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# The Bahamas' place in a Cryptographic World

A WHITEPAPER

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## **Should The Bahamas be at the forefront of cryptocurrency regulatory policy by implementing smart, flexible regulation that encourages the legitimate operators in the sub-sector to bloom or should we leave well enough alone?**

The Bahamas' position in the landscape of the cryptocurrencies is a familiar one to many in the traditional financial services economy - they'll know this story all too well with the growth, development, and decline of private banking: a new and exciting innovation in the financial space that develops at break-neck speed; it becomes a place for the innovators, contrarians, and forward thinkers but also nefarious entities and actors; there are high-profile implosions blamed on lax regulation; large economies introduce regulation, and the IFCs do not act or do not act swiftly; the weight of global regulation forces change, but last of all for IFCs.

So here we are again at the crossroads, or perhaps a precipice (depending on your outlook), one which currently is not adequately addressed by law or regulatory policy and before any significant implosion in this hemisphere at least<sup>1</sup>. Do we allow it to develop as a wholly unregulated activity in The Bahamas almost accidentally or do we seek to craft common-sense legislation around it and encourage it to bloom? Let's be clear that I intend that rather one-sided question to be viewed as preferring a particular outcome. Nothing can develop in the context of

uncertainty, and a policy framework has to be implemented that supports clarity and certainty of outcomes. Further, so as not to be abused by rogue operators, and ensure consumer protection of investors, there must be at least a minimum level of oversight of more risky activity.

That's not to say that the regulatory approach is an easy one, the concept of regulation seems anathema in the context of a system that has fundamentally democratized fund-raising, payment, and settlement. Might we not kill the nascent business which is already developing in The Bahamas altogether by even whispering it? Some say unequivocally yes, if Bitcoin arose as an alternative to traditional bank accounts and as a contrarian ideal, then perhaps in its very essence it champions a more libertarian approach.

In the introduction to the white paper which conceptualized Bitcoin, the writer states very clearly that Bitcoin would restore trust without the need for intermediate actors, and presumably also without an overarching and omnipresent regulator:

"Commerce on the Internet has come to rely almost exclusively on financial institutions serving as trusted third parties to process electronic payments. While the system works well enough for most transactions, it still suffers from the inherent weaknesses of the trust based model. Completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes. The cost of mediation increases transaction costs, limiting the minimum practical transaction size and cutting off the possibility for small casual transactions, and there is a broader cost in the loss of ability to make non-reversible payments for non-reversible services. With the possibility of reversal, the need for trust spreads. Merchants must be wary of their customers, hassling

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<sup>1</sup> Note the 2014 collapse of Tokyo-based Mt Gox, then the largest bitcoin exchange in the world which prompted Japan's FSA to propose regulating Bitcoin Exchanges.

them for more information than they would otherwise need. A certain percentage of fraud is accepted as unavoidable. What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party.”<sup>2</sup>

Some jurisdictions that have sought to regulate certain activities have experienced a “virtual” and “literal” exodus. Take for example New York’s BitLicense introduced in 2015, which was much maligned by some executives in the cryptocurrency space. The BitLicense focusses on cryptocurrency activity associated with:

- i. Receiving virtual currency for transmission or transmitting virtual currency on behalf of others;
- ii. Storing, holding, or maintaining custody or control of Virtual Currency on behalf of others;
- iii. Buying and selling virtual currency as a customer business;
- iv. Performing Exchange Services as a customer business; or
- v. Controlling, administering, or issuing a Virtual Currency.<sup>3</sup>

There were many cryptocurrency exchanges caught by the legislation, and there were certainly those who voted with their feet<sup>4</sup>. There were others, including well-funded ones like Coinbase, which stayed and which were successful in procuring the BitLicense. The critics of the NY approach note that it is overly broad, unclear or heavy handed.<sup>5</sup> Those who find the approach excessively broad seem to be particularly concerned with the words “storing” and “holding” and the lack of definition of “custody or control”. It has been proposed that “maintaining custody or control”

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<sup>2</sup> As an aside, in The Bahamas we know all too well about the cost of lack of trust in payment processing. One only has to look at what seems like the absurd and broadly implemented merchant policy (though not required by law) that customers sign credit and debit transaction receipts even when they have digitally keyed in their unique pin code.

