, the damages in dispute were not abnormal in relation to the injury involved.

While rejecting Axo's arguments and granting enforcement of the U.S. opinions, the Supreme Court seized the opportunity to set an important precedent on the recognition in Italy of foreign civil judgments granting punitive damages.

Previous Approach to Punitive Damages

The Venice Appellate Court granted Nosa's request under Article 64 of Law No. 218/1995.[7] The statute applies where no other international treaty exists on the point. Such is the case of Italy and the United States, which have no applicable convention on the enforcement of foreign judgments in civil matters. Art. 64 of Law No. 218/1995 thus regulates the automatic enforcement of foreign decisions in Italy, subject to the following conditions:

(1) The foreign court had jurisdiction according to Italian jurisdictional criteria;

(2) Service of process complied with foreign law, and no violation of the right of defense occurred;

(3) The parties' appearance or default complied with foreign law;

(4) The judgment was final in accordance with foreign law;

(5) No Italian judgment exists with the effect of res judicata relating to the same subject matter;

(6) There are no pending proceedings in Italy between the same parties for the same subject matter; and

(7) The foreign judgment does not produce effects that are contrary to Italian public policy.[8]

Accordingly, once determined that the foreign judgment results from a proceeding that complies with due process under foreign law, public policy stands as the ultimate bulwark of the forum's fundamental principles. The purpose of legal damages falls within such principles. As a civil law country, the Italian legal system is characterized by a rigid separation between criminal and tort law. This is also true with regard to damages, which translates into the distinction between a primary compensatory purpose, typical of tort law, and a punitive function, which pertains to criminal law.[9] It follows that compensatory damages are designed to reinstate the victim in a pre-tort position, whereas malice and gross negligence remain elements of the criminal system.

As a result, the idea of punishment is alien to civil liability under Italian law. The Supreme Court has traditionally embraced this view, confining a punitive purpose to the criminal field.[10]

The Supreme Court's Latest Stance

In its recent opinion, however, Italy's Supreme Court acknowledges a significant change in legislative and jurisprudential trends on punitive damages in civil cases. In reaching its conclusion, the Court analyzes the notion of public policy and its evolution in relation to the enforcement of foreign judgments. According to the Court, public policy is a set of fundamental principles that inform a legal system in a certain historical time. Contrary to a traditional restrictive interpretation, such principles are no longer limited to domestic values, but they are based on the protection of shared constitutional and European fundamental rights. The evolution of public policy thus marks a progressive cutback of national closure, in favor of an opening toward global values.

In so holding, the Court criticized its previous case law—including Cass. No. 1183/07 and No. 1781/12, as being outdated. It maintained, in fact, that such case law led to gradually recognizing that a punitive purpose no longer per se conflicts with civil liability damages.[11] A number of statutes that already provide for punitive-like damages in trademark law, employment law, or child custody, corroborate the Court's view.

In light of the above, the Supreme Court openly recognized a multi-functional nature of tort damages that envisions a punitive function, aside from its traditional primary compensatory purpose.

Limits

Nonetheless, the Court imposes certain restrictions.

First, the principles of legality, foreseeability, and proportionality mandate that punitive damages be based on

an existing (Italian or foreign) provision. Articles 23 and 25 of the Italian Constitution, as well as Art. 7 ECHR[12] codify the Roman rule of law *"nulla poena sine lege"* (literally, "no punishment without law"). Further, Art. 49 of the European Constitution[13] establishes the principle of proportionality between penalty and offense, which also applies to the ratio between punitive and compensatory damages. Interestingly, the Court cites U.S. cases rejecting grossly excessive damages to show the importance of proportionality (*BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996); *Exxon Shipping Co. v. Baker*, 554 U.S. 471 (2008); *Philip Morris USA v. Williams*, 549 U.S. 346 (2007)).

Second, the foreign judgment cannot conflict with public policy, intended as a global system of protections, in which European public policy does not substitute, but rather coexists with, national values. This derives from Art. 67 TFEU,[14] which creates a European area of freedom, justice, and respect for fundamental rights, where Member States cooperate through a mutual recognition of judgments.

