

# 10 Things Judges Should Know About CRYPTOCURRENCY

By Lee Reiners

**B**y now, you have probably heard of cryptocurrency and blockchain technology. Perhaps, however, you have found the topics impenetrable or doubted their relevance to the courtroom. But cryptocurrency is a growing force in our economy, and all of us — perhaps especially judges — should prepare for its effect on the law and our lives more generally.

The climate for cryptocurrencies and blockchain changed substantially in 2019, when Facebook — now Meta — announced plans to launch its own cryptocurrency, called Libra. The cryptocurrency sector has evolved rapidly since, raising novel legal and jurisdictional issues that judges across the country are grappling with. What follows are the basic details of what cryptocurrency is and how legal and regulatory frameworks are evolving to govern it.

## 1 To Understand Cryptocurrency, You Must Know the Origins of Money

Economists have long argued that money came about as a way to solve the hassles of bartering.<sup>1</sup> If one villager needed a pig for a feast, he could get it from another villager for four clay pots, or a different villager for ten pairs

of shoes. But constantly making mental calculations to determine the best value for a pig, or whatever else you wanted to acquire, was time consuming; money simplified the process.

The problem with this story is that it is simply not true.<sup>2</sup> In reality, these villagers knew one another; rather than exchange ten pairs of shoes for one pig, the villager who provided the pig simply took note of the contribution and that his fellow villager owed him something of comparable value. This is the same thing as credit, and the archaeological record reveals that credit systems of this sort “preceded the invention of coinage by thousands of years.”<sup>3</sup> Thus, money can be thought of as way to measure IOUs, or debt, and currency is simply what is used to clear credit accounts.<sup>4</sup> For the villagers, currency was not valuable in and of itself; rather, it was valuable because the recipient could exchange it to receive something of equivalent value to one pig.

So currency is simply anything that someone else will accept as payment. But how do you know that a specific currency will be accepted by a specific person, or that what you receive as currency from one transaction will work for your purchase in another? Enter the state, which has always had a vested interest in standardizing units

of measurements within its borders. The view that money derives its value from its status as state-backed legal tender is known as Chartalism; anthropologist David Graeber offered a simple hypothetical to explain the concept:

Say a king wishes to support a standing army of fifty thousand men. Under ancient or medieval conditions, feeding such a force was an enormous problem. Such a force would likely consume anything edible within ten miles of their camp in as many days; unless they were on the march, one would need to employ almost as many men and animals just to locate, acquire, and transport the necessary provisions. On the other hand, if one simply hands out coins to the soldiers and then demands that every family in the kingdom was obliged to pay one of those coins back to you, one would, in one blow, turn one’s entire national economy into a vast machine for the provisioning of soldiers, since now every family, in order to get their hands on the coins, must find some way to contribute to the general effort to provide soldiers with things they want. Markets are brought into existence as a side effect.<sup>5</sup>



In the mere acts of government spending and taxation, money is created. Because all citizens must pay taxes and thus share a common creditor, government-issued tokens can freely circulate as currency within the community. People are willing to accept these tokens as payment because they know that they can use the tokens to pay their obligations to the state — and to each other, too.

## 2 Bitcoin Overcame Geographic Limitations of Private Money

The first and most popular cryptocurrency, Bitcoin may rely on new *physical* technology, but money, fundamentally, is a *social* technology that originally allowed privately issued IOUs, or tokens, to circulate as a medium of exchange.

Returning to the villager in need of a pig: Rather than barter, the villager could issue an IOU to the provider of the pig, who could then claim the IOU at a future date and redeem something of equivalent value to one pig. As Felix Martin notes, “For sellers to accept buyers’ IOUs in payment, they must be convinced of two things.”<sup>6</sup> First, they “must have reason to believe that the debtor whose obligation they are about to accept will, if it comes to it, be able to satisfy their claim,” and, second, that “sellers must also trust that third parties will be willing to accept the debtor’s IOU in payment as well.”<sup>7</sup>

Naturally, these two conditions are easier to meet in close-knit societies where everyone knows one another. But token-based money breaks down once you start transacting with parties from outside your immediate geographic area, or if you live in a large enough city where it is simply impossible to know the creditworthiness of every IOU issuer.

# Cryptocurrency attempts to solve the geographic limitations of previous forms of token-based money by representing a new form of community made possible by the internet.