<sup>3</sup> New York State Department of Financial Services

<sup>4</sup> <http://fortune.com/2016/08/14/bitcoin-startups-leavelnew-york-bitlicense/>

<sup>5</sup> Coin Center maintains a state by state regulatory tracker which evaluates a state by state approach to digital currency policy. <https://coincenter.org/page/state-digital-currency-regulatory-tracker>

should be defined as: “having the ability to unilaterally execute or prevent a virtual currency transaction.”<sup>6</sup> The argument here is that where there is a decentralized security approach (a “multi-sig”) requiring two separate private keys, there can be no effective control of a customer’s cryptocurrency.

New York’s approach aside, The Bahamas once again has a unique opportunity to get its legislation and legislative policy right. It cannot do so without a significant investment in understanding cryptocurrencies and the needs of crypto service providers.

## THE CURRENT STATE

Will The Bahamas need to firmly answer for itself the question as it relates to cryptocurrency - “what is this”? Aristotle posited that this question, “what is the nature of the thing?” is one of four basic and inalienable questions that one might ask about anything. This question is known in philosophical thought as the quidditas or “what is” of a thing. Many things can only be described relationally, by comparison with something. In other words, we can say something is the same as itself, if and only if, we can say it is different than something else<sup>7</sup>. Malta’s MFSA argues “Depending on their end-use, virtual currencies may be structured in various ways, thereby embedding different properties. Therefore, a “one size fits all’ definitional approach poses significant challenges for both the industry as well as the regulators worldwide.” Malta has proposed different treatment for payment instruments (Bitcoin, Litecoin, and Ethereum) and ICOs using securitized or utility tokens.

Definitional challenges aside, it is interesting to note how crypto-currency is and is not like the things it is most compared to – “money” or a “security”.

The foremost treatise on the legal nature of money under English law<sup>8</sup>, states “only those chattels are money to which such character has been attributed by law i.e., by or with the authority of the state.” After the departure from the Gold Standard, fiat currency had and continued to have the feature of being issued by or with the authority of the state through Central Banks, a distinction not shared by crypto-currencies which effectively have no issuer standing behind

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<sup>6</sup> See Footnote 4 above.

<sup>7</sup> PASNAU, Robert. Theories of Cognition in the Later Middle Ages. Cambridge University Press, 1997

<sup>8</sup> The Law of Money, Dr. F A Mann

them. Bitcoin, as an example, comprises a ledger of transactions. Wallets that store Bitcoin store the information indicating where in the individual blocks the transaction confirmation can be found. A holder of a cryptocurrency, therefore, holds, not money but a “store of value” - it has a subjective value in that a community of users has decided to give it value.

In many jurisdictions, it has also been viewed as a chattel or property right, one that is represented by a unique record in the ledger. For instance, the IRS for tax purposes treats cryptocurrencies as digital property<sup>9</sup>. Japan recognizes Bitcoin as a method of payment (note at one time cows, sheep, and honey was too!) but not currency. It has recently implemented legislation which defines Bitcoin and other virtual currency as a form of payment method and as an asset for Japanese tax purposes. The SEC<sup>10</sup> has signaled that cryptocurrencies like bitcoin are securities, holding them subject to the same disclosure laws as other commonly traded assets. In rulings, it has also sought to block initial coin offerings, sales of cryptocurrencies meant to raise capital for a business, that don’t follow federal trading laws.

To add to the quagmire of patchwork regulatory policy, the United States Commodities Futures Trading Commission (CFTC) settled charges against Coinflip, which marketed bitcoin derivatives. In the process, the CFTC asserted for the first time that bitcoin is a “commodity”<sup>11</sup>. On the other side of the Atlantic, and likely to adopt a more progressive approach, Malta’s financial regulator has issued a discussion paper on Initial Coin Offerings, Virtual Currencies and related Service Providers. There are also rumblings about Singapore - likely to be seen as a leader in Asia.