Finally, the enforcement of a foreign judgment granting punitive damages is subject to its compliance with Italian private international law.

Principle of Law

The Court thus establishes the following rule of law:

> In the current [Italian] legal system, the purpose of civil liability is not only to reinstate the economic sphere of the injured party, for deterrence and punishment of the wrongdoer also fall within the same system. Therefore, U.S. punitive damages are not ontologically inconsistent with the Italian legal system. Nevertheless, the recognition of a foreign judgment granting such damages must be based on foreign laws, that satisfy the principles of legality, foreseeability, and of quantitative limits of penalties. That is because the question the [Italian] authorities must answer pertains to the foreign judgment's effects and their compatibility with public policy.[15]

Future Scenario

There is little doubt the Supreme Court's Opinion No. 16601/17 marks a turning point on punitive damages in the Italian civil liability system. However, this does not imply Italian judges can now liberally grant punitive damages, absent a specific provision. As the Court itself indicates, only a legislative intervention could widely open the doors to punitive damages. Even so, the decision has important implications for Italian and foreign parties. On the one hand, foreign companies seeking to enforce awards for punitive damages in Italy now have a strong legal basis for obtaining them. On the other hand, companies operating in Italy might be more exposed to disbursement of large amounts of money respecting both compensatory and punitive damages. At this point, though, we can only argue de iure condendo.

Endnotes

1. *See* Cass. Civ., Sez. I, 7 luglio 2017, n. 16601 (It.), *available at* http://www.foroitaliano.it/wp-content/uploads/2017/07/cass-civ-16601-17.pdf.
2. *See Nosa, Inc. v. Axo Sport, S.p.A.*, Case No. 02-5072(14) (Fla. 17th Cir. Ct., Sept. 23, 2008) (Judgment #1).
3. *See id.* (Jan. 13, 2009) (Judgment #2).
4. *See Axo Sport, S.p.A. v. Nosa, Inc.*, 41 So. 3d 910 (Fla. Dist. Ct. App. 2010) (Judgment #3).
5. Ordinance No. 9978, of May 16, 2016, *available at* http://www.foroitaliano.it/cass-ord-16-maggio-2016-n-9978-i-1973-circa-la-non-riconoscibili-ta-di-sentenze-straniere-che-liquidino-danni-punitivi.
6. *See* Cass. Civ., SS. UU., 4 maggio, 2007, n. 10214 (It.); Cass. Civ., Sez. I, 18 aprile, 2013, n. 9483 (It.) (defining the scope of the Supreme Court's authority).
7. Article 64 of Italian Law No. 218 of May 31, 1995 (Italian Statute on Private International Law), *available a*t http://www.esteri.it/mae/doc/l218_1995.pdf.
8. *Id.*
9. *See also* Marco Cappelletti, *Punitive Damages and the Public/Private Distinction: A Comparison Between the United States and Italy*, 32 ARIZ. J. Int'l & Comp. L. 821 et seq. (2015).
10. *See* Cass. No. 1183/07, *supra* (denying enforcement in Italy of an Alabaman judgment granting punitive damages for a motorcyclist's death, resulting from a defective helmet in a motocross accident); *see also* Cass. No. 1781/12.
11. *See* Cass. Civ., SS. UU., 6 maggio 2015, n. 9100 (It.) (holding a punitive character of damages is compatible with Italian public policy).
12. European Convention for the Protection of Human Rights and Fundamental Freedoms of 1950, *available at* http://www.echr.coe.int/Documents/Convention_ENG.pdf.
13. Charter of Fundamental Rights of the European Union, 2000 O.J. C 83/389, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12010P&from=EN.
14. Lisbon Treaty on the Functioning of the European Union, 2008 O.J. C 326/47, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:12008E067&from=EN.
15. Cass. No. 16601/17, p. 25. (unofficial translation) (emphasis added).

