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**Smart Contracts: Navigating Legal, Regulatory and Consumer Protection Issues**

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The proliferation of blockchain laws across the United States

In June 2017 two US states - Nevada and Vermont - passed laws concerning blockchain, with the legislation following a law enacted in Arizona in April this year on the same subject. The laws address, for example, contract enforcement in regard to blockchain transactions, something that is not standardised across the US. Kari Larsen and Kimberly Chow describe here the latest US state efforts alongside activity at a federal level on blockchain, and discuss the kind of regulation industry is looking for.

While the United States federal Government is making efforts to become more knowledgeable regarding blockchain technologies, individual US states are leading the way in enacting legislation or issuing guidance addressing new technologies and digital currencies.

Blockchain is a distributed digital ledger technology (DLT), the first of which was originally designed to serve as the platform for Bitcoin, but one that is now being analysed and experimented with for numerous other use cases. Blockchain is catching the attention of states possibly because there has been limited federal action on blockchain and digital currencies as of yet, mostly consisting of guidance regarding anti-money laundering requirements and consumer protection. State regulators recently have made statements regarding gaps in digital currency and FinTech regulations and blockchain certainty. For example, a representative of the Illinois Department of Financial and Professional Regulation said in November 2016, “As innovative payment technologies grow in popularity, it is vital that we provide a succinct regulatory framework that gives businesses operating in this space necessary clarity.”

While most state laws on blockchain are concerned with money transmission issues such as anti-money laundering and know-your-customer laws, three states so far stand apart for their focus on the enforceability of blockchain contracts and otherwise clarifying that blockchain should not be subject to different requirements than other forms of contracting or exchange. In June 2017, both Nevada and Vermont passed new laws concerning blockchain, following the example set by Arizona in April 2017. The Nevada law, Senate Bill 398, was signed by the Governor on 5 June 2017, and prohibits local governments from imposing taxes or fees on the use of a blockchain; requiring a certificate, licence, or permit to use a blockchain; or imposing any other requirement relating to the use of blockchain. Additionally, Nevada law already gives legal recognition to electronic records, signatures, and contracts, and allows them to satisfy requirements for a written record or signature in certain circumstances. The new law explicitly includes blockchain within the definition of electronic record for similar purposes.

The Nevada law defines blockchain as ‘an electronic record of transactions or other data which is 1. Uniformly ordered; 2. Redundantly maintained or processed by one or more computers or machines to guarantee the consistency or non-repudiation of the recorded transactions or other data; and 3. Validated by the use of cryptography.’ Arizona passed a similar law, House Bill 2417, in March 2017, also requiring that smart contracts and blockchain signatures be given legal binding status. It likewise encompasses blockchain under existing laws that give legal effect to electronic signatures and records, stating, ‘A signature that is secured through blockchain technology is considered to be in an electronic form and to be an electronic signature,’ and ‘A record or contract that is secured through blockchain technology is considered to be in an electronic form and to be an electronic record.’ The law further states, ‘Smart contracts may exist in commerce. A contract relating to a transaction may not be denied legal effect, validity or enforceability solely because that contract contains a smart contract term.’

The Arizona law defines blockchain technology as ‘distributed ledger technology that uses a distributed, decentralized, shared and replicated ledger, which may be public or private, permissioned or permissionless, or driven by tokenized crypto economics or tokenless. The data on the ledger is protected with cryptography, is immutable and auditable and provides an uncensored truth.’ Smart contracts are defined as ‘an event-driven program, with state, that runs on a distributed, decentralized, shared and replicated ledger and that can take custody over and instruct transfer of assets on that ledger.’

Vermont has recently passed two laws clarifying the legal status of blockchain in the state. H.868 included language establishing that ‘a fact or record verified through blockchain technology is “authentic,” thereby giving data placed on and transferred via a blockchain legal bearing in court. The Governor signed H. 868 into law on 8 June 2017. The Law states, ‘A digital record electronically registered in a blockchain shall be self-authenticating pursuant to Vermont Rule of Evidence 902, if it is accompanied by a written declaration of a qualified person, made under oath, stating the qualification of the person to make the certification and: (A) the date and time the record entered the blockchain; (B) the date and time the record was received.”'
from the blockchain; (C) that the record was maintained in the blockchain as a regular conducted activity; and (D) that the record was made by the regularly conducted activity as a regular practice.’

