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Deciphering cryptocurrencies

A global legal and regulatory guide

Chapter 3: The legal nature of cryptocurrency



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Deciphering cryptocurrencies

Overview

Use of, and interest in, cryptocurrencies and the technology which underpin them has grown substantially in recent years. There has been wider acceptance of cryptocurrencies as a payment mechanism and the underlying decentralised public ledger technology has been applied to an increasing number of areas outside of virtual currencies. This has cemented interest in its potential as a disruptive technology. There has also been significant growth in investment in businesses operating in this sector and increasing interest from financial institutions in the technology and its potential.

Against this backdrop, a number of regulators have been focusing on the benefits, challenges and risks posed by the technology and how it fits within the existing legal and regulatory framework. In addition, a number of regulatory initiatives have been announced across the globe and a patchwork of legislation and regulation has begun to emerge.

In view of these developments, Norton Rose Fulbright's global cryptocurrency team has produced a guide to the legal and regulatory framework within which cryptocurrencies and their underlying technology operate.

The guide will be published in a series of chapters:

Introduction to cryptocurrencies

Insuring cryptocurrency risks

The legal nature of cryptocurrency

Taxation of cryptocurrencies

Cryptocurrency litigation risks

Taking security over cryptocurrency

Cryptocurrencies – crime and compliance

Regulation of cryptocurrencies

We hope that you will find this month's chapter on 'The legal nature of cryptocurrency' insightful and would welcome the opportunity to discuss any aspect with you in greater detail.

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July 2015

Chapter 3: **The legal nature** **of cryptocurrency**



Introduction

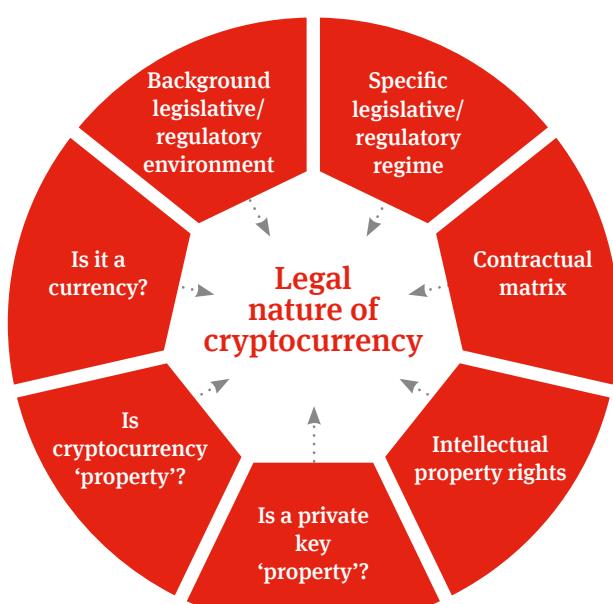
The legal nature of cryptocurrency is, in most jurisdictions, yet to be determined by statute, regulation or case law. In the absence of statutory or regulatory authority addressing the issue, how are the courts likely to analyse the legal nature of cryptocurrency?



Under many common law jurisdictions, the legal nature of cryptocurrency is likely to be a corollary of what legal rights and obligations can be asserted in relation to it, and by and against whom (the position in the case of civil law jurisdictions may differ). What factors are likely to be relevant to the courts in determining such rights and obligations? They might approach the issue in a number of ways.

For example:

- 01 | is the background legislative or regulatory environment within which cryptocurrency operates relevant in determining its legal nature?
- 02 | will the courts analyse the legal nature of cryptocurrency by reference to a matrix of contracts that might exist between stakeholders in a cryptocurrency transaction?
- 03 | are intellectual property rights relevant in analysing the legal nature of cryptocurrency?
- 04 | is a private key ‘property’?
- 05 | is cryptocurrency ‘property’?
- 06 | is cryptocurrency a currency?



This chapter considers how the courts might analyse these issues. They would not do so in a vacuum devoid of facts. It is important, therefore, to be mindful of the fact that much could well turn on a factual analysis of the particular transaction (and type of cryptocurrency) at issue.

01 | Is the background legislative or regulatory environment within which cryptocurrency operates relevant in determining its legal nature?

It is entirely possible that the courts of a particular jurisdiction could be called upon to consider the relevance of the legislative or regulatory environment within which cryptocurrency operates, even if there is no enactment providing specifically for cryptocurrency.