Stefania Boscarolli is at Lazer, Aptheker, Rosella & Yedid, P.C. You can reach her at boscarolli@larypc.com.

New Legislation on Registration of Beneficial Owners

By Carl-Olof Bouveng and Richard Perez

As part of the Fourth Anti-Money Laundering Directive EU 2015/849 (“The Directive”), each EU member state must implement national legislation pertaining to the registration of beneficial owners. The aim of the Directive is to increase the transparency of ownership and control of companies, associations, trusts and other associations (legal persons) and to prevent money laundering and the financing of terrorism. The Directive requires the member states to transpose the Directive into national law by June 26, 2017. According to EUR-Lex, as of the date of this article, 20 out of 27 member states had done so.

“A beneficial owner is assumed to include a natural person who directly or indirectly through other legal entities holds more than 25 percent of the total number of shares, votes or ownership interest in the relevant legal entity or exercises control via other means.”

The Directive gives the member states the option to impose more far-reaching legislation than the Directive requires. Hence, there may be variations in the implementation in the various EU states. The following text outlines the minimum requirements of the Directive for the registration of ultimate beneficial owner. Other aspects of the Directive are not elaborated on in this article. For the purpose of illustration, certain provisions included in Swedish law are also mentioned.

Who Falls Within the Scope of the Directive?

The Directive applies to all corporate and other legal entities incorporated within the member states’ territories. The Directive also includes trusts (and similar legal arrangements) and natural persons exercising effective control over a trust.

Limited companies listed on a regulated market may be exempted. Whether the subsidiaries of such companies are exempt differs between the member states.

What Are the Obligations of the Legal Entity?

The legal entity (or natural person, as the case may be) is obligated to obtain and register information on their beneficial ownership in a central register. The information must be kept current and accurate at all times.

Carl-Olof Bouveng

Richard Perez

The information must include the name, the month and year of birth, the nationality and the country of residence of the beneficial owner as well as the nature and extent of the beneficial interest held. Local law may in its implementation impose further obligations on the legal entity.

Who Is the Beneficial Owner in the Context of a Legal Entity?

A beneficial owner is (i) any natural person who ultimately owns or controls the legal entity and/or (ii) the natural person on whose behalf a transaction or activity is being conducted. The latter is characterized as a natural person enjoying the benefits of someone else’s action, such as a front man.

“In Sweden, the Swedish Companies Registration Office can order the company, its CEO or a director of the company to make the registration. Fines may be imposed if no registration is made or if the registration is incomplete or contains incorrect information.”

A beneficial owner is assumed to include a natural person who directly or indirectly through other legal entities holds more than 25 percent of the total number of shares, votes or ownership interest in the relevant legal entity or exercises control via other means. If such natural person cannot be identified, the natural person(s) who holds the position(s) of senior managing official(s) will be considered beneficial owner. The latter does not, however, apply in Sweden. Instead, in such cases, the company

may register that no beneficial owner can be identified or that it does not exist, without having to register senior management as beneficial owners.

Under Swedish law implementing the Directive, beneficial owner will also include a natural person who has the right to appoint or remove more than half of the legal entity's directors or equivalent officials, or may exercise the equivalent control by agreement with the owner, member or the legal person itself, through provisions in the company's articles of association, shareholders' agreement or similar.

For trusts, the beneficial owner is assumed to be the settlor, trustee, protector, and beneficiary or other natural person(s) exercising ultimate control over the trust.

When Must the Registration Be Made?

The Directive does not regulate when registration is to be made. In Sweden, however, the first registration had to be made by February 1, 2018. New legal entities established must report information on its beneficial owner within four weeks after being established. If the beneficial owner changes, such changes must be reported as soon as the legal entity becomes aware of the change.

What Happens If No Registration Is Made?

No remedy for failing to make the registration is set out in the Directive. Nevertheless, remedies may be provided for under local laws. In Sweden, the Swedish Companies Registration Office can order the company, its CEO or a director of the company to make the registration. Fines may be imposed if no registration is made or if the registration is incomplete or contains incorrect information.

