CRYPTO NEEDS COMMON SENSE FINANCIAL REGULATION – SUGGESTIONS FOR 2022

BY
SEAN STEIN SMITH

Professor, City University of New York – Lehman College.

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By Sean Stein Smith

While the blockchain and cryptoasset sector has continued to grow, mature, and expand at a rapid rate, the regulatory outlook has simply not kept pace. In almost every market where cryptoassets have become more mainstream there are substantial questions regarding how these assets should be taxed, valued, and treated from a financial reporting standpoint. Written with both policymakers and practitioners in mind, this research seeks to both identify the open questions with regards to cryptoasset integration as well as propose potential solutions to these issues. In addition, this piece provides action steps and processes for policymakers - regardless of geographic location - to develop a commonsense regulatory framework for cryptoassets moving forward.

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INTRODUCTION

As 2022 gets underway, and the true implications of the rapid proliferation of cryptoassets the world over in 2021 becomes more understood, the following implication should be clear. Regulation, and regulatory frameworks, must evolve to keep pace with the rapid changes that have emerged in the various aspects of the crypto ecosystem. This does not mean, nor recommend, that regulatory frameworks should be constructed hastily, nor should they be implemented with an eye toward squashing or limiting innovation. Innovation and competition, in whatever industry is being analyzed at the moment, invariably leads to better results for the individuals and institutions involved in this sector.

Attempts to artificially limit or curtail the proliferation and development of blockchain based products and services are already being observed as stop-gap solutions – which will be discussed in more detail further along in this piece. Instead of seeking to control a global and decentralized industry, appropriate and reasonable regulation will seek to foster a business landscape with novel solutions that can be tested, developed, and improved in an iterative feedback loop.

Generally speaking, the less regulation and direct oversight that regulators and policymakers have and exercise over a specific industry, the healthier and more competitive that industry ends up becoming. This is not to say that regulations are not necessary. Quite to the contrary, reasonable, flexible, yet robust rule-making is imperative to the healthy maturation of any economic sector. Free market competition and the diversity of ideas, products, and services that such competition creates have led to improvements and higher quality experiences in virtually every asset category.

On the other hand, there have been multiple examples – as would occur in any industry or economic sector that has grown from nothing to over $3 trillion in just over a decade – of fraud, scams, and other unethical activities. That is to say that while the best approach to regulation and oversight is, and will continue to be, a relatively lighter and more accommodative touch this is not the universal answer. Rather, on the other hand, it is reasonable to expect, and would be naïve to think otherwise, that increased regulation and scrutiny is coming to this space.

The critical factor will be how well this regulation allows continued innovation and creativity while also protecting the investors and organizations involved. In other words, the balance between regulation and innovation must be integrated into every policy decision regarding blockchain and cryptoassets.

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PURPOSE OF REGULATION

Prior to diving into specific examples or recommendations for how blockchain and crypto regulation should be developed it is worth briefly revisiting what the primary drivers and intents of regulation usually are. Firstly, there are legal requirements and obligations that all organizations must be able to comply within every jurisdiction, especially since cryptoassets represent a truly decentralized and distributed industry. Whether these be reporting, accounting, tax, or other disclosure obligations connected to environmental, social, or governance issues the importance is the same. Legal compliance is the core many regulations. Secondly, consumer protection and the enforcement of investor rights is a common theme underlying many regulatory measures.

For example, the Consumer Financial Protection Bureau ("CFPB") in the United States has enforcement and compliance powers directly connected to enforcing the rights of individual consumers in various aspects of financial transactions. Investor protection is also at the center of the mandate of the Securities and Exchange Commission ("SEC"), arguably the most powerful financial markets regulator in the world. One final aspect of regulation and regulatory measures is connected to what types of actions or enterprises will be actively encouraged or discouraged.

For example, certain and tax and regulatory positions – accelerated depreciation or favorability deductibility of interest expense – have been overtly developed to encourage certain types of behaviors over others. This is mirrored in the current treatment of cryptoassets in the United States (and other jurisdictions), where every transaction or exchange involving cryptoassets – except direct purchases of crypto with fiat currencies. This taxation treatment limits the utilization of crypto as a medium of exchange, and instead continues to push crypto toward treatment as an investable asset.

