



SPRING 2018 E-NEWSLETTER

At Digital Mountain we assist our clients with their computer forensics, e-discovery, and cybersecurity needs. For this E-Newsletter, we discuss leading cryptocurrency fundamentals, blockchain infrastructure basics and the regulatory, security and legal impact.

Cryptocurrency Regulation: New Challenges for Established Agencies

On November 28, 2013, *The Economist* published an article entitled “Bitcoin Under Pressure”, in which the author wrote, “No wonder Bitcoin is so appealing to geeks, libertarians, drug dealers, speculators and gold bugs.” While this may not have been the first time Bitcoin was disparaged, it certainly wasn’t the last. Various reiterations of the sentiment have populated articles, documentary films, and even court filings, ever since. Beyond the sarcasm, what makes the sentiment conveyed in the statement important is that it captures an underlying suspicion that cryptocurrencies are by nature lawless, and therefore, the activities of such need to be carefully policed. It is no wonder then, the agencies with the power to police financial markets have been eager to test cryptocurrencies against existing statutes and regulations.



Taking a New Road

One of the first important cases establishing cryptocurrency as a monetary equivalent was *United States of America v. Ross William ULBRICHT, a/k/a “Dread Pirate Roberts,” a/k/a “DPR,” a/k/a “Silk Road,” Defendant (31 F. Supp. 3d 540 – Dist. Court, SD New York 2014)*. While the case itself is a narcotics trafficking conspiracy, continuing criminal enterprise, computer hacking conspiracy and money laundering case, it raised a ground-breaking question with regard to Bitcoin. Ulbricht’s lawyers challenged the money laundering charge because all of the transactions involved Bitcoin and not fiat currency; therefore, the defendant argued, there was no recognizable “financial transaction.” The court disagreed, looking to the broader term “funds” in money laundering statutes. Under the statutes, “funds” is synonymous with “medium of exchange.” The court reasoned that because Bitcoin could be used as a medium of exchange, including being exchanged for fiat currency, Bitcoin qualified as “funds” for the purposes of

money laundering. The case tied together the online black-market concept to cryptocurrencies, much to the dismay of Bitcoin enthusiasts.

Liability by Design?

The anonymity afforded by cryptocurrency wallet applications presents a liability in that the anonymity that makes cryptocurrency so attractive, also makes it easy to run afoul of the Bank Secrecy Act, specifically anti-money laundering and suspicious activity reporting regulations. The Bank Secrecy Act, or “BSA,” requires that money service businesses, not just banks, proactively detect and defend against money laundering. The US Treasury’s Financial Crimes Enforcement Network, “FinCEN,” is authorized to impose civil money penalties on those found violating the BSA.

In 2017, BTC-E, a/k/a Canton Business Corporation, and Alexander Vinnik were fined a total in excess of \$122,000,000 for willfully violating the BSA’s requirements to “implement an effective anti-money laundering program,” “detect suspicious transactions and file suspicious activity reports,” and “obtain and retain records relating to transmittals of funds in amounts of \$3,000 or more.” Because BTC-e, a cryptocurrency exchange, required only a password, username, and an email address from customers, they could not, and frankly did not attempt, to report suspicious activity occurring on BTC-e’s exchange, including activity which involved email addresses known to be connected with ransomware, drug trafficking, and stolen Bitcoin from other cryptocurrency exchanges. Even had BTC-e attempted to file suspicious activity reports with FinCEN, they did not have the names, addresses, and other identifying information required by the Treasury. With Bitcoin trading well above the \$3,000 threshold for BSA reporting, the anonymous trade of a single Bitcoin violates the BSA if any part of the transaction occurs within the US.

“9. A combination of any of the above.”

On March 6, 2018, a seventeen-page Memorandum and Order in *Commodity Futures Trading Commission, v. Patrick K. McDonnell, and Cabbagetech, Corp. d/b/a Coin Drop Markets, (No. 18-CV-0361. United States District Court, E.D. New York)*, outlined nine possible alternatives for cryptocurrency regulation in the absence of action by the legislative branch, from no regulation, to regulation by individual agencies such as the SEC, the CFTC, FinCEN, and the IRS, to regulation by private exchanges, state regulation, and option number 9, as quoted above. Concurrent work on regulating cryptocurrencies appears to be the way the federal government is pursuing this area of financial crimes. The *Cabbagetech* Order meticulously establishes jurisdiction and standing, including extensive background on cryptocurrencies as commodities, to justify shutting down the fraudulent exchange and the surrender of records to the CFTC. For anyone interested in the intricacies of cryptocurrency crime prosecution, this Order makes for instructive reading.

There’s Always a Tax

If there’s a currency or a commodity, there’s an Internal Revenue Service tax treatment for it, and cryptocurrency will not be the first exception. The IRS’s guidance on how cryptocurrency should be treated reflects the flexibility of the product. Primarily seen as property, cryptocurrencies are treated much like other commodities that realize gains and losses, although in this instance, their values must be converted to dollars first. Just as fiat currencies can be both investment vehicles and exchange mediums, the IRS recognizes this in cryptocurrencies as well.

When goods or services are exchanged for cryptocurrencies, the receiver must treat the receipts as if they are dollars, the same as if receiver were paid in Euros or Yen. The value is determined as of the date of receipt and is the fair market value of the cryptocurrency. Payments made by cryptocurrency for goods and services, which constitute income for an individual or other taxable entity, are subject to all the standard taxes to which income in US dollars is subject. The same goes for deductions, including deductions for bitcoin mining businesses. Bitcoin miners can deduct mining expenses in accordance with allowable business deductions. Considering the rising costs of mining, Bitcoin miners are going to want to take advantage of those deductions.

Just the Beginning

The United States, France, Germany, and the United Kingdom have all indicated that cryptocurrency regulation will be an important part of the discussions at the G20 Summit in Buenos Aires in July 2018. This once upstart financial experiment of those attracted to the lack of government control and a near anonymous exchange capability has now garnered the attention of the most powerful economies in the world. And while we await legislation from Congress, we'll no doubt continue to see a variety of enforcement alternatives employed by federal agencies to meet the challenges presented by new developments in cryptocurrency.

Please direct questions and inquiries about cybersecurity, computer forensics and electronic discovery to info@digitalmountain.com.

UPCOMING INDUSTRY EVENTS

ENFUSE 2018

Las Vegas, NV: May 21-24, 2018

MASTERS CONFERENCE

Chicago, IL: May 22, 2018

2018 EDM WORKSHOP

Durham, NC: May 23-25, 2018

CYBERSECURITY LAW INSTITUTE

Washington, DC: May 23-24, 2018

NINETEENTH ANNUAL INSTITUTE ON PRIVACY AND DATA SECURITY LAW

New York, NY: May 29-30, 2018

[Click here to see more upcoming events and links](#)



Digital Mountain, Inc. Founder and CEO, Julie Lewis, will be presenting at various upcoming industry events. Please send requests for speaker or panel participation for her to marketing@digitalmountain.com.

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