To Whom Will the Information on the Beneficial Ownership Be Accessible?

The Directive requires the member states to ensure that the information on beneficial ownership is held in a central register. The register must be accessible to competent authorities and any person or organization that can demonstrate a legitimate interest. In Sweden, the information is accessible through the Swedish Companies Registration Office's website, with a Swedish e-identification certificate.

Carl-Olof Bouveng and Richard Perez, Advokatfirman Lindahl KB, Sweden.

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Russian Sanctions: How Do They Affect U.S. Business?

By Serhiy Hoshovsky

On April 26, 2018, a roundtable discussion was held at HodgsonRuss LLP in New York, connecting by video link participants from Washington DC, New York City and Europe. The discussion focused on recent sanctions imposed by the U.S. Government on Russia, enforcement trends and how they affect the way that U.S. companies conduct business around the Globe. This event was jointly organized by the Committee on Eastern Europe and the Committee on International Trade. The distinguished panelists included Charles R. Johnston, Chair of the Trade and Investment Committee of the USCIB and Managing Director of Citi; Michael Hendrix, OFAC, U.S. Department of Treasury; Hon. Volodymyr Yelchenko, Permanent Representative of Ukraine to the UN, and Robert J. Leo, Co-chair of the Committee on International Trade. The discussion was moderated by Serhiy Hoshovsky, Chair of the Committee on Eastern Europe. Participation from overseas was moderated by Oleh Beketov, Chapter Chair in Kyiv.

Serhiy Hoshovsky

The event was opened by Paul M. Frank, a former Chair of the International Section and renowned international law attorney, who hosted the event at his law firm. The Permanent Representative of Ukraine to the UN, Hon. Volodymyr Yelchenko, provided a comprehensive political context for the Russian sanctions and reminded participants of the events that led to their initial imposition in 2014. Michael Hendrix, an enforcement officer with OFAC, summarized the legal framework for the sanctions and enforcement priorities. He also shared some recent enforcement actions. Charles R. Johnston provided a great overview of the sanctions regime from the perspective of the U.S. business community. Mr. Johnston explained in detail how the sanctions are becoming a new reality, which is here to stay for a long period of time, and how U.S. businesses are adapting and adjusting to doing business in this environment. He also shared some practical experiences of what U.S. companies are doing to stay compliant. Robert Leo then rounded this out on the compliance side by sharing a very useful handbook on sanctions and practical tips on what to do when issues arise and how to stay compliant.

The event provided a unique opportunity for the participants, especially those from overseas, to ask questions and hear from people who are on the frontlines of the sanctions policy and enforcement at the U.S. government and within the business community and legal profession. All panelists and participants agreed that the event was a major success and provided a great platform for sharing views and discussing major issues affecting the business and legal community not only in the U.S. but also internationally.

Mr. Hoshovsky of Hoshovsky Law Firm in New York City focuses his practice on domestic and international matters including complex transactions, litigation and dispute resolution. His clients include government entities, businesses and individuals. Mr. Hoshovsky serves as a Chair of the Committee on Eastern Europe of the International Section of the New York State Bar Association. Mr. Hoshovsky dedicates a lot of time to public service and serves on the boards of several non-for-profit organizations.

Save the Date!

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Recent Developments–Financial Centers in the Gulf

By David Russell QC[1]

There are five financial centers in various stages of development in the GCC (Gulf Cooperation Council).

The oldest is the Bahrain Financial Harbor.[2] More recent financial centers are the Dubai International Financial Centre[3] (DIFC) (2004), the Qatar Financial Centre[4] (QFC) (2005), the Abu Dhabi Global Market[5] (ADGM) (2016) and the still incomplete King Abdullah Financial District (KAFD) in Riyadh.[6]

Both the oldest and the youngest of these differs from the other three as neither has its own court or separate legal framework, although Bahrain initially addressed the issue of trusts in the Bahrain Financial Trust Law 2006 and more recently in the Trust Law 2016, and has enacted modern banking and company legislation.