All of that said, it is also worth noting that the somewhat benevolent nature of regulation can oftentimes be overshadowed by the politics of the moment in certain jurisdictions. No country or region is exempt from this influence, but this political influence and impact can also be harnessed in a positive manner. Let us now look at some high-level examples of regulatory efforts that have sought to either actively encourage the usage of cryptoassets or drive the sector to the fringe thanks to ill-conceived and poorly executed initiatives.

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EXAMPLES GOOD AND BAD

Regulation, as noted above, is a multi-faceted and complicated endeavor that is difficult to get right even under the best of circumstances. Given that blockchain and cryptoassets still represent relatively new technologies that remain only tangentially understood by the mainstream marketplace the risk of inappropriate regulation remains high. Mainland China has seemingly tried to lead the way in term of developing and enforcing onerous regulatory and compliance-based standards. Examples of these efforts include, but are not limited to, the following. Several efforts, including the shutting off of electricity to crypto miners, have been implemented in an attempt to forcibly close down the bitcoin (and other) crypto mining industry in the nation. In addition, several efforts, and pronouncements from the People's Bank of China ("PBoC") have banned the holding or trading of bitcoin and other cryptoassets since 2017. In addition to these headline efforts, Chinese nationals – even those located overseas – are effectively legally banned from owning any cryptoassets.

Interestingly, the efforts and initiatives to ban or limit other crypto have seemed to coincide with the development and subsequent implementation or the E-CNY or crypto-yuan. This central bank digital currency ("CBDC") is directly issued and managed by the PBoC. This CBDC was used by over 140 million people in the country during 2021, and while usage has remained primarily domestic to date, the PBoC is actively and persistently seeking to have other countries and organizations utilize this cryptoasset.

Several other nations have completely banned cryptoassets, while many other have made operating private cryptoassets a complicated and onerous basis. This often coincides with government pronouncements or developments of a nationally issued cryptoasset, indicating a robust understanding of the opportunities provided by this technology. At the same time, many of these same nations have implemented various levels of bans and restrictions on both blockchain trading and mining, as well as limiting the ability of individuals and organizations to own or trade individual cryptoassets.

Ultimately, these efforts will most likely be uncovered to be either 1) short-sighted attempts to prevent disruption or innovation by incumbent financial institutions, or 2) present a back-door opportunity for central governments or other such institutions to develop and implement their own centralized alternatives in the meantime. Regulation over a fast moving and still-evolving economic sector is bound to be complicated, but should not be heavy-handed nor targeted specifically toward private market options.

On other hand, however, there are several notable examples in the United States – not at the federal by rather the state and local levels – where creative and forward-thinking leaders have fostered adoption of, and investment in, blockchain and cryptoassets. Notably these efforts and initiatives have focused not only on the financial sector, but have also integrated various legal, payment, and compliance aspects into these conversations. Such an approach reflects the reality that blockchain and cryptoassets are not solely concentrated around financial services or any one other specific area.

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Wyoming is perhaps the most noteworthy example of a state that has wholeheartedly embraced blockchain and cryptoasset innovation. Beginning with efforts in 2017, the state eventually wrote and passed over a dozen blockchain specific laws that firmly integrated the technology and cryptoasset class into the business landscape and economic outlook of the state. Specifics of these laws include the development of a new banking institution designed specifically to conduct transactions in cryptoassets, the ability of firms to use blockchain as a definitive corporate proof of ownership and record keeping for stock and other financial instruments, and the authorizations of decentralized autonomous organizations "DAOs") to operate freely within the state. It is true that the DAO cannot operate in a truly decentralized manner, and must have an individual identified and registered as the representative of the firm for business filing purposes, this does represent a tremendous step forward.

More recently, specifically in 2021, a recent development around the intersection of public sector interest and investment in cryptoassets intersected with continuing private sector innovation; the CityCoin initiative.