In *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10 the English High Court decided that a claimant, who had lost greenhouse gas emission allowances (EUAs) under the EU Emissions Trading Scheme (EU ETS) as a result of a phishing e-mail attack by a third party, was entitled to judgment against a defendant who had innocently received the EUAs and paid a fraudulent third party for them.

The court decided that EUAs were a species of intangible property and that the claimant had a proprietary restitutionary claim at common law and a personal claim in equity against the defendant (who had failed to carry out adequate ‘know your customer’ due diligence procedures).

Key to the court’s decision in characterising the EUAs as a species of intangible property was the fact that they operated within a statutory framework that regulated them and conferred certain rights in respect of them.

The case is not authority for the legal nature of cryptocurrency. At best, it is an example of how the courts in common law jurisdictions might be willing to characterise something as attracting proprietary rights by reference to a specific statutory or regulatory framework. (The courts in civil law jurisdictions could well take a different approach.)

Of course, if legislation were enacted or regulation passed in a particular jurisdiction that dealt specifically with cryptocurrency, the courts would naturally take account of that legislation in determining its legal nature. The legislatures of some jurisdictions have already started down this path in providing for certain aspects of cryptocurrency (which will be covered in the later chapter on Regulation of cryptocurrencies).

02 | Will the courts analyse the legal nature of cryptocurrency by reference to a matrix of contracts that might exist between stakeholders in a cryptocurrency transaction?

The existing case law in many jurisdictions is littered with instances of the courts determining rights and obligations between parties based on findings that contracts exist within a given set of facts. It is entirely possible that the courts might attempt to analyse a particular cryptocurrency transaction in such a way.

An acquisition and disposal of the relevant cryptocurrency may occur following the conclusion of a contract for purchase between the relevant parties (say, a customer and trader). If the trader’s terms and conditions for a purchase contractually regulate payment, a court might analyse the cryptocurrency transfer according to those terms.

However, a contractual analysis might also be relevant in relation to other interactions connected with a cryptocurrency transfer (such as those with a cryptocurrency miner). It is possible that a court might look at the transaction in the round, and consider whether a matrix of separate contracts (potentially with different parties) regulates the position.





Until resolved by statute, regulation or case law, sellers or service providers who accept cryptocurrency payments should use their terms and conditions of sale to define the circumstances in which the obligation to pay would be discharged by tendering cryptocurrency (and how refunds would work in that context).

03 | Are intellectual property rights relevant in analysing the legal nature of cryptocurrency?

A banknote is a piece of paper and a denomination of currency. There may be intellectual property rights in relation to the banknote (for example, copyright in pictures appearing on it), but the value of the banknote lies in the fact that it is accepted as legal tender, not because of its intrinsic value as property or because intangible rights (such as copyright) might vest in it.

There is published legal commentary examining whether intellectual property rights might confer a legal basis for analysing the legal nature of cryptocurrency. For example, the key pairs could be analysed in terms of whether they constitute copyright works. Like the banknote, however, the fact that copyright (or other intellectual property rights) may reside in key pairs does not equate to value in the currency at issue.

04 | Is a private key ‘property’?

A private key in a key pair is typically a 256-bit number which can be expressed in a number of ways (for example, in different numerical bases). Ultimately, it is data. There is English authority for the view that information is not of itself property:

- in *Oxford v Moss* [1979] Crim L R 119 a student obtained an original of an examination paper for an examination he was later due to sit. The student was prosecuted for theft on the basis that he had stolen confidential information. The court acquitted the student on the basis that the information was not property, and therefore could not be stolen
- the English Court of Appeal has held that databases (a form of information) are not tangible property to which a lien may attach (*Your Response Ltd v DataTeam Business Media Ltd* [2014] EWCA Civ 281)
- other case law suggests that a key as an electronic data file (as opposed to the physical medium on which the file is stored) would not constitute property. For example, software is not ‘goods’ for the purposes of the Sale of Goods Act 1979 (*St Albans City & District Council v International Computers Ltd* [1996] 4 All ER 481). Under the UK’s Consumer Rights Act 2015 the position is now ameliorated in respect of consumer protection applicable to digital content, as the Act confers on consumers many protections similar to those applicable to goods.