Cryptocurrency attempts to solve the geographic limitations of previous forms of token-based money by representing a new form of community made possible by the internet. Unlike IOUs of yore, cryptocurrency has no underlying debtor. Bitcoin is not issued; it is created using computer code and it exists as computer code. This computer code is open source and accessible to all; it cannot be changed unless a majority of the computing power on the Bitcoin network agrees to change it.

But if there is no issuer, then who, or what, are Bitcoin users trusting? Rather than trust a person, in real or legal form, Bitcoin’s revelation was its underlying blockchain technology — a shared online ledger that maintains “blocks” of data that can be recorded and distributed but not edited. Blockchain technology allows network participants “to trust the information recorded on a shared ledger without trusting anyone to validate it.”<sup>8</sup> Some have called this “blockchain trust,”<sup>9</sup> while others refer to it as “trustless trust.”<sup>10</sup> The end result is that, for the first time, a system exists that allows users to confidently transmit value without having to trust any other users of the system or any kind of central administrator.<sup>11</sup>

## 3 Cryptocurrency’s Properties Make it an Ideal Payment Mechanism for Bad Actors

Bitcoin is different from traditional fiat or government-sponsored currency in a variety of ways. The first is that it is decentralized, meaning no central authority controls the currency’s issuance. The second difference is that accessing the Bitcoin network is relatively easy. Anyone with a laptop or computer can become a node on the Bitcoin network and begin sending transactions through it. Bitcoin is also “pseudo-anonymous,” meaning that your personal information is not identifiable on the Bitcoin network. Instead, users are only referred to by their public key or wallet address, which is a long string of alpha-numeric characters. Bitcoin is not fully anonymous because every transaction conducted by a single address is stored forever in the blockchain. If your address is ever linked to your identity, every transaction will be linked to you. Bitcoin is also unique because it is completely transparent; every transaction in the history of the Bitcoin network is available to all nodes on the network. And, unlike most noncash transactions, Bitcoin transactions are irreversible; once a Bitcoin is sent to another node on the network, there is no way for that transaction to be reversed, unless the node that received the original Bitcoin is willing to send it back.

Some of these properties make it ideally suited for bad actors. The first high-profile example of this reality was the online black market known as Silk Road. Silk Road was a marketplace for selling illegal drugs and other illicit goods that operated on the dark web and utilized Bitcoin as its preferred method of payment because of the pseudo-anonymity it provides. In October 2013, the FBI shut the website down and arrested its founder for omnibus violations of federal drug and anti-money-laundering laws.<sup>12</sup> He was sentenced to a lengthy prison term and ordered to pay restitution of \$183 million, which represented all sales of illegal items on Silk Road.

Cryptocurrency has also ushered in a not-so-golden era of ransomware attacks, such as last year's Colonial Pipeline attack, when a cybercrime syndicate with links to Russia hacked the pipeline operator, then demanded — and received — \$4.4 million worth of Bitcoin to restore the system.<sup>13</sup> Clearly, crypto's pseudonymity makes it a highly attractive method of payment for hackers. Ransomware victims paid more than \$600 million in cryptocurrency to cybercriminals in 2021, with over 70 percent of this flowing to entities within or affiliated with Russia.<sup>14</sup> Nation-states, principally Iran, North Korea, and Russia, have also turned to cryptocurrency to bypass Western economic and financial sanctions.<sup>15</sup>

## 4 Law Enforcement Is Getting Better at Tracking Illicit Crypto Flows, but Challenges Remain

The Department of Justice has noted that bad actors can use cryptocurrency to: "(1) engage in financial transactions associated with the commission of

crimes; (2) engage in money laundering and tax evasion; and (3) commit crimes within the cryptocurrency market itself, such as stealing cryptocurrency from online exchanges."<sup>16</sup> Tracking these illicit-use cases and attempting to bring bad actors to justice has strained the abilities and resources of law enforcement agencies. However, recent signs suggest that law enforcement's crypto-tracing capabilities are improving, aided by new blockchain analytics companies that provide data, software, services, and research to government agencies and other private-sector entities.

