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ATTORNEYS AND TAX ADVISORS

Cryptocurrency: EU and Dutch Legal Aspects of the Revolutionary Technology

1. Introduction

Cryptocurrencies began creating controversy soon after their launch. The growth and their increasing popularity have led to questions about their regulation. Virtual currencies are exclusively digital and organized through a network known as a blockchain, which is an online ledger that keeps a secure record of each transaction all in one place. No one controls the blockchain, because these chains are decentralized across every computer that has a Bitcoin wallet. This means no single institution controls the network. The technical aspects of the system are well established, but can the same be said about the legal framework in Europe and the Netherlands?

This paper examines cryptocurrency from a legal and regulatory perspective, answering several important questions. We will start by looking at the cryptocurrency called Bitcoin. After that, we will discuss Initial Coin Offering (ICO) and its legality. This forms the basis for our main question: ‘What are the regulatory responses to the digital currencies in the Netherlands and the European Union?’.

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2. Bitcoin

The birth of the Bitcoin (BTC) in 2009 was the world's first successful attempt at a decentralized cryptocurrency. Bitcoin is a non-fiat cryptographic electronic payment system. In other words, it is a peer-to-peer, client-based, completely distributed currency that does not depend on centralised issuing bodies (a 'sovereign') to operate.¹ The value is created by users, and the operation is distributed using an open source client that can be installed on any computer or mobile device.

An important aspect of the concept behind Bitcoin is scarcity. Mining for coins becomes more difficult as time goes by and the market grows. The processing power necessary to create each new block is increased by algorithms that produce new coins. Therefore, producing new coins becomes more difficult in order to keep the total amount of bitcoins at the maximum of 21 million.

At this time of writing, there are around 1100 cryptocurrencies in existence.² Bitcoin is the best known currency, not only because it was the first currency, but also because it is the largest of all. At this moment, bitcoin has a market capitalization of 70,6 billion US Dollar and 1 bitcoin costs around 4.000,00 US Dollar. It is followed by ethereum (ETH), which has a market capitalization of 28,6 billion US-dollar and cost around 300,00 US-dollar per ethereum. New cryptocurrencies are created every day. In the next paragraph we will discuss why there are startups which create and sell digital tokens to the public.

3. Initial Coin Offering

Blockchain startups have embraced initial coin offerings (ICOs) as a way to raise early capital. An ICO is an offering whereby a company can sell digital tokens to the public in order to fund operations and meet other business objectives.³ The crypto-tokens offered in these sales are intended to fill a widely varied set of roles on different platforms. Some

¹ A. Guadamuz, C. Marsden, article Blockchains and Bitcoin, 7 december 2015.

² According to the website: coinmarketcap.com, Cryptocurrency Market Capitaliations.

³ C. Bovaird, ICO vs. IPO: What's the Difference? Bitcoin Market Journal september 2017.

tokens are similar to currencies, others are more like securities, and others have properties that are entirely new. Each company's technological vision calls for a token with unique properties and uses.⁴

ICOs deal with supporters that are keen to invest in a new project much like a crowdfunding event. But ICOs differ from crowdfunding in that the backers of the former are motivated by a prospective return in their investments, while the funds raised in the latter campaign are often basically donations. For these reasons, ICOs are referred to as crowdsales.

While the terms ICO and IPO may sound similar, they are actually quite different. To hold an ICO, companies frequently need to simply create a whitepaper and set up a website with purchase information. In contrast, holding an IPO requires a lengthy process that involves working with investment banks. Furthermore, no underwriters are necessary for ICOs, unlike for IPOs as the virtual currency is created almost instantly. Likewise, no syndicates are necessary and hence no brokers to resell the shares to the investors. Finally, while IPOs tend to be one-day events, ICO can last for almost a month, giving time for investors to participate, no matter how busy their schedule may be.

Unfortunately, the way that many ICOs take place leaves investors uncertain about how to estimate revenue streams. Some startups even launch without producing a white paper. A white paper outlines the businessmodel and technology in detail. Even when a white paper exists, it is not always clear what revenue streams token owners will share in. This lack of information leads to investor uncertainty and an increase in perceived risk. Investors expect to be compensated for risk, and so the willingness to pay for a share of profits is lower than it might be otherwise. In this situation an IPO would raise less money for the company. That is the reason why firms involved in IPOs try to be as clear and convincing about their prospects as possible. However, in the case of an ICO, a lack of

⁴ J.P. Conley, Blockchain and the Economics of Crypto-tokens and Initial Coin Offerings, Vanderbilt University Department of Economics Working Papers.

clarity simply creates uncertainty. Investors may end up overestimating instead of underestimating a company's future revenues, which is beneficial to the ICO.