A wider view of data

Under English law there is, however, a tort of misuse of private information in the data protection context (see *Google Inc. v Judith Vidal-Hall and others* [2015] EWCA Civ 311), and other jurisdictions may sometimes take a wider view in relation to information and data more generally. For example:

- electronic data and other information has been held under U.S. law to constitute intangible property. It is possible to bring a conversion cause of action, for example, in relation to misappropriation of electronic information (see *Thyroff v Nationwide Mut. Ins. Co.*, 864 N.E.2d 1272 (N.Y. 2007)). However, other U.S. courts (for example, Illinois) have found that digital information is not a chattel and could not support a trespass to chattel claim (*Ogbolumani v Young*, 2015 IL App (1st) 141930-U (Ill. Ct. App. Mar. 20, 2015))
- in South Africa, the law recognises proprietary rights in information itself (commonly asserted contractually specifically in relation to confidentiality). In terms of South African consumer protection legislation, the definition of ‘goods’ includes ‘information, data, software, code or other intangible product written or encoded on any medium’.



While such case law suggests that information or data constituting a private key in a cryptographic key pair could potentially be protectable as property in some way in some jurisdictions, there are also some countervailing arguments.

The person who has exclusive possession of the private key of a cryptographic key pair does so to the exclusion of all others. A comparable situation is the status of passwords and security codes for bank accounts. In order to authorise a transaction, a bank customer requires a password and security code.

It would be surprising if the courts were to regard a bank customer's password or security code as itself amounting to a species of property. It simply provides authentication for the requested transaction (effectively the transfer of a chose in action in favour of the customer to another person).

While a court may be tempted to come to a similar conclusion in the case of a private key relating to cryptocurrency, there are some characteristics that differentiate a cryptocurrency private key from bank account passwords and security codes.

For example, a bank may hold a record of passwords and security codes, and it can operate a bank account independently of a customer (for example, by transferring money out of an account). This is in contrast to the position of a cryptographic private key of a key pair, which is in the exclusive possession of the owner of the cryptocurrency.

05 | Is cryptocurrency 'property'?

While a private key in a cryptographic key pair may be constituted by information or data that is (under the case law of some jurisdictions at least) potentially protectable as property, does that mean that the courts will treat cryptocurrency itself as property?

Although the New York (such as *Thyroff v Nationwide Mut. Ins. Co.*) and South African case law mentioned above potentially leaves the door open for this conclusion, there is

English judicial authority to the effect that, before a right or an interest can be regarded as 'property', or of a right affecting property, it must be definable, identifiable by third parties, capable in its nature of assumption by third parties and have some degree of permanence or stability (*Lord Wilberforce in National Provincial Bank v Ainsworth* [1965] 1 AC 1175 at 1247- 8).

In *Armstrong DLW GmbH v Winnington Networks Ltd* [2012] EWHC 10, the English High Court held that an EUA was 'property' because it was:

- definable, as being the sum total of rights and entitlements conferred on the holder pursuant to the EU ETS
- identifiable by third parties. It had a unique reference number
- capable of assumption by third parties, because under the EU ETS an EUA was transferable
- permanent and stable, since it continued to exist in a registry account until it was transferred out either for submission or sale and was capable of subsisting from year to year
- operating within a statutory framework.

Cryptocurrency shares some of these characteristics but clearly not all of them (e.g. it does not operate within a statutory framework, at least in the UK). In civil law jurisdictions other factors may also be relevant.

What, then, can be taken from all this?

While the case law in at least some common law jurisdictions might suggest that a cryptographic private key of a key pair could potentially be property, the status of cryptocurrency itself as property remains unclear.

06 | Is cryptocurrency a currency?

One factor that a court might take into account in determining the legal nature of cryptocurrency is whether it operates as a currency in the relevant jurisdiction. That question is problematic, since there is no globally-recognised standardised definition of ‘currency’ or indeed ‘money’.



However, meeting these economic conditions does not mean that a cryptocurrency will necessarily be regarded as money for legal or regulatory purposes. Market studies have revealed that digital currencies are in practice treated as money only to a limited extent, and by relatively few people (who primarily view them as a store of value rather than as a medium of exchange or a unit of account).

Characteristics of standard currencies

It may be helpful to consider the ways in which a cryptocurrency shares commonly identified features of ‘standard’ currencies. In order to achieve widespread acceptance and a stable store of value, currencies tend to display most (if not all) of the following general characteristics:

- ✓ they are thought of as a series of claims or ‘IOUs’
- ✓ they are generally protected by extensive regulation
- ✓ they are usually recognised as ‘legal tender’
- ✓ the government is usually obliged to accept them for tax payments
- ✓ they are subject to banking system regulations
- ✓ they are routinely used for banking and saving and are backed by the safety net of a deposit guarantee scheme
- ✓ they are subject to government and central bank control with a view to satisfying monetary policy objectives.