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CITYCOINS

The development and implementation of the CityCoin initiative at several major metropolitan centers in the United

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States, notably Miami, Austin, and New York City, also serves as a potential example and framework for other areas and jurisdictions to emulate moving forward. Prior to discussing the benefits and positives of such a framework it seems appropriate to examine just what this concept is, what it potentially represents, and what some of the challenges of this concept might end up being.

On the surface the idea of the CityCoin project is to attempt to link together the financial rewards and benefits of cryptoassets – notably the ability to mine or mint new cryptoassets, and the projected ability to benefit from both increases in price as well as the income able to be derived from these endeavors. Drilling down a little deeper the project itself does not involve bitcoin or any of the other cryptoassets that tend to make headlines and draw attention. Rather, the primary coins used – to date – in these initiatives are the STX tokens native to the Stacks blockchain. Stacks is not a corporation per se, but instead of a community of developers and individuals who have agreed to collaborate on the CityCoin initiative with metropolitan areas.

How this process works, without getting lost in the technical weeds of any other specific project is that the protocol running on the Stack blockchain – bitcoin adjacent but not the bitcoin blockchain – mines the STX tokens. After this mining process is complete a preset percentage, currently approximately 30% is held in reserve for the city in question. Once the vesting period, or whatever predetermined period, has passed the city then has access to these funds and can do with them what they wish. Options include immediately liquidating these STX tokens for cash, converting the STX tokens into other cryptoassets, or reinvest the token into some alternative project such as a decentralized finance (“DeFi”) initiative.

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ACTION STEPS FOR A FRAMEWORK

Implementing a comprehensive regulatory and tax framework for cryptoassets is never going to be a simple or straightforward, and proceeding otherwise is simply setting up the project for failure before it even starts. Cryptoassets, by their very nature, represent unique and decentralized financial instruments that do not always comply with well-established norms or standards in the financial marketplace. In other words, attempting to fit the round peg of cryptoassets into the square hole of traditional financial instruments is simply not going to work, and just result in frustration on all sides. Rather, and an approach that seems to be taking hold in some corners of the regulatory world, is that innovative and creative solutions to these regulatory issues and open items should be presented. Clearly every jurisdiction is going to operate differently, and every cryptoasset should be treated as the differentiated asset that it is, but there are several common themes that can should be incorporated into how these frameworks are developed and put into place. Without seeking to present an all-inclusive listing, these factors should instead be viewed as a starting foundational point for future conversation.

Firstly, any well thought out regulatory framework needs to be the result of a collaborative effort between the public sector and private sectors. CityCoins, referenced above, seems to be a good example of such a collaborative effort. Wyoming is also an example as to how legislatures can coordinate efforts with other policymakers and learn from private sector participants. It is important to note that collaboration is a buzzword and term that is often overused and not terribly well understood. For any frameworks or policies to 1) be developed in the first place, 2) operate and have the intended effect, and 3) be able to survive and maintain effectiveness into the future, regulation needs to be treated as an iterative process. Especially since the blockchain and cryptoasset sector is still emerging and fast-moving, the need for flexibility and iterative improvements are critical for policy success.

Secondly, and an approach that can borrow from existing regulatory experiments is the idea of a sandbox; a selected and separate area within which organizations can develop and implement new types of operations without necessarily having to be in full compliance with regulatory obligations. Sandboxes have been used to great effect across a number of emerging technologies and applications, and there is no reason why blockchain and cryptoassets should be treated any differently. For example, regulators could seek to implement crypto payment options for certain local organizations, waive local and state taxes on cryptoasset transactions, or introduce other incentives to assist businesses seeking to start accepting payments denominated in cryptoassets.

Thirdly, how will this regulatory structure evolve – and have the capacity to evolve over time. It is no secret that cryptoassets represent one of the most dynamic and quickest moving economic sectors in the global economy today. In 2020 and 2021 alone the innovations of decentralized finance, non-fungible tokens, and central bank digital currencies all moved from conceptual or fringe ideas to topics that have rapidly moved into the mainstream financial market conversation. Given this accelerated pace of change, which shows no sign of dissipating or slowing down in any way, it seems logical to expect any rules or plans for regulation instituted at this time to invariably require updates along the way.