For most virtual currencies, information stored on the blockchain includes specific identifying information, such as the sending and receiving of wallet addresses, as well as the time, date, and value of the transaction. However, these wallet addresses are typically pseudonymous, with nothing on the face of the cryptocurrency transfer tying back to the originator, beneficiary, or underlying beneficial owners. So the fundamental challenge for law enforcement is tying a blockchain wallet address to a real-world identity, which can take years of painstaking work and often requires good luck. Take, for example, the February 2022 arrest of a New York couple accused of laundering billions of dollars' worth of cryptocurrency traced to the 2016 hack of cryptocurrency exchange Bitfinex.<sup>17</sup> As Duke Law's Shane Stansbury has noted, "three different federal agencies had to untangle years' worth of complex transactions designed to hide the defendants' identities and, in the end, benefited from some favorable facts," such as that the defendants were living in New York City and were active social media users, purchased a Walmart gift card using cryptocurrency and had the gift card sent to their personal email

address, and stored a list of cryptocurrency addresses and the corresponding private keys in a U.S.-based cloud storage account.<sup>18</sup>

## 5 Cryptocurrency Does Not Fit Neatly Within Existing Regulatory Structures

No one agency has exclusive jurisdiction over cryptocurrencies, and different agencies have different interpretations of what cryptocurrency is, with each definition largely reflecting that agency's statutory mandate. In the U.S., cryptocurrency is regulated as money, a commodity, a security, and property depending on how it is used and structured.

Cryptocurrency first came under the regulatory umbrella as a form of money. The Financial Crimes Enforcement Network (FinCEN) is a bureau of the United States Department of the Treasury that collects and analyzes information about financial transactions to combat domestic and international money laundering, terrorist financing, and other financial crimes. FinCEN is responsible for enforcing the Bank Secrecy Act (BSA), the nation's first and most comprehensive federal anti-money-laundering and counter-terrorism financing statute. In 2011 and again in 2013, FinCEN issued guidance clarifying how the regulations that implemented the BSA apply to people who create, obtain, distribute, exchange, accept, or transmit virtual currencies.<sup>19</sup> FinCEN's guidance makes clear that the definition of a "money transmitter" does not differentiate between real currencies and convertible virtual currencies. Accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under BSA regulations. ►

The act of transferring money or value from one person to another also brings into play state statutes that license money transmitters. State licensing requirements vary but typically include some form of minimum net worth, maintenance of a bond, annual audits, examinations by regulators, record-keeping, anti-money-laundering programs, and a list of permissible investments for funds received and held.

States are taking different approaches to regulating cryptocurrency; some say that the use of cryptocurrency to transfer funds from one person to another falls within the state's money transmitter statute, while others take the opposite position. Recognizing that cryptocurrency firms do not fit neatly into its existing money-transmission statute, the New York Department of Financial Services established a first-of-its-kind licensing regime for cryptocurrency companies, known as the BitLicense, which came into effect in 2015.<sup>20</sup> In addition to imposing requirements similar to those of money-transmitter regulations, the BitLicense also imposes requirements tailored to unique aspects of the virtual currency business, such as cybersecurity and special suspicious activity reports. The BitLicense has been criticized within the crypto industry for being too onerous and too likely to stifle innovation, which is probably why no other state has followed suit.<sup>21</sup>

The Commodity Futures Trading Commission (CFTC) is the agency responsible for overseeing U.S. commodities markets. Specifically, the CFTC aims to protect market users and their funds, consumers, and the public from fraud, manipulation, and abusive practices related to derivatives and other products that are subject to the Commodity Exchange Act. The CFTC

has classified Bitcoin and Ether — and, by extension, other cryptocurrencies that are similarly structured — as commodities, and courts have upheld this classification. While the CFTC regulates commodity derivatives, it does not regulate commodity spot markets, although it does have enforcement authority for fraud and manipulation in commodity spot markets. The practical effect of this structure is that cryptocurrency exchanges in the U.S. are not regulated at the federal level (they are instead required to register with FinCEN and obtain state money-transmitter licenses).

Because the CFTC classifies virtual currency as a commodity, this means that it cannot also be a security that would otherwise be subject to Securities and Exchange Commission (SEC) rules and regulations. However, any sort of investment vehicle that holds virtual currency and offers ownership interests is considered a security subject to SEC registration (unless it meets SEC exemption requirements). This is why the SEC must sign off before any sort of Bitcoin, or other virtual currency or exchange-traded fund, can enter the market.

The SEC has also argued that many cryptocurrencies qualify as investment contracts and has filed numerous enforcement actions for unregistered securities offerings. Section 2 of the Securities Act of 1933 defines the term “security,” which includes things like notes, stocks, and bonds, as well as the ill-defined term “investment contract.”<sup>22</sup> The Securities Act did not establish clear guidelines for what constitutes an investment contract, which is why it ultimately fell to the Supreme Court, in the 1946 case of *SEC v. Howey*, to establish a test for determining whether or not certain transactions qualify as investment contracts.<sup>23</sup> In what has

become known as the *Howey* test, the Court stated a transaction is an investment contract if: (i) it is an investment of money, (ii) there is an expectation of profits from the investment, (iii) the investment of money is in a common enterprise, and (iv) any profit comes from the efforts of a promoter or third party.<sup>24</sup> If all four of these factors are met, the transaction is an investment contract — and therefore a security — that needs to be registered with the SEC or qualify for an exemption from SEC registration requirements.