3.1. Legality of ICO's

The treatment of these two offering types under existing law is very different. Companies aiming to hold IPOs must follow strict rules and must provide significant information about the business and potential risks. ICOs, on the contrary, are not governed by specific regulations or government agencies. This lack of regulation has raised concern about the potential risks investors run. As a result, volatility has become a concern. Unfortunately, if an investor loses funds during this process, they have no course of action to recover money.

In September 2017, the People's Bank of China officially banned ICOs, citing it as disruptive to economic and financial stability. *"Any form of fundraising through digital currency issuance should be halted immediately,"* the central bank said. *"Those schemes which are already launched should repatriate funds to investors,"* it said in the circular, which also carried the endorsement of the securities and banking regulators and the task force under the State Council that is responsible for internet finance security.⁵ The central bank said tokens cannot be used as currency on the market and banks cannot offer services relating to ICOs. The ban also penalizes offerings already completed.

Zennon Kapron, director of the Shanghai-based financial technology consultancy Kapronasia, said he suspected regulators were putting a hold on ICOs in order to better understand the phenomenon. "Regulators globally are struggling to understand what ICOs are, what the risks are, and how to regulate them," he said.⁶

4. Virtual Currencies at European Level

⁵ D. Ren & J. Ye, China bans ICOs over concern about financial and social stability, South China Morning Post, september 2017.

⁶ J. Ruwitch & J. Kelly, China hits booming cryptocurrency market with coin fundraising ban, Reuters september 2017.

4.1. The ECB and the EBA

The risks associated with the use of virtual currency raise the need of the European Union and its institutions to regulate.

The 2012 European Central Bank report (ECB)

The European Central Bank was the very first institution in the EU which expressed an opinion on the issue of virtual currencies and provided the first definition. According to this definition, 'virtual currency represents the unregulated digital money that is issued and subsequently supervised by its creator and used among the members of a special virtual community.'⁷

The European Banking Authority statement

The EBA Opinion sets out the result of their assessment and is addressed to EU legislators as well as national supervisory authorities in the 28 Member States.

While there are some benefits of virtual currencies, for example, faster transaction speed, financial inclusion, and reduced transaction costs, these benefits are less relevant in the European Union, according to the European Banking Authority. Due to the existing and pending EU regulations and directives that are explicitly aimed at faster transactions speeds and costs and at increasing financial inclusion. By contrast, there are numerous risks. More than 70 risks were identified across several categories, including risks to users; risks to non-user market participants; risks to financial integrity, and risks to regulatory authorities.⁸ The risk of abuse of virtual currency by committing crimes such as money laundering, tax evasions, terrorism financing and more, grows as the group of users extends. The Commission of the EU presented a draft amendment in 2016 to the Fourth Anti-Money laundering Directive, which also contemplates the regulation of virtual currency. The following text was proposed for paragraph 1 of article 47 of AMLD4:

⁷ The European Central Bank, Annual Report, 2012.

⁸ A. Vondráčková, Regulation of Virtual Currency in the European Union, 2016.

“1. Member States shall ensure that providers of exchanging services between virtual currencies and fiat currencies, custodian wallet providers, currency exchange and cheque cashing offices, and trust or company service providers are licensed or registered, and that providers of gambling services are regulated.”⁹

This revision has brought a change in widening the range of the obliged entities, i.e. entities that are required to perform due diligence of their clients. Reducing the anonymous nature and tackling terrorist financing risks linked to virtual currencies are the main goals of this regulation. In order to prevent misuse of virtual currencies for money laundering and terrorist financing purposes, the Commission proposed to bring virtual currency exchange platforms and custodian wallet providers under the scope of the Anti-Money Laundering Directive. These entities will have to apply customer due diligence controls when exchanging virtual for real currencies, ending the anonymity associated with such exchanges. On the fifth of July, 2016, the Commission adopted the proposal.

4.2. Legislative Issues

On the most basic level, the legal problems with virtual currencies and ICOs are the same in both the European Union and the United States. Important issues include anti-money laundering laws, payment services regulations and, of course, taxes. However, these topics are more complicated under the EU law than under the corresponding U.S. regulations. There are two main reasons for that.

First, the relevant EU regulatory frameworks are changing. Many laws are new, evolving or under ongoing reconstruction. To name just a few: the new Anti-Money Laundering Directive (as discussed above), MiFID II (the cornerstone piece of legislation for investment services) and Prospectus Regulation (PR3).¹⁰

⁹ Draft Amendment to the AMLD4, 2016.

¹⁰ A. Bennington, Tokens can be Securities? Even ICO advisors agree with the SEC, Coindesk, august 2017.

Second, the situation in the EU is quite complex. We have the EU-level and the member states level, and many laws developed on the former have yet to be implemented on the latter. This sometimes leads to regulatory inconsistencies across member states, even though, in theory, the laws should be the same. Also, many issues are left to member states discretion, which can cause differences in their regulatory approaches.