Now, let’s pivot to specific considerations for policymakers seeking to further integrate blockchain and cryptoassets into municipal and other operations. Clearly, every cryptoasset will need to be assessed on its individual merits,

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but these are general considerations that should form the basis for future conversations and debates.

What cryptoassets will be integrated into the plan in the first place? The sheer array of cryptoassets that have been developed just in the last several years is astounding to think about, so this is an important aspect of any broader regulatory conversation. CityCoins provides an interesting template and example that others could potentially follow, but is just one option that should be assessed.

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Decentralized finance applications – from staking to yield mining to providing liquidity for liquidity pools – also seem to hold significant promise. Regardless of the item selected there are a few additional items that need to be designed and implemented as a part of this process.

1) How will taxpayers and residents of the city, state, or nation be able to access the cryptoassets in question? Or, conversely, is there going to be any restriction as to who can participate in these transactions? In other words, will a cryptoasset in question actually be limited to a certain set of individuals, or will anyone be able to participate in these transactions.

2) Is there a process in place to deal with volatility, especially for cryptoassets that achieve increasingly mainstream adoption and utilization? Stablecoins and other cryptoassets might not possess the high levels of volatility commonly associated with bitcoin, but the risk and potential for volatility still certainly exist. Especially since the entire conversation around crypto policy and policy frameworks are still relatively new, it seems prudent to establish such a plan.

3) Will cryptoassets be exempt for local and other types of taxation? The tax issues that complicate the cryptoasset conversation will not be solved or addressed in any one policy proposal or framework, but there is one simple tactic that can be implemented. Building on the sandbox idea mentioned previously, eliminating, or reducing certain local or transactional (such as VAT) is a method that can be implemented to reduce the friction associated with using cryptoassets for transactional purposes.

An additional facet that should be implemented into the policy conversation is whether the jurisdiction in question will tolerate an array of cryptoassets. For example, and illustrative of the array of options that currently exist – how will the tax and other regulatory issues impact the future development of blockchain and cryptoasset development?

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TAX AND GLOBAL IMPLICATIONS

One aspect of regulation that should be assessed and needs to be incorporated into any regulatory framework of action plan is the impact of tax treatment and the global impact of tax regimes on the development of cryptoassets. Taxes are almost always a complicated and multifaceted issue, and cryptoassets are not exempt from these issues. Rather, and illustrated by the current treatment of cryptoassets, the differences in tax policies can have a significant influence over the specific sector develops and evolves moving forward. It is important to link back to both earlier points raised in this piece as well as the underlying idea of cryptoassets in the first place.

Cryptoassets were, and by many still are, intended to be used as a transactional medium of exchange for both domestic and international transactions. Taxation, and specifically taxing cryptoassets at every point in time that a transaction occurs, will ultimately undermine this use case, and make it more difficult to have this concept manifest into reality. The discussion around tax policy and regulation is fay beyond the scope of this – or any other singular article – but is something that needs to be factored into the broader policy conversation. Stated simply, if cryptoassets are going to emerge as a transactional tool, tax treatment and regulation will need to become more nuanced to keep pace with the development of the marketplace.

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CONCLUSIONS

Regulation and policy decision making are invariably going to be an ongoing and complicated topic as adoption and integration of blockchain and cryptoassets continue to become an increasingly mainstream financial tool. Effective policy and rule-making processes will need to reflect the fast changing and evolving nature of the blockchain and

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cryptoasset sector; new iterations of applications continue to be introduced and implemented on an almost continuous basis.

With these new applications, however, will invariably come an array of regulatory, reporting, and financial reporting challenges that will need to be effectively addressed. Regulation and policy frameworks will also need to, on top of the specific policy actions taken, need to factor into the competitive implications of how policy decisions and actions impact the broader ecosystem at large. Blockchain and cryptoassets represent an innovative and dynamic technological sector, and have already created multiple advancements in terms of technical development and financial wealth creation.

Successfully shepherding this fast-growing space to a more mature position in the marketplace, and doing so in a manner that is dynamic and inclusive, is a responsibility that policymakers should be taken seriously. A complicated task to be sure, but a challenge that must be proactively addressed in a proactive way, utilizing best practices that already exist as well as thinking of new ways to effectively lead this space forward.

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