

CRYPTO-CURRENCIES AND THE ISLE OF MAN: REGULATORY OVERSIGHT AS A MEANS OF ATTRACTING BUSINESS

by Katherine Johnson

The Isle of Man is showing great enthusiasm for crypto-currencies - from the landlord at a popular Douglas drinking hole to his Excellency the Lieutenant Governor, everyone is talking about digital currency and the potentially huge benefits to the Island. The Isle of Man Government has thrown its arms wide open, even suggesting that residents may soon be able to pay their taxes in Bitcoin. The Isle of Man Financial Supervision Commission (**FSC**) has been quick to respond to interest in the area, announcing plans to apply anti-money laundering (**AML**) rules to the industry. The Isle of Man Government appears keen not to suffocate this evolving area with onerous regulation.

Significant is the very public, and very quick, way in which this has all been done. Yet rolling out the red carpet could be a risky strategy: Bitcoin has received plenty of bad press and there's still some mysticism surrounding digital currency and what it is and why we need it, and a tendency to focus on risks rather than opportunities. Indeed, some operations found out that their treasury services were being withdrawn because of pressures from banks, just as the inaugural Crypto Valley Summit, aiming to showcase the Island as a front-runner in the sector, was opening. It is hoped that registration with the FSC will provide the integrity these start-ups so desperately need and, in turn, bring potentially lucrative business to the Manx economy.

WHAT IS BITCOIN?

"Bitcoin" is one type of crypto-currency (albeit the original and best known) in a sea of emerging digital currencies, alternatives include Litecoin, Dogecoin and Darkcoin.

Digital currencies do not have legal tender but are representations of value that can be traded, functioning as a medium of exchange. Crucially, and perhaps scarily for some, they are not endorsed by a government and not backed by a physical commodity such as gold. These crypto-currencies are instead based on maths, with computers in private homes across the globe running software to “mine” the currency by solving complex algorithms with each “coin” essentially being a string of code which answers the mathematical problem at the heart of the currency. This will eventually produce a finite number of “coins” as there are a limited number of answers to the mathematical problem at the heart of each crypto-currency.

Coins accumulated from mining, received as payment, or purchased on an exchange, are kept in a digital “e-wallet”. This allows the coins to be accessed from anywhere in the world by logging on to a computer or using a mobile phone app.

One appeal of digital currency is the removal of a bank in payment processing and the associated costs otherwise incurred by retailers. Some also argue that digital currencies (such as Bitcoin) are superior to physical cash from an AML perspective, as the transactions a digital coin is used for are recorded on a “blockchain” ledger which attaches to the coin and transfers along with its value when it is used as payment, making tracing easier than following the flows of cash.

ARE CRYPTO-CURRENCIES BAD?

Crypto-currencies have encountered opposition and been the subject of much bad press: there have been high profile stories about hacking (not just of individuals but also e-wallet operators and currency exchanges), resulting in users losing their Bitcoins; in February the then largest Bitcoin exchange, based in Japan, “lost” around six per-cent of all Bitcoins in circulation; a Texan Bitcoin-based virtual hedge fund turned out to be a Ponzi scheme; and some of the first merchants to accept payment in Bitcoin sold illicit substances. Another big criticism of Bitcoin has been the volatility in its price, with a mixture of speculation and uncertainty not helped by each new negative press story. The European Banking Authority (**EBA**) also recently published an opinion on the topic of virtual currencies, identifying a long list of risks associated with the sector.

To combat bad publicity and perceived risks, proponents of digital currencies are crying out for higher standards in the industry, arguing that hacks are not the fault of Bitcoin but of the businesses employing insufficient security controls, much like a bank robbery is not the fault of the stolen gold but of the bank for failing to make its vaults impenetrable.

THE REGULATORY POSITION IN THE ISLE OF MAN

In June the Isle of Man made a bold pro-crypto-currency statement, with Peter Greenhill, the Department of Economic Development (**DED**)’s Director of E-Business, announcing that DED and the FSC were working together to produce a framework for regulation of digital currencies which would promote business opportunities whilst applying appropriate AML requirements. This declaration of policy was accompanied by a list of Questions and Answers, with further details of the framework then announced in July.