*Which regulator will take up the mantle?*

### **THE CENTRAL BANK OF THE BAHAMAS**

In so far as Wallet and Payment Services Providers are concerned (outside of the ICO context which might be viewed as an SCB mandate if the tokens are securities rather than themselves a commodity or property right), the Central Bank is a natural fit. Indeed, we already have the framework, though not originally built for virtual non fiat-currencies in the context of

<sup>9</sup> IR-2014-36, March, 25, 2014

<sup>10</sup> <https://www.sec.gov/litigation/investreport/34-81207.pdf>

<sup>11</sup> <http://www.cftc.gov/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoinfliporder09172015.pdf>

the Payment Services Act, 2012 (“PSA”). The Central Bank of The Bahamas Act brought payment systems utilizing payment instruments (which are now given wide definition in regulations promulgated under the PSA) within the remit of the Central Bank of The Bahamas. The Act permits The Central Bank to –

- (a) establish, operate, organize, promote, participate or assist in the establishment, operation, organization and promotion of, and regulate and oversee any system –
  - (i) for the clearing and settlement of payments and other arrangements for the making or exchange of payments;
  - (ii) for the clearing and settlement of securities and other arrangements for the exchange of securities; and
  - (iii) to facilitate the clearing and settlement including other arrangements for the making or exchange of payments or the exchange of securities as well as Links among systems;
- (b) regulate and oversee the issuance, provision, and functioning of payment instruments, operating either with or without the opening of an account, including the issuance of electronic money or any other forms of stored value.”

A “payment instrument” means any instrument, whether tangible or intangible, that enables a person to obtain money, goods or services or to otherwise make payment or transfer money and includes, but is not limited to cheques, funds transfers initiated by any paper or paperless device (such as automated teller machines, points of sale, internet, telephone or mobile phones), payment cards, including those involving storage of electronic money.”

The PSA Regulations provide that only “a bank, a bank and trust company, a co-operative credit union or a money transmission service provider may provide “payment services” which means “services enabling cash deposits and withdrawals, execution of payment transactions, the provision of money transmission business, and any other services which are incidental to money transmission and shall include the issuance of electronic money and electronic money instruments.” There seems to be a manifest error in the inclusion of the term “electronic money instruments”. First, there is no such term defined in the PSA or PS Regulations, and it is likely that this was meant to be a reference to payment instruments, which is defined. Note that specifically excluded is the provision of solely internet or telecommunication services provided by technical service providers, which

support the provision of payment services, without the provider entering at any time into possession of the funds to be transferred. Conceptually, a service provider which enabled the acceptance of virtual currency like Bitcoin or Ethereum in the settlement would be caught only if the provider entered into “possession” of “private keys”. The preceding may be an attractive position for wallet providers that offer multi-signature or single signature wallet services in which users, rather than the wallet provider, control their private keys.

There are aspects of the money transmission business definition which wallet and payment service providers might also find themselves caught by and therefore it is important that The Bahamas seek to not wedge virtual currency business into a legislative framework that doesn't quite fit but to develop a piece of legislation, either by amendment to the PSA or otherwise, that is virtual currency specific.

### **INITIAL COIN OFFERINGS (“ICO”)**

In The Bahamas, we don't have a broad catch-all “financial instrument” test for what constitutes a security though the Commission can designate an instrument as a security by rules or regulations. However, contracts relating to virtual currencies, depending on their terms, may be securities. If Bitcoin is treated as a “currency” an option to acquire the currency would be a security. If Bitcoin is treated as a commodity, a Bitcoin Future - in my view cash settled and not settled by physical delivery of the Bitcoin – would be. A Bitcoin swap would absolutely constitute a Contract for Difference under the SIA.

In the context of an ICO, would an issuer of tokens ordinarily be caught by the Securities Industry Act, 2011 (“SIA”) ? To be an “issuer” one has to either have a security outstanding or propose to issue a security. The definition of security is somewhat narrowly defined and includes, among other things, derivatives of securities and debenture stock, bonds, and certificates of deposits, shares and stock of any kind in the share capital of a company, and equity interests in a regulated or unregulated investment fund as defined in the Investment Funds Act, 2003.

In some ICOs, the tokens are embedded with underlying assets (like another cryptocurrency) or quasi-equity rights (dividends and participation in profits). In others, the tokens provide platform or application utility without any underlying rights. In either case, even if the token looks like equity, it is not typically structured to be a “share” in the “share capital of the company”. It could be viewed as an

equity interest in an unregulated fund, but only if the equity interest carried with it the right to participate in the profits and redeem from the fund - the “open-ended” test.