As for now virtual currencies are not regulated and are not closely supervised or overseen by any public authority, even though participation in these schemes exposes users to credit, liquidity, operational and legal risks. This means national authorities need to consider whether they intend to acknowledge or formalise and regulate cryptocurrency. Detailed regulation at EU-level will certainly be a long process, with respect to the fact that the technology itself is developing faster than the legislator's regulatory attempts.

4.3. Ruling by the European Court of Justice

Bitcoins and their VAT treatment

The European Court of Justice (ECJ) ruled in response to a request by Swedish tax authorities, who had argued bitcoin transactions should not be covered by a European Union directive exempting currency transactions from value added tax (VAT). However, a Swedish Court considered that bitcoins should be exempt from VAT and decided to refer the case to the EU judges.

The court ruled that bitcoins should be treated as a means of payment, and as such were protected under the directive.

“Those transactions are exempt from VAT under the provision concerning transactions relating to ‘currency, bank notes and coins used as legal tender’,” the ECJ concluded.¹¹

¹¹ ECLI:EU:C: 2015:718.

This judgement is particularly important for the member States of the European Union's legal systems as it is a binding precedent that aims to unify the criteria to be followed by them.

At this point in time the VAT treatment of Bitcoin in various jurisdictions differs significantly. This is a major issue for market participants and governments that require a level playing field.¹² Considering that virtual currencies could have a significant impact on the global digital economy, it is desirable to globally ensure a level playing field with legal certainty for all parties involved with regard to the treatment of Bitcoin from a VAT point of view, possibly starting with the European Union as an accelerator for other jurisdictions.

5. Virtual Currencies in the Netherlands

5.1. Legal Status

Bitcoin is used as a method of payment and as a medium of exchange. Economically speaking virtual currencies like Bitcoin may be placed under the definition of 'electronic money'. However, from a legal point of view this would be incorrect. According to the Dutch Financial Supervision Act (FSA) electronic money represents a monetary value that is stored electronically or magnetically. An electronic money institution stores the monetary value in a central accounting system (the enterprise's server), or it may be stored on an electronic carrier like a chip. This monetary value is intended to be used to perform payment transactions and can be used to make payments to other parties than the one that issued the electronic money.¹³

Virtual currencies cannot be defined as electronic money, because not all legal criteria are met. Bitcoins are not necessarily issued in exchange for money, therefore they do not represent a claim on the issuer. After all bitcoins are not issued by central institutions.

¹² M.L. Veldhuijzen, R. Van de Berg, E.A. Van Goor, Bitcoin, income tax and vat – current legislation & policy and an outlook on the future.

¹³ [The Financial Supervision Act, section 1:1](#)

Moreover, Bitcoins are subject to a fluctuating exchange rate and therefore the requirement that the emission must occur at nominal value is not met either. If cryptocurrency cannot be legally defined as money or electronic money, as what can it be defined?

In response to parliamentary questions in december 2013, the Dutch Minister of Finance (Dijsselbloem) confirmed that Bitcoin can also not be described as a financial product. In the context of the Dutch Financial Supervision Act cryptocurrency is just a medium of exchange. Nothing more, nothing less. Everyone has the freedom to engage in barter trade, therefore permission in the form of a license is not needed. The Dutch financial supervisory institutions only monitor legal methods of payment. Which means they do not monitor virtual currencies and do not stand up against illegal activities resulting from the use of these currencies. In other words, financial supervision is absent. Furthermore, the Minister of Finance indicated that revision of the formal legal definition of electronic money is not yet desirable, given the Bitcoin's limited scope, relatively low level of acceptance, and limited relationship to the real economy. He emphasized that the consumer is solely responsible for their use.¹⁴

5.2. Dutch Ruling

In the Netherlands Bitcoins do not qualify as 'currency' in accordance with the Dutch Civil Code (DCC). According to a Dutch District Court (Overijssel), the Bitcoin has the status of a medium of exchange.¹⁵

¹⁴ Ministerie van Financiën, Beantwoording van kamervragen over het gebruik van en toezicht op nieuwe digitale betaalmiddelen zoals de bitcoin, december 2013.

¹⁵ ECLI:NL:RBOVE:2014:2667.