We learned that DED’s approach would be to treat digital currencies as property, rather than a currency, and does not consider digital currency exchanges to be conducting regulated activities which would require licensing. The FSC is not introducing a full prudential regulatory regime until such time as international standards are introduced, given that the industry is moving at a tremendous pace and any regulations would soon become out-of-date. However, the Isle of Man Government is acting to bring digital currency businesses within the FSC’s AML regime, which will be carried out in a two stage process:

- 1 Schedule 4 of the Proceeds of Crime Act 2008 (**POCA**) will be amended later this year

Carrying on digital currency activities (undefined as yet), will be deemed to be conducting “business in the regulated sector” and consequently subject to the requirements of the Money Laundering and Terrorist Financing Code 2013 (**AML Code**). Digital currency businesses will need to comply with the Anti-Money Laundering and Countering the Financing of Terrorism Handbook (**AML Handbook**) and employ rigorous know-your-customer procedures, just like other businesses operating in the financial services industry in the Isle of Man; and

- 2 The Designated Business (Registration and Oversight) Bill 2014 will be amended before being put to Tynwald (expected in the first half of 2015)

This Bill has been on the cards for some time, its purpose is to make the FSC (rather than industry bodies) responsible for oversight of the adherence with the AML Code of certain businesses and professions, such as advocates and accountants. Digital currency businesses will need to register with the FSC, who will publish and maintain a register of “Designated Businesses”. These businesses must submit annual returns confirming compliance with AML requirements and detailing any instances of non-compliance. The FSC will, amongst other things, carry out on-site inspections and have the power to request information, issue public statements and impose civil penalties. Being registered as a Designated Business will not be as burdensome as being licensed by the FSC but this means that consumers will not as well protected.

It is worth noting that the Questions and Answers confirm that the Depositors’ Compensation Scheme does not extend to cover funds held as digital currencies, meaning that any Bitcoin held in the Island is not protected by a statutory compensation regime. Also worth mentioning is confirmation that, in deciding how to apply VAT rules to the industry, the Isle of Man will follow the UK which has ruled that the activities of mining a digital currency, exchanging it or charging for related transactions are not subject to VAT.

WHY IS THE ISLE OF MAN MAKING THIS MOVE?

As alluded to above, there are digital currency businesses who want to be regulated. Being accountable to a reputable supervisory body brings credibility, which is something the industry needs just to access basics, such as a lender willing to provide start-up funds or a trusting landlord to provide office space, as well as to attract customers.

The Isle of Man is already known for innovation and high quality service in the financial services and e-gaming industries, so this seems to be a logical progression in expanding and diversifying its global business offering. This opportunity also accords with the regulatory objectives of the FSC, which include the reduction of financial crime and supporting the Island’s economy and its development as an international financial centre.

Speaking when the Government’s plans were first announced, then Minister for Economic Development John Shimmin MHK commented that the Isle of Man “welcomes well-controlled and compliant businesses while sending a clear message to those who would seek to operate outside the law that we are open for good business only”. With low taxes, a high-tech infrastructure and a well-established support industry of corporate services providers, accountants and lawyers already making the Island attractive to e-business, it is important to deter bad businesses who would seek to exploit openings for money-laundering, in order to uphold the Isle of Man’s strong reputation and good-standing with the International Monetary Fund.

However the Isle of Man is not alone in welcoming crypto-currency business: Luxembourg has been attracting start-ups following a ruling by its financial regulator that Bitcoin could be used as a means of payment; Gibraltar was publicly discussing the topic as early as 2011; and Jersey is lobbying to become “Bitcoin Isle” and the Jersey Financial Supervision Commission has approved the launch of a Bitcoin investment fund.

Conversely, the Isle of Man may be taking a risk in publicising its stance on digital currencies before international bodies have declared theirs: whilst recommending that participants in the virtual currencies market are made subject to AML regimes (which the Isle of Man is already doing), the EBA also recommended in its opinion to the European Union that national supervisory authorities should discourage credit institutions, payment institutions and e-money issuers from buying, holding or selling virtual currencies in order to shield the regulated financial sector from the risks of virtual currency.

Having now publicly sided with the pro-crypto-currency side of international debate, the Isle of Man cannot afford to rest on its laurels if it wants to earn and maintain a position of jurisdiction of choice for this fast-moving industry whilst, at the same time, keeping up with international expectations for an established well-regulated international finance centre. So far the Isle of Man Government looks to be making the right moves by offering supportive and proportionate regulatory oversight, aiming to attract the businesses the Isle of Man does want and to deter those it does not. Indeed, the results of this positive outreach are already showing: a number of businesses have now launched and the turnout at the Cypto Valley Summit was a very visible sign of the industry interest in the Island.

This article has been written by:

Katherine Johnson

Associate

+44 (0) 1624 647 971

kjohnson@applebyglobal.com

A copy of this column is available on the firm's web site at applebyglobal.com