A further financial center is in the course of establishment in another Islamic nation: the Astana International Financial Centre[7] (AIFC) in Astana, Kazakhstan. The essential elements of this are currently being assembled. The closest analog to the other Centers discussed in this article is the DIFC.

The legal structures of the DIFC and the Qatar Financial Centre (QFC)[8] have many similarities which, as much of the preliminary work on the QFC's establishment was done by former DIFC personnel, is not surprising. The essential differences between the DIFC and QFC models are that:

- The separate legal regime for the QFC applies to licensed entities in the QFC (the so-called "club" financial center model) while that in the DIFC applies within its defined geographical area (the so-called "enclave" financial center model);
- There is somewhat less codification of the common law,[9] and
- There is no separate admissions regime in order to practice before the QFC Courts (an approach also adopted in the ADGM).

The ADGM, similar to the DIFC, and no doubt due to the provisions of the UAE Federal Constitution,[10] was established following the enclave model, the relevant enclave being Al-Maryah Island in Abu Dhabi.

The principal difference between the DIFC and QFC on the one hand and the ADGM on the other is the treatment of the role of English law, a matter discussed in the first Consultation Paper issued by the ADGM. The ADGM Consultation Paper saw advantages in extremely limited codification, arguing that this is the approach which applies in similar jurisdictions such as Hong Kong and Singapore. This view was reflected in the resulting legislation.[11]

David Russell

It is of course not possible to codify the common law completely. The question is rather the extent to which the common law (and for that matter English statutory law, which has modified it) is to be received directly or is to be received by a process of partial codification.

The advantage of a hybrid system such as that adopted in the DIFC (which partially codifies the common law and imports the remainder of it together with residual English statute law directly without specific reference to English statute law[12]) is that those unfamiliar with the common law have a definitive and comprehensible foundation upon which they can begin to advise clients. On the other hand, international practitioners more used to practice in London are compelled to proceed on the basis of the codified law, rather than the law with which they are familiar.

"One change from the approach outlined in the Consultation Paper is that the English perpetuities rules have not been retained."

The QFC's approach of more limited codification, such that (for example) contract and trust law have been codified, but tort law has not, may be regarded as arising from its different legal basis. Within the QFC, the framework legislation[13] does not affect the non-application within a specific geographical area of local civil or commercial laws as is provided for in the corresponding UAE provisions,[14] with the result that Qatari law applies in the QFC unless a specific QFC law provides to the contrary in respect of a QFC registered entity, and QFC law applies to the entity irrespective of where in Qatar the entity operates.

On one view, those advising the ADGM authorities aimed to create a difference between it and the DIFC and QFC. In addition, they were persuaded by the argument that duplicating the positions of Singapore and Hong Kong would give the ADGM a market advantage.

Singapore and Hong Kong have a significant history of use of English law so that the approach adopted there does not effectively exclude local practitioners with little knowledge of English law. That is not the position in the Gulf region, and the alternative view that rather than giving the ADGM courts a market advantage, it will make local practitioners even more reluctant to use them than they are to use the DIFC and QFC Courts, is certainly plausible.

The need for codification in a regional context is arguably particularly acute with elements of English law such as trust law. The concept of a trust is sufficiently alien to non-common law practitioners (although in many ways it is analogous to the Islamic *waqf*) that it might be thought codification of this part of the common law would assist local understanding of this part of English law. It is noteworthy that Hong Kong has recently moved to a more comprehensive codification of trust law, as have many other financial centers, including the DIFC and QFC, whose laws are very similar. The DIFC Trust Law was reviewed in *Trusts & Trustees* by Andrew de la Rosa in 2008,[15] wherein he described it as "very much in the mold of an archetypal offshore financial center trust law" although based, to a large extent, on the provisions of the United States Uniform Trust Code. It was recently re-enacted with significant enhancements. The original Bahrain Financial Trust Law was not particularly well adapted to private trusts and, unusually, required registration as a condition of validity. The 2016 Bahraini legislation is much improved for this purpose, although registration is still required as a condition of validity (which shows something of a misunderstanding of the nature of a trust).