The Case in first instance

In this case someone bought 2750 Bitcoins. The buyer paid up his part of the deal soon after this deal was agreed upon. The seller, however, did not send all 2,750 Bitcoins, but instead transferred only 990 of them. The remaining 1,760 Bitcoins were never sent. The buyer therefore disbanded the remainder of the deal two months later, in October of 2012. He then asked the seller to reimburse him with the rest of the money that he had paid him instead, which added up to EUR 14,168. But once again, the seller ignored all attempts to close the deal. As a result, the buyer saw no other option than to take the case to court. The seller was summoned almost a year after the original trade should have taken place, in June of 2013. By now the bitcoin exchange rate had skyrocketed to almost EUR 70, a rise of more than 800 percent. Consequently, the buyer did not only demand to be paid back the EUR 14,168 that was defrauded from him, but also wanted the profit he would have made if he had gotten all of the Bitcoins within a reasonable time. On top of the original EUR 14,168, he asked for an additional compensation of EUR 132,792.

The basis for compensation of loss due to exchange rate movements is laid down in article 6:125 DCC. The buyer claimed that a transfer of Bitcoins can be seen as a payment. According to the court, the assumption that the Bitcoin qualifies as 'currency' is incorrect. Firstly, the court stated: 'Bitcoin is not legal tender and in view of the foregoing it cannot be concluded that Bitcoin can be regarded as 'current money' as referred to in article 6:112 DCC.'

Secondly, a transfer of Bitcoins does not constitute a bankgiro payment, since Bitcoins are not managed by a third party but by the user itself. Consequently, the buyer is not eligible for compensation of damages due to exchange rate movements. The seller is however obliged to compensate the buyer for the amount paid plus interest. Lastly, the court concluded that Bitcoin can be considered as a medium of exchange and is therefore acceptable as a form of payment in the Netherlands.

The Appeal

In September 2014, the Dutch Bitcoin brokerage Bitonic supported by the buyer, his law firm Solv, and the Dutch Bitcoin Foundation announced a plan to appeal the verdict. They wanted to take the case to a higher court in order to prove for once and for all that Bitcoin is in fact money, and should be regarded as such under civil law. In order to take the case to a higher court, money was needed. Therefore, Bitonic launched a crowdfunding campaign ('Bitcoin is Geld'). Within a week the goal, collecting 15,000 euro, was reached.

Statement by mr. Hofman, Bitonic CEO and board member of the Dutch Bitcoin Foundation:

*"We believe that the decision is based on an incorrect interpretation of the law. Because of this, we feel that the resulting classification of Bitcoin may not last. We experience the resulting uncertainty as a restraining force not only in the progress of our business, but also in our contacts with, for example, customers, business partners and governments. Furthermore, as a secondary reason, we feel that bitcoin can benefit from a classification as money."*¹⁶

In higher appeal the court stated that Bitcoins cannot be qualified as money. However, the Court of Appeal considered Bitcoins can be qualified as sold objects as referred to in article 7:36 DCC. Therefore, the increase in value of the Bitcoin should be taken into account.¹⁷

6. Conclusion

The increasing popularity of Bitcoins and other cryptocurrency is a fact. The hype has spread among ordinary people. No one can predict if a particular virtual currency may become a direct competitor for existing currencies in the distant future, or if it might just

¹⁶ A. Van Wirdum, Court of appeal divides Dutch bitcoin community, march 2015.

¹⁷ ECLI:NL:GHARL:2016:4219.

collapse overnight. It can be concluded that it is not only desirable, but also necessary to reflect this change in European and national legislation. Uncontrollable development would lead to inconsistencies which will eventually lead to legal issues.

This paper aimed to determine what the regulatory responses are to the digital currencies in the Netherlands and the European Union. Regarding the current legal framework, it can be concluded that current regulation should be described as a regulation in the negative sense. What is not a virtual currency and what regulations will not apply to it. No clear definition of virtual currency or criteria for selling tokens are laid down in the law.

The risks associated with the use of virtual currency raise the need of the European Union and its institutions to regulate. However, regulation at European Union level is quite complex, due to changing EU regulatory frameworks and regulatory inconsistencies across member states.

According to the Dutch District Court (Overijssel) and the Dutch Minister of Finance a virtual currency, such as Bitcoin, has the status of a medium of exchange.¹⁸ In appeal the Dutch Court considered Bitcoins can be qualified as sold objects as referred to in article 7:36 DCC. The Dutch Court of Appeal also stated Bitcoins cannot be qualified as legal tender but only as a medium of exchange. In contrast, the European Court of Justice ruled that bitcoins should be treated as a means of payment, indirectly suggesting Bitcoins are similar to legal tender.¹⁹

Regarding the complexity of regulating cryptocurrency, it can be assumed that the Court of Justice of the EU will have to be involved in the clarification of terminology. In case of the Member States that have chosen to adapt the terminology differently from the EU legislation, the difficulties may arise in connection with interpretation in line with the EU legislation.

¹⁸ ECLI:NL:RBOVE:2014:2667.

¹⁹ ECLI:EU:C:2015:718.

From this perspective, it is necessary to recommend to the Member States that they follow the EU legislation terminology while implementing the legislation into the national law.

Contact

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