Digital Currencies: Taming an Unpredictable Market

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On 22 February 2018, the Treasury Committee launched a new inquiry into digital currencies and distributed ledger technology. Digital currencies such as Bitcoin – often known as cryptocurrencies – are digital tokens which allow the transfer of funds in a secure and anonymous way, independent of a government or central bank. In recent years, the market for cryptocurrencies and the associated blockchain technology has been in a state of constant flux, developing at such a rapid pace that scarcely a day passes without new developments.

Cryptocurrencies, unlike more "traditional" asset classes such as shares and bonds, are an entirely unregulated market. There are no laws surrounding their creation, registration or trading, no regulatory oversight and no real transparency to the inner workings of the market. This has, understandably, raised myriad concerns with regulators and enforcement agencies across the world, and different jurisdictions have so far reacted in different ways. Switzerland, for example, has demonstrated its keenness to be at the forefront of not only regulation but of technical innovation, issuing guidance for companies hoping to issue an initial coin offering in the jurisdiction.[1] The US, meanwhile, is taking a slightly more cautious stance, and has indicated that cryptocurrencies should, where appropriate, be regulated as securities.[2]

It cannot be denied that there is a need for regulation in this area. By launching its inquiry, the Treasury Committee hopes to gain a better understanding of the role of cryptocurrencies and blockchain within the UK economy and its existing financial institutions and, crucially, to scrutinise the UK's regulatory response to this nascent yet highly dynamic market. It will seek to not only identify the risks posed by the market, but to consider how to legislate in such a way as to mitigate dangers while preserving innovation. Three areas of focus are likely to be consumer protection, anti-money laundering and market abuse.

Consumer protection

When it comes to cryptocurrencies, a crucial question that the Treasury Committee is likely to ask is: do consumers really know what they are buying, and understand the associated – and substantial – risks? Aside from the highly complex nature of the technology underpinning the industry, one need only look at the volatility in the market to consider that perhaps more stringent rules may be needed.[3] Often, consumers may simply not understand the full scale of the risks they are exposing themselves to in such a volatile and unpredictable market. Drawing a parallel with the stock market, listed companies have strict disclosure and reporting requirements for a very good reason: so that investors know what they are buying, can make informed decisions and try to predict which investments may prove fruitful. Cryptocurrencies have no such requirements, often leaving consumers with, at best, a misunderstanding and worst, misinformation as to what is involved.

Anti-money laundering

Another area of scrutiny for the Treasury Committee is likely to be the use of cryptocurrencies for money laundering. Criminals may take advantage of the anonymous nature of the blockchain to clean illicit funds before funnelling them back to the mainstream financial systems. Indeed, some UK banks have already refused to accept deposits of funds derived from the sale of cryptocurrencies for this very reason.[4] Anti-money laundering has been a recent area of focus for the FCA, with a key objective being to implement robust anti-money laundering processes across the entire financial system. The new inquiry provides a prime opportunity for consideration of how regulation of cryptocurrencies may fit into, and indeed contribute to, this wider goal.

Market abuse

A final area of consideration may be in the regulation of cryptocurrency trading itself. While mainstream markets are governed by a framework aimed at preventing market manipulation – in the UK, the main legislation is the Financial Services and Markets Act 2000 and the EU Market Abuse Regulation – there are, unsurprisingly, no such rules in place in the cryptocurrency market. This leaves the market ripe for abuse. Practices such as spoofing and wash trading, which would be deemed manipulative in mainstream markets, are allegedly widespread. This, in turn, distorts the true picture of how the market operates, linking back to the core idea of consumer protection and ensuring that consumers have a full understanding of what they are investing in. Regulation of trading must be a key part of the regulation of the market as a whole.

The future?

Naturally, the inquiry and any subsequent regulation of the industry will not be without its challenges. It is as yet unclear what regulation would actually look like. In such a dynamic and innovative industry, legislators must be alive to not stifling innovation with overly burdensome regulation. Indeed, harsh and restrictive legislation would likely not dampen activity in the market, but would merely drive it to other jurisdictions with more lax oversight, allowing potentially dangerous proliferation of problematic practices. In particular, regulators should be aware of the dangers posed by an increase in decentralised trading venues, which operate on a blockchain and entirely independently of a controlling company, and may elude traditional methods of regulatory oversight.

Perhaps one answer to this would be, initially, to approach regulation from a principles-based perspective. By putting in place a loose framework of guidance and broad principles, rather than a rigid system of rules, the UK could maintain an appropriate level of oversight while also allowing the market to develop naturally.

Of course, one major hurdle to be overcome is that, ultimately, the government is playing a game of catch-up in attempting to regulate what is already a relatively well-established, if unpredictable, market. There are already over 1500 cryptocurrencies in existence, some performing specialist functions beyond being a mere token of exchange, and over 100 unregulated exchanges trading billions of dollars every day. Bringing the market into line will be no easy feat.

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[1] https://finma.ch/en/news/2018/02/20180216-mm-ico-wegleitung/

[2] https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11

[3] To take but one example, the value of Bitcoin, the most famous cryptocurrency, lost almost 50% of its value in the early days of 2018 after reaching highs of over US $19,000 a mere four weeks prior.

[4] *Financial Times*, “Bitcoin investors struggle to cash out new fortunes”, 12 January 2018.

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