Finally, in 2014, the Internal Revenue Service announced that it would treat cryptocurrencies as property rather than currency under federal tax law.<sup>25</sup> Thus, purchases and sales of cryptocurrency, and payments made with cryptocurrency, are taxable events.

## **6 The U.S. Lacks a National Strategy on Cryptocurrency but Work Is Underway**

In March 2022, President Biden signed the Executive Order on Ensuring Responsible Development of Digital Assets.<sup>26</sup> The order was an acknowledgment by the federal government that cryptocurrency and other digital assets are here to stay, and that the U.S. should harness the benefits while controlling for the risks. As Treasury Secretary Janet Yellen explained, this task “will be guided by six policy objectives: first, protect consumers, investors, and businesses; second, safeguard financial stability from systemic risk; third, mitigate national security risks; fourth, promote U.S. leadership and economic competitiveness; fifth, promote equitable access to safe and affordable financial services; and, finally, support responsible technological advances, which take account

of important design considerations like those related to privacy, human rights, and climate change.”<sup>27</sup>

The executive order tasked nearly every federal agency and regulatory body to produce reports and recommendations related to these objectives. We will have a better sense of what changes lie ahead for cryptocurrency regulation in the U.S. once these reports are published. As SEC Chair Gary Gensler has said: “Right now, large parts of the field of crypto are sitting astride of — not operating within — regulatory frameworks that protect investors and consumers, guard against illicit activity, ensure for financial stability, and yes, protect national security.”<sup>28</sup>

## 7 New Efforts to Regulate Cryptocurrency Will Meet Resistance

Any attempt to legislate more stringent regulation of cryptocurrency will meet stiff resistance from the crypto sector, which has emerged as a formidable political force over the past year and has repeatedly flexed its muscle on Capitol Hill. This was apparent when Senate negotiations over the bipartisan infrastructure bill stalled for several days over a seemingly mundane provision that would amend the definition of “broker” under the Internal Revenue Code to include certain cryptocurrency actors that would then be required to issue 1099s to their users.<sup>29</sup> While the crypto sector lost this specific fight, they have since organized political action committees to support crypto-friendly politicians and have aggressively hired former government officials and regulators to help shape the regulatory landscape.<sup>30</sup> And the sector has allies on Capitol Hill, notably the “crypto caucus,” which the *Financial Times* noted “is set to become one of the most pow-

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erful blocs on Capitol Hill in the coming years, as politicians rush to set the rules for one of the fastest-growing industries in the world.”<sup>31</sup>

These efforts are already bearing fruit. On June 7, 2022, Senators Kirsten Gillibrand (D-N.Y.), member of the Senate Agriculture Committee, and Cynthia Lummis (R-Wyo.), member of the Senate Banking Committee, introduced the Responsible Financial Innovation Act to create a complete regulatory framework for cryptocurrency. Then, on Aug. 3, 2022, Senators Debbie Stabenow (D-Mich.), Corey Booker (D-N.J.), and John Thune (R-S.D.) introduced the Digital Commodities Consumer Protection Act of 2022. Both bills assign regulatory authority over cryptocurrency spot markets to the CFTC, which the industry has sought.<sup>32</sup> Although the bills are widely supported by the cryptocurrency industry, they stand little chance of becoming law anytime soon.<sup>33</sup>

## 8 There Are Multiple Ways for Crypto to Show Up in the Courtroom

Cryptocurrency might make an appearance in the courtroom in a host of ways. One is the possibility that a court is asked to rule on regulatory authority. For example, in 2018, the U.S. District

Court for the District of Massachusetts found that cryptocurrency constitutes a class of items that are commodities under the CEA, because one member of that class, Bitcoin, is the subject of futures trading.<sup>34</sup> The defendants alleged that the cryptocurrency in question, My Big Coin, could not be classified as a commodity nor subjected to CFTC’s anti-fraud authority, because My Big Coin did not underlie a futures contract. The court disagreed, pointing to the existence of Bitcoin futures contracts and noting that the CEA defines “commodity” generally and categorically, “not by type, grade, quality, brand, producer, manufacturer, or form.”