In the case of the ADGM, existing English trust law has been adopted with some modification of the statutory provisions.[16] One change from the approach outlined in the Consultation Paper is that the English perpetuities rules have not been retained.[17] This is consistent with the position of Hong Kong, Qatar,[18] and the DIFC,[19] although the power in the court to bring a trust to an end, usually found in similar laws, has no counterpart. In addition, modern provisions relating to delegation of trustee powers, and appropriate protections of trustees from liability or duties to provide trust information to beneficiaries, will be absent.

Each of the DIFC, ADGM, and QFC has adopted a Foundations Law. In addition, the Emirate of Sharjah has enacted a Waqf Law (2011), and Dubai has enacted an Endowments Law (2017).

Each of these centers has an arbitration center which (in the case of the KAFD) will apparently sit in both London and Saudi Arabia.

What is common to all these financial centers, apart, presently, from the KAFD, is the recognition that it is not enough just to co-locate banks, lawyers, and accountants in impressive new buildings: there has to be a proper legal framework that provides both certainty of the applicable law, modern commercial structures, and ready access to courts, which will decide matters expeditiously and effectively enforce their judgments.[20] If the KAFD is to realize its full potential the necessary legal infrastructure needs to be created.

At times the KAFD authorities appear to have recognized this. There have been numerous contacts between the KAFD and the DIFC, including visits by KAFD personnel to the latter. However, the DIFC has not, in recent times, been able to engage with the KAFD to progress the matter, despite its expressed willingness to do so (as, indeed, it is doing with the AIFC).

Endnotes

1. E-mail: david.russellqc@outertemple.com.
2. http://www.bfharbour.com/index.php.
3. https://www.difc.ae.
4. http://www.qfc.qa/en/Pages/default.aspx.
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6. http://www.kafd.com.sa/sites/en/Pages/default.aspx.
7. http://www.aifc.kz.
8. www.qfc.qa/Pages/qfc-home.aspx.
9. *See*, http://www.complinet.com/qfcra/display/display.html?rbid=1557&element_id=3 for details.
10. Article 121.
11. *Application of English Law Regulations* 2015.
12. *DIFC Law on the Application of Civil and Commercial Law in the DIFC* Article 8(2)(e).
13. Articles 11 and 18 of the Qatar Financial Centre Law.
14. Article 3(2) of the UAE Federal Law 8 of 2004 Regarding the Financial Free Zones, Dubai Law No (9) of 2004 Article 13, Abu Dhabi Global Market Law Article (22)7.
15. Volume 14, No.7 480.
16. *See*, in particular, *Application of English Law Regulations* 2015 section 4 and *Trusts. (Special Provisions) Regulations* 2016.
17. *Application of English Law Regulations* 2015, Article 4.
18. *QFC Trust Regulations*, Article 23.
19. *DIFC Trust Law* 2018 Article 36.
20. *See* e.g. https://www.bloomberg.com/news/articles/2017-09-19/dana-gas-faces-700-million-sharia-fight-with-goldman-blackrock.

David Russell, Co-chair of the UAE Chapter of the International Section of the New York State Bar Association.

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530 East 76th Street
Apt. 27CD
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stesq17@hotmail.com

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Thevenin Arbitration & ADR, LLC
New York, NY
nancy.thevenin@theveninarbitration.com

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45 Rockefeller Plaza
New York, NY 10111
gzeballos@bakerlaw.com

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pmfrank@hodgsonruss.com

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AllenEKaye5858@gmail.com

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Sullivan & Cromwell LLP
125 Broad St.
New York, NY 10004
omerc@sullcrom.com

Neil A. Quartaro
Watson Farley & Williams LLP
250 West 55th Street
New York, NY 10019
nquartaro@wfw.com

