

## **VIRTUAL CURRENCIES AND THE STATE**

# **J.S. Nelson, The Case for Cryptocurrencies as a New Category of Regulated Non-Sovereign Fiat Currency**

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What are cryptocurrencies: securities, commodities, or another form of established currency – a non-sovereign fiat currency? In my forthcoming article, “Cryptocommunity Currencies,” I argue that, like other self-governing bodies, communities that issue cryptocurrencies should be judged on how well they support their currencies, an approach very similar to how we have evaluated traditional sovereign issuers of currency. Indeed, as traditional-sovereign-issued currency becomes entirely digital, functional distinctions between it and widely-accepted non-sovereign fiat currency start to disappear. The primary way, then, to distinguish between the value of such currencies is to compare the quality of their institutional backing. Through that lens, some self-governing online communities are better organized and more supportive of their currencies than traditional sovereigns.

My article argues that cryptocurrencies should be regulated as a new category of non-sovereign fiat currency, and that such regulation should evaluate the institutional structures behind the currency as created and maintained by its community.

First, cryptocurrencies *qua* currencies are neither securities nor commodities but fiat currencies. (Here we are speaking of true cryptocurrencies, and not other forms of crypto-assets.) The distinguishing feature of cryptocurrencies as currencies is that they are intended to be traded directly for goods and services: They are not being offered by another party as a future investment, nor are they valuable apart from their

ability to be exchanged for something else. Their primary use is as a method of payment. This distinguishes cryptocurrencies from securities, which are often investments, such as stock; and from commodities, which have intrinsic value, such as wheat or pork bellies. See more on the legal definitions [here](#).

For lay purposes, consider the distinction between the U.S. dollars (a fiat currency issued by a traditional sovereign) that you might use to buy tickets at a fair, and the tickets (or tokens) that you buy for use at the fair. The U.S. dollars have the backing of the U.S. government and can be used widely. By contrast, the tickets are valuable only by specific agreement within the fair, as payment for the goods and services offered by the promoters of the fair, and for only as long as the fair exists. The fair tickets may be securities if they are an investment in the promoters' efforts, or commodities if a market develops within the fairground for collections of fair tickets tradeable at a fixed rate for other items. Either way, the fair tickets are not general tender broadly exchanged for goods or services outside of the limited efforts of the fair. Thus, the terms and representations upon which those tickets are issued are very important and specific to the tickets' value. By contrast, the terms upon which you trade five U.S. one-dollar bills for a U.S. five-dollar bill or for a certain number of euros, pounds, or other currencies should not be the governing factor in those bills' (euros, pounds, or other currencies) general applicability after your trade as tender.

As a programming note, this distinction between U.S. dollars (fiat currency) and fair tickets (tokens) maps well on the distinction between coins and tokens. Cryptocurrencies (aka, often "coins" with their own blockchain) typically have more extensive infra-structure than fair tickets ("tokens"), which run over the territory of their fairgrounds for limited application. As one source summarizes: "The basic difference is relatively simple. [Coins and tokens] are both used to

define a unit of blockchain value.” Coins “are unique digital currencies which are based on their own, standalone blockchains, [while]. . . tokens are built and hosted on existing blockchains.” Coins intended to be general currency: “[a]lthough there are some blurry lines between the definition of [coins and tokens], the crypto community generally agrees that coins function as a method of payment.” By contrast, “[t]okens operate on top of a blockchain and give access to a DApp [decentralized application], enabling the functions of that [specific] project.”

Second, the SEC and other authorities have the test for whether cryptocurrencies should be subject to regulation backwards. The SEC’s director of the Division of Corporation Finance, William Hinman, for example, would look to the importance of a centralized promoter’s role in distinguishing Initial Coin Offerings (ICOs) for regulation from cryptocurrencies that escape regulation such as Bitcoin. Under the so-called “Hinman paradox,” why should cryptocurrencies such as Bitcoin and Ether escape regulation merely because they already exist as mature networks, so that the SEC does not have to evaluate their systems? Although Bitcoin and Ether are arguably decentralized, representations about how their codes work were made at some point by someone trying to encourage new people to adopt them. In fact, because the systems are arguably decentralized, such representations may have been made by more people in more places at more times for their own financial advantages. Having more potential misrepresentations in the market for a mature product would seem to argue for a *greater* need to regulate, not to support an argument against regulation.