Cryptocurrency has also come up in family court cases, with *The New York Times* noting that crypto’s wider acceptance has become a “major source of contention” in divorce proceedings. The digital and pseudonymous nature of cryptocurrency make it relatively easy for one spouse to underreport or hide their cryptocurrency assets from the other.<sup>35</sup>

Finally, cryptocurrency has appeared in many national security cases. One notable example is that case of Virgil Griffith, who was charged by the Department of Justice with conspiring “to provide services to the Democratic People’s Republic of Korea, including technical advice on ▶

using cryptocurrency and blockchain technology to evade sanctions” in violation of the International Emergency Economic Powers Act.<sup>36</sup> Griffith pleaded guilty and was sentenced to 63 months in prison.

## 9 Different Countries Are Taking Different Approaches to Cryptocurrency

In 2021, El Salvador became the first country to adopt Bitcoin as legal tender.<sup>37</sup> The country went beyond the typical lawyer’s definition of legal tender as “any item that a debtor can always depend on to discharge his or her debt”<sup>38</sup> and is requiring that every economic agent “accept Bitcoin as payment when offered to him by whoever acquires a good or service.”<sup>39</sup> Despite the precedent-setting nature of El Salvador’s Bitcoin embrace, the country is not forfeiting its monetary sovereignty; that already happened in 2001 when the country adopted the U.S. dollar as its legal tender.<sup>40</sup> The dollar will remain legal tender alongside Bitcoin, and the government has committed to providing Salvadorans instant convertibility from Bitcoin to U.S. dollars. Early evidence, however, indicates that Salvadorans’ use of Bitcoin for everyday transactions is minimal.<sup>41</sup>

On the opposite end of the spectrum lies China, which completely banned cryptocurrency in September 2021. The country’s central bank cited concerns around financial crime, speculation, and fraud.<sup>42</sup> Other possible reasons for the ban include concerns over Chinese citizens bypassing strict capital controls and the government’s desire to limit competition for the country’s new central bank digital currency, the digital yuan.

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## 10 Cryptocurrency Is Constantly Evolving and Is Here to Stay

Bitcoin’s launch 13 years ago created a new asset class that has grown exponentially, to the point where there are now over 19,000 different cryptocurrencies with a combined market capitalization of close to \$2 trillion.<sup>43</sup> Everyday Americans have gotten in on the action, with surveys suggesting that around 16 percent of adults have invested in, traded, or used cryptocurrencies.<sup>44</sup>

Cryptocurrency and blockchain use cases have evolved as well. Stablecoins are a class of cryptocurrency that offers price stability by maintaining a peg to a reference asset, typically U.S. dollars. As Mike Hsu, acting comptroller of the currency, has noted, stablecoins have emerged as a bridge between “the fiat and crypto worlds and serve as the blockchain-native medium of exchange on crypto trading platforms.”<sup>45</sup> Policymakers have expressed concerns around the potential for a run on stablecoins should their holders begin to doubt the quality and value of the assets used to back them.<sup>46</sup> In addition, decentralized finance (DeFi) aspires to deliver existing financial products and services in a decentralized way using blockchain-based smart contracts (self-executing contracts with terms of agreement written in lines of computer code). The total value of crypto-assets deposited in DeFi transactions grew from \$700 million in December 2019 to over \$200 billion at the begin-

ning of 2022.<sup>47</sup> Finally, some blockchain platforms allow unique assets to be brought into the digital space, where ownership of those assets is verifiable and transferable. Nonfungible tokens (NFTs) can represent assets ranging from digital artwork and music files to real property titles, and NFT trading hit \$17.6 billion in 2021, a 21,000 percent increase from 2020.<sup>48</sup>

The cryptocurrency sector is sure to evolve in unexpected ways in the years ahead. But one thing is for certain — cryptocurrency is here to stay. For proof, look no further than Fidelity’s decision in April 2022 to offer Bitcoin as an investment option to the 23,000 companies that use its services to administer 401(k) plans.<sup>49</sup> Buyer beware.



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<sup>1</sup> To be fair to economists, even Aristotle subscribed to the belief that money arose to solve the problem of barter. See ARISTOTLE, *POLITICS* 16 (Benjamin Jowett trans., Oxford: Clarendon Press, 1905) (350 B.C.E.).

<sup>2</sup> Anthropologist Caroline Humphrey said, “No example of a barter economy, pure and simple, has ever been described, let alone the emergence from it of money; all available ethnography suggests that there has never been such a thing.” See Caroline Humphrey, *Barter and Economic Disintegration*, 20 *MAN* 48–72 (1985).

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