On an “in-bound” offer of tokens to the public in The Bahamas, if they were viewed as securities, there would be a number of disclosure, and filing requirements. However, it should be noted that the SIA does not seek to control the “cross-border” issuance of securities utilizing a Bahamas vehicle. By way of example, parties are free to use a Bahamas international business company as an issuer of a security that will be listed on an exchange or otherwise sold outside of The Bahamas as long as it complies with the law where it is being offered.

Assuming nothing changes, an ICO organized utilizing a Bahamas international business company, can be structured in a manner such that it avoids regulatory oversight. Of course, there are unique and defining features of each ICO and therefore the minute details matter.

### **CRYPTO EXCHANGES**

The Securities Industry Act, 2011, regulates the conduct of securities business in The Bahamas. The SIA requires that “marketplaces” be registered and regulated by the SCB. A marketplace is defined in the SIA as, “(a) a securities exchange, a quotation and trade reporting system, or an ATS;(b) a person not included in paragraph (a) that -(i) constitutes, maintains or provides a market or facility for bringing together buyers and sellers of securities;(ii) brings together the orders for securities of multiple buyers and sellers; and(iii) uses established, non-discretionary methods under which the orders interact with each other, and the buyers and sellers entering the orders agree to the terms of a trade; or (c) a person described in an order made under subsection 16 I (2).”

An "alternative trading system" or "ATS" means a marketplace that (a) is not a quotation and trade reporting system or a securities exchange; and (b) does not -

- (i) require an issuer to enter into an agreement to have its securities traded on the marketplace;
- (ii) provide, directly, or through one or more subscribers, a guarantee of a two-sided market for a security on a continuous or reasonably continuous basis;
- (iii) set requirements governing the conduct of subscribers, other than conduct in respect of

- the trading by those subscribers on the marketplace; and
- (iv) discipline subscribers other than by exclusion from participation in the marketplace.

A “securities exchange” is defined to include “a mechanical, electronic or other system that facilitates execution of trades in securities by matching offers of purchase and sale; (aa) described in an order made under subsection 161 (l); or (bb) within a prescribed class of persons”.

Whether or not an exchange is viewed as an ATS, or a Securities Exchange depends on a) rules for participation in the exchange and the manner in which the exchange is operated and b) whether “securities” are being traded within the definition of the SIA.

**THE FUTURE STATE**

We have learned many lessons as an IFC; that nimbleness is vital, is one such lesson. We should take an approach which anticipates the opportunities and navigates a path forward for The Bahamas. We should seek to be at the forefront of crafting smart policy that encourages the innovators to base operations here. We have already taken some steps toward this in the conception of the Commercial Enterprises Act. The Bahamas Financial Services Board, which is to be commended for always engaging in a “deep –dive” analysis on “what’s next” for the financial services industry has already started work by constituting a FinTech working group that will help to frame the discussion and enunciate a position that is hopefully crypto-friendly. The proposals echo a true “regulatory sand-box” approach which is welcome. In such a fast-paced environment, where new technologies are developing all of the time, the only way we can keep pace is in lock-step with the persons who play in this space.

How The Bahamas positions itself from a regulatory and messaging standpoint in this dynamic and sometimes volatile landscape is incredibly important. We cannot ignore the fact that there are cowboys in the field otherwise we would not have learned the lessons of our past. However, we should not be paralyzed by fear of what we do not know - we should

simply endeavor to know it and to know it well. When the knowledge jobs leave - the ones that can be done through supercomputing, Artificial Intelligence, and block-chain technology - what will be left? If this is a great disrupter in the vein of other great disrupters like the motor vehicle or the airplane, we should not wait for the world to be transformed around us, we should change ahead of it.



**Photo credit: Donald Knowles**

**About Aliya Allen**

Aliya Allen is a partner in the law firm of Graham Thompson, and former CEO and Executive Director of the Bahamas Financial Services Board. In that position she provided industry leadership in the development of the Investment Condominium (ICON) legislation. She similarly led the Graham Thompson team in the revision of the Investment Fund Act. A member of the firm’s Corporate, Financial Services and Private Wealth Practice Group, her practice areas include banking law, investment funds, securities law, trusts and estate planning and structuring, securitisation and capital markets.

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