

'Unnecessary complexity': the crypto industry's continuing efforts to avoid regulation

*Financial authorities face a balancing act in trying to deter socially destructive actors without stifling innovation. **Martin Walker** writes that the complexity of the cryptocurrency industry is used to defeat regulators. He says that if the authorities learn to deal with both decentralisation and complexity, they will be ready to deal with bad actors in both crypto and conventional finance.*

A [previous article](#) suggested that in spite of the cryptocurrency industry's calls for regulatory clarity, the foundation on which it is based (the bitcoin payments system), was specifically designed to avoid regulation. In its early years, bitcoin had failed to get much attention from the criminally and libertarian minded who were looking for an alternative to the e-gold digital currency, which had been closed down in 2008 (the same year bitcoin was announced). The major reason for the lack of interest was the launch of the Liberty Reserve dollar, which offered users a digital currency with a stable value and clear mechanisms to convert money to and from Liberty Reserve. However, over 2011 to 2013 legal action was taken against Liberty Reserve and interest started to grow in bitcoin, particularly amongst users of the "dark web".

Early adopters of cryptocurrencies were typically libertarians, technology enthusiasts, and criminals. The broader attention given to bitcoin and rapid price appreciation started making the new currency attractive to speculators. People needed a place to trade bitcoin and a new business grew up to serve that need, the cryptocurrency exchange. From the get-go, cryptocurrency exchanges were characterised by shoddy technology, recurrent thefts of depositors' bitcoin and blatant market manipulation. A major factor driving these problems was the lack of obviously applicable laws and regulations, since the status of bitcoin (and the ever-growing band of competing cryptocurrencies) was so ambiguous. For some purposes it was treated like a commodity; in other circumstances central banks equated them to the virtual currencies used in computer games.

The year 2014 saw the first significant attempts to regulate the growing band of cryptocurrency firms that handled customer funds in real money as opposed to cryptocurrency. (*New York Bit Licence -Regulation 23 NYCRR Part 200, under the New York Financial Services Law.*) There was, however, little attempt to regulate the actual trading of cryptocurrencies. The same year also saw the "crowdfunding" of a new and more sophisticated form of cryptocurrency/payments network called Ethereum. To those used to conventional markets, the Ethereum fundraising looked suspiciously like an IPO (initial public offering): tokens, i.e., shares, were sold in exchange for bitcoin, i.e., money. However, there was no company *per se* issuing the tokens. It was also unclear whose jurisdiction the fundraising took place within. Most regulators did not pay attention. Once again, the concept of "decentralisation" inherited from bitcoin has left even interested regulators feeling confused and powerless.

The more sophisticated programming capabilities of Ethereum gave cryptocurrency businesses far more scope to build complex financial structures. In 2016 a new concept was implemented using Ethereum, a digital autonomous organisation (DAO). It was designed to use investors' Ether cryptocurrency to fund crypto-related businesses but with no persons or legal entities that could be regulated. Essentially, though, it was performing the same function as fund manager. The DAO rapidly turned into a disaster. The code that ran the DAO (commonly referred to as a smart contract) had a flaw that was soon exploited by a hacker to steal funds. Nobody could be held accountable for the operation of the DAO and there was no obvious way to either fix the problem or pursue the culprit. However, free from the constraints of real-world business, the Ethereum "community" reacted by creating a new version of the Ethereum network, where the bug did not exist and the hack had never happened. Imagine pretending the stock market crash had never happened because a stock exchange reverted all their records back to before the crash and pretended it had never happened.

In spite of the DAO, crypto influencers started to propagate the idea Ethereum (and similar public blockchains) would provide the basis for new industry of “decentralised” businesses. A dream that never had a grounding in reality. Aside from the accountability problem demonstrated by the DAO, running any kind of software on a public blockchain is grossly inefficient and expensive. Instead of having a single centralised system running a program, thousands of computers attempt to run the same code in the hope of winning fees or newly created cryptocurrencies. 2017 saw the dream start to become more real with the start of the initial coin offering (ICO) craze. An ICO was to all intents a share issue but without any protection for investors. “Tokens” were issued to fund the creation of businesses that would be based on public blockchains. The businesses funded ranged from the ill-conceived to the outright fraudulent. During 2017-2018 (the height of the craze) [over \\$21 billion](#) were raised. In spite of the apparent invulnerability of the crypto sector to the law, organisers of ICOs went to great lengths to avoid any kind of legal responsibility. Complex legal structures were set up, often involving Swiss non-profit foundations, and disclaimers stated that the purchasers of ICO tokens received no rights in return for their investment. ICOs were perhaps a little too obviously like initial public offerings of shares. From 2017 the US Securities and Exchange Commission (SEC) started prosecuting organisers and promoters of some ICOs.