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JSafer@WMD-LAW.com

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fberbinau@bfpl-law.com

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rosenbergm@sullcrom.com

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Montreal, QC H3B 3V2, Canada
slapierre@stikeman.com

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dpm@hrfmlaw.com

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rosenbergm@sullcrom.com

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Baker & McKenzie
Schottenring 25
1010 Vienna, Austria
filip.boras@bakermckenzie.com

Delegates to House of Delegates
Nancy M. Thevenin
Thevenin Arbitration & ADR, LLC
New York, NY
nancy.thevenin@theveninarbitration.com

Neil A. Quartaro
Watson Farley & Williams LLP
250 West 55th Street
New York, NY 10019
nquartaro@wfw.com

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Gerald J. Ferguson
BakerHostetler
45 Rockefeller Plaza
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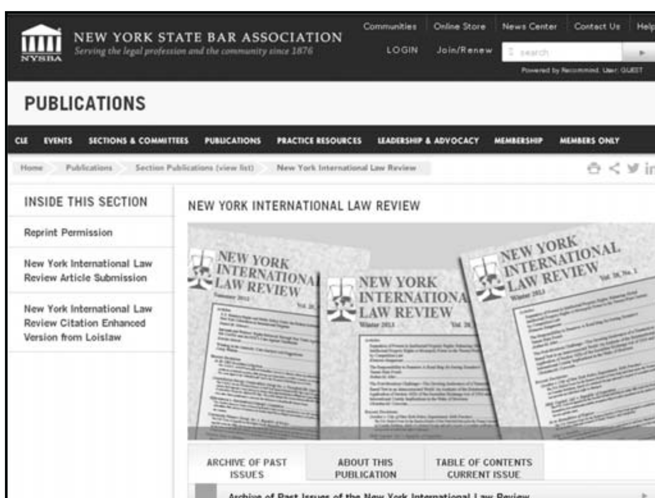

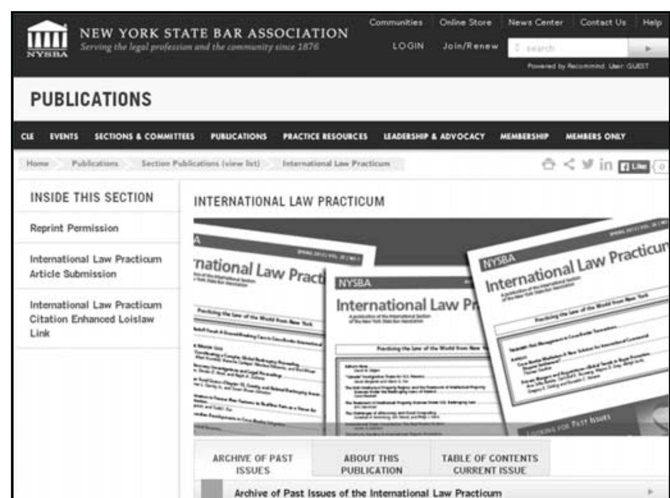

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Please submit articles for consideration to Torsten Kracht at tkracht@hunton.com. Chapter News articles should be submitted to Dunniela Kaufman at dkaufman@ cdntradelaw.com.

Executive editor: Andria Adigwe (aadigwe@hhk.com)

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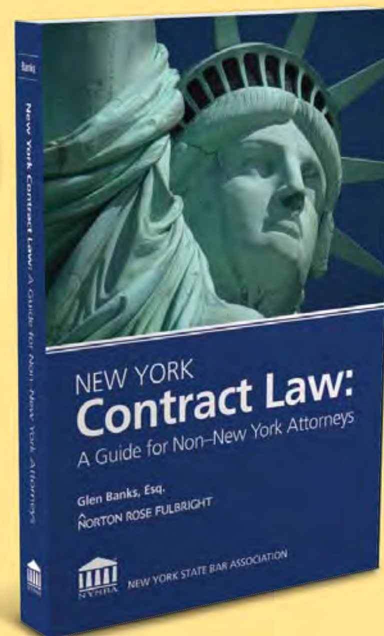

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