Characteristics of a cryptocurrency

A cryptocurrency is a form of digital currency and, as such, is considered to be a representation of value that, in different circumstances, can display key functions of money as:

- ✓ a medium of exchange with which to make payment; and/or
- ✓ a unit of account in which debts and liabilities are expressed; and/or
- ✓ a store of value or purchasing power.

Standard currencies versus cryptocurrencies

A key distinction between ‘standard’ currency and digital currencies is that banknotes or bank deposits are thought of as a debt claim or liability of the central bank. In contrast, a digital currency is not a claim on anybody. It may have more conceptual similarities to commodities, such as gold, than currency. However, unlike physical commodities, digital currencies are thought of as intangible assets or digital commodities.

In the United Kingdom, a digital currency does not have the status of ‘legal tender’ (i.e. when tendered to a creditor, legal tender may be accepted without question as to its validity in final discharge of a debt), and its creation does not have the same extensive regulatory protections and restrictions that apply in relation to the pound sterling.

This is similar to the position in a number of other jurisdictions. For example, in South Africa:

- only the South African Reserve Bank has the authority to issue legal tender and the definition of legal tender does not include digital currencies
- the South African Reserve Bank has observed that cross-border transfers of digital currencies are not subject to the Exchange Control Regulations, 1965 and do not fall within the jurisdiction of their Financial Surveillance Department.

Unlike money held on deposit or on trust (e.g. client money), digital currency values held by intermediaries are not currently protected under the UK’s statutory compensation fund for customers of authorised financial services firms (the Financial Services Compensation Scheme).



Nevertheless, in recognition of the increasing risk that illicit digital currency use poses to the integrity of the UK financial system, the UK Treasury recently announced the government's intention to apply anti-money laundering regulation to digital currency exchanges in its March 2015 Budget. The United States has already taken that step (which will be covered in the later chapter on Regulation of cryptocurrencies) but the regulators in many other jurisdictions have yet to do so.

The view from the EU

The question of the nature of Bitcoin is the subject of a case currently being considered in the Court of Justice of the European Union, which will rule on the liability to VAT of Bitcoin exchanges (*Skatteverket v David Hedqvist*, Case C-264/14). The Advocate General delivered her conclusions in July 2015, taking the view that the exchange of Bitcoin for traditional currencies is exempt from VAT as a result of article 135(1)(e) of the 2006 VAT Directive.

In reaching this view, the Advocate General accepted that Bitcoin is a currency, and relied upon the principle of fiscal neutrality to conclude that exchanges of Bitcoin should not be taxed less favourably than exchanges of legal tender.

The Advocate General's opinion will surprise a number of European tax authorities. The UK tax authority's guidance (published on 3 March 2014) takes different approaches to the classification of Bitcoin for taxes on income and capital gains compared with VAT. For income and capital gains taxes, the UK accepts that Bitcoin is a currency. This contrasts with the VAT position, where the basis for concluding that exchanges of Bitcoin should be exempt is less clear. This difference may result from the UK tax authority taking the view that the 'currency' exemption in article 135(1)(e) should only apply where both currencies being exchanged are legal tender.

The view from the US

In the United States:

- the federal tax authority (the Internal Revenue Service) issued Notice 2014-21 on 25 March 2014, which states, for U.S. federal tax purposes, that 'virtual currency is treated as property'
- the chairman of the Commodity Futures Trading Commission (which regulates the US futures and swaps markets) has noted that its authority extends to futures and swaps contracts in any commodity – which includes currencies – and accordingly derivative contracts based on virtual currencies fall within its responsibility.

Conclusion

Despite these various early regulatory indications and positions, in practice the function of cryptocurrency as a currency remains unclear in most jurisdictions. Unless it becomes a widely accepted and stable store of value, or the matter is put beyond doubt by the courts, statute or regulation, it seems that the question whether cryptocurrency more closely resembles a private currency or a digital commodity will remain.

Legal nature of cryptocurrency: an issue in a number of contexts

In the absence of legal authority prescribing the legal nature of cryptocurrency, any analysis at this point can only be conceptual. It is, however, potentially an issue in a number of different legal contexts, and for this reason we return to it in subsequent chapters, including the following:

- Cryptocurrency litigation risks
- Taking security over cryptocurrency
- Regulation of cryptocurrencies.

If you have not already registered and would like to receive the subsequent chapters, please contact julie.frizzarin@nortonrosefulbright.com

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