ICOs, however, drove the great cryptocurrency bubble of 2017/18, which saw explosive growth in the profitability of cryptocurrency exchanges. Cryptocurrency exchanges are the point where the cryptocurrency industry intersects with the conventional finance system. Cryptocurrency investors need the ability to transfer funds from their banks to fund the purchase of cryptocurrencies. However, the problems of fitting cryptocurrencies into existing regulatory frameworks meant that the core trading activity of the exchanges remained [largely unregulated](#).

Areas such as payments and management of client funds should have clearly fallen within conventional rules. However even there the crypto industry worked to avoid regulation. Binance, considered the largest cryptocurrency exchange, has been condemned by multiple regulators (see [here](#), [here](#), and [here](#)) In large part because of a complex and opaque legal structure seemingly constructed to avoid effective regulation. The FCA [described it](#) as “impossible to oversee the sprawling group, which has no fixed headquarters and offers services around the world.”

One of the major problems for exchanges in offshore or ambiguous locations was opening dollar bank accounts. Most of the conventional banking sector has long been worried about the risks of dealing with the crypto industry, in terms of potential fines for anti-money-laundering (AML) or know-your-customer (KYC) regulation breaches. A solution to this was invention of the Stable coin. Stable coins first appeared in 2014 but have seen explosive growth over the last 12 months. These financial instruments are created using the same technologies as cryptocurrencies but instead of being purely speculative assets they function as substitutes for (generally US dollar) bank accounts. The Stable coin issuer creates a US dollar substitute (claimed to be) backed by good quality [US dollar-denominated assets](#).^[vii] Although issuers claimed to do background checks of direct customers, once issued, the Stable coins are bearer assets (like physical cash), but which can be electronically transferred to anyone with no real controls.

The question of how Stable coins were allowed to thrive is puzzling in many ways, given the [criminal prosecution](#) of Liberty Reserve in 2013, **which resulted in the founder receiving a 20-year prison sentence**. Liberty Reserve also created a dollar equivalent, with a payment network that allowed uncontrolled international payments. The difference was that the management of Liberty Reserve were not protected by an additional layer of blockchain technical complexity and notional decentralisation. Stable coin issuers such as Tether Inc. do not process transactions (done by “miners” on public blockchains), do not maintain records of who owns what and do not have any kind of contractual relationship with most holders of their currency. They are also seemingly immune from the regulations applying to real banks including the need to maintain capital to insure against losses on their investments/loans.

Creating alternative and mostly unregulated forms of bank accounts, fund management, share issuance and gambling was not enough for the crypto industry. 2020 saw the growth of DeFi or decentralised finance. DeFi deserves a book on its own but fundamentally it combined concepts from crypto, the DAO and ICOs, to create apparently decentralised, i.e., unaccountable, entities for trading, lending, insurance, and cryptocurrency derivatives. The reality beyond the hype was the creation of thousands more tokens that provided leverage to pump up the cryptocurrency market even further and create even further layers of confusion for regulators.

In reality, the crypto industry, which positions itself as alternative to the conventional financial sector, has adopted the techniques of conventional finance's dark corners. Unnecessary complexity is used to defeat regulators and the intentions of legislators. The socially destructive is presented as inherently good because it is "innovative". Given the long running problem of regulating financial "innovation" in a timely manner (as opposed to after the damage is done), what can regulators do when confronted by the additional challenges of decentralisation and rapidly evolving technological complexity? If regulators can answer that question, it would be the key to dealing with bad actors in both crypto and conventional finance.



Notes:

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