Additional problems with Director Hinman’s analysis stem from his focus on generational processes (with the perverse use of decentralization as a proxy for maturity), and not on the organizational qualities of the communities behind currencies. In the case of Bitcoin, for example, a central person – the

legendary Satoshi Nakamoto who invented the processes to create Bitcoin – involved a community around him to follow those uniting instructions. These people following Nakamoto’s instructions are, of course, still part of Hinman’s “person or group to carry out essential managerial or entrepreneurial efforts” necessary for a currency, but not considered as such under his analysis. Moreover, studies of Bitcoin show that Bitcoin is not as decentralized in performance as advertised – even by the SEC. Nonetheless, there is no serious talk of regulating Bitcoin as a security.

Third, some cryptocurrencies now have better institutional support than some traditional sovereign-issued fiat currencies. What is so different from a government issuing currency for universal exchange than another entity issuing it? One may say that no other entity has the market power of the U.S. or Chinese governments, but some corporations, for example, have more revenue, and arguably sophistication, than governments. Consider that Apple in 2016 had more “cash . . . on hand . . . [than] the GDPs of two-thirds of the world’s countries.” By 2017, in terms of revenue collected, “Walmart exceed[ed] [both] Spain and Australia.” During that year, in fact, “[o]f the top 100 revenue generators [including both national governments and corporations],. . . 71 [were] corporations.”

But when communities are self-governing, they may still need external regulation. The corporation is an excellent example. My article analyzes Facebook’s Libra cryptocurrency initiative, which by some estimates may be used by 2.4 billion people a month to buy goods and services by later this year. Although U.S. regulators and politicians have been cautious about this expansion of Facebook’s power, the article notes that the major arguments for being cautious are actually arguments in favor of regulation. As described in the article, our options may be the existence of the best-backed cryptocurrencies as regulated systems versus their existence

as unregulated systems: U.S. prohibition of global systems may not be meaningful, and merely cuts us out of shaping them.

In exploring the political objections to Facebook's plans, U.S. national security concerns seem to fall into two broad categories: first, concerns about more widespread money-laundering and transactions of illegal goods; and second, concerns about challenge to the hegemony of the U.S. dollar. External regulation would help combat widespread money-laundering and transactions of illegal goods. Protecting the hegemony of the U.S. dollar may ultimately depend on the wisdom of the country's foreign policy choices. But insofar as other steps are helpful, we should regulate what we can of the global programs that impact our financial system or lose that power because rival sovereign currencies are already becoming digital, and cryptocurrencies will be based around the world anyway – à la Libra in light-touch Switzerland.

A deeper concern is that administering its own cryptocurrency will give Facebook even more financial data than the enormous amount of information that the company and its partners already collect on individuals. Ironically then, the widespread use of alternative cryptocurrency systems insofar as individuals are allowed to remain anonymous within those payment systems (which may not be what Facebook allows through its exchange platform, Calibra), may help combat concerns about personal data abuse.

As neither securities nor commodities, cryptocurrencies fall into a significant hole in our regulatory system. My article calls on regulators and academics to rethink their assumptions about cryptocurrencies and the communities that develop them. We should recognize well-institutionalized cryptocommunity currencies as non-sovereign fiat currencies and regulate them accordingly. *This post comes to us from Professor Josephine Sandler Nelson (writing as J.S. Nelson) at Villanova Law School. It is based on her forthcoming article for the Cornell Law Review, "Cryptocommunity Currencies," available here. The*

*article is a tribute to the late Professor Lynn A. Stout.*