The second Vermont Law, S. 135, was signed by the Governor on 8 June 2017. It provides that the state will embrace the innovations of blockchain technology in order to promote economic development, while also being aware of potential risks to consumers. Instead of prescribing specific regulations on the use of the technology at this point, the Law directs the Center for Legal Innovation at Vermont Law School, in consultation with the State, to submit a report to the State Assembly that includes findings and recommendations on the potential opportunities and risks presented by developments in financial technology, suggestions for an overall policy direction and proposals for legislative and regulatory action that would effectively implement that policy direction, and measurable goals and outcomes that would indicate success of the implementation of such a policy.

Other states are considering additional potential issues related to DLT and digital currencies that may prompt further state legislation or regulation. States such as North Carolina and Connecticut have passed legislation relating to virtual currencies, generally focused on the regulatory and supervisory issues pertaining to the transmission of virtual currency under the states’ respective money transmission statutes. Delaware’s legislature is currently considering a law that would make stock registries and other business records legal if they are recorded in blockchain format, which would be helpful for Delaware registrants’ corporate interests.

In crafting their legislation, Nevada and Arizona worked closely with industry groups and experts. As a result, the bills are simple and brief, as well as substantially similar (though they differ slightly in their definitions of blockchain), and neither is strikingly out of step with industry’s positions on these issues and the state of the technology.

These states’ interest in embracing blockchain stems in part from their interest in attracting cutting edge companies, including new blockchain startups and other technology companies considering leaving Silicon Valley. Venture capitalists and other investors also are increasingly interested in blockchain technology and its applications. Experts in the blockchain research field estimate that investments in blockchain startups in 2016 exceeded $1.5 billion. With this significant and continuing growth in investment, we expect that the application of DLT and smart contracts will continue to increase.

**Enforceability of contracts**

Arizona and Nevada’s laws are unique in specifically addressing contract enforcement and taxes with regard to blockchain transactions. While the federal Government has addressed the uncertainty of moving contracts to electronic format with the federal E-Sign Act, which provides that electronic signatures shall have the same legal effect as signatures on paper, these state laws have addressed broader enforcement issues by clarifying that the enforcement of software code will be equal to the written word in contracts.

The enactment of the E-Sign Act in 2000 addressed the evolution of business and how contracts are formed. It broadly mandates that ‘a signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.’

At the time of the E-Sign Act’s passage, a Congressional committee made several findings regarding the need for such a law, including that “[a] consistent legal foundation, across multiple jurisdictions, for electronic commerce will promote the growth of such transactions, and that such a foundation should be based upon a simple, technology neutral, nonregulatory, and market-based approach.”

With the advent of blockchain technology, not only the individual US states and the country as a whole, but the world as well, find themselves with a new need for a consistent foundation and a common understanding of contract enforceability. DLT industry participants, blockchain creators and users would appreciate the certainty that a blockchain law similar to the E-Sign Act would provide. The federal Government has not yet conclusively stepped in to standardise the US approach.
Federal efforts on blockchain

There generally has been limited federal guidance on blockchain thus far. Representatives Jared Polis (D-Colo.) and David Schweikert (R-Ariz.) formed a Congressional Blockchain Caucus in February 2017. The bipartisan group is dedicated to the advancement of sound public policy toward blockchain based technologies and digital currencies. The Financial Crimes Enforcement Network and Securities and Exchange Commission, as well as the Commodity Futures Trading Commission, have engaged in enforcement actions and have issued guidance addressing digital currencies, but have focused on digital currency products (and their transmission), investments, or derivatives, as applicable to each agency’s jurisdiction, as opposed to blockchain technology itself.

However, the federal Government may be becoming more interested in being proactive with regard to blockchain and digital currency policies. Senator Grassley of Iowa and Senator Feinstein of California recently filed a new AML bill aimed at increasing oversight of digital currency activities. The Bill proposes to incorporate Bitcoin and other digital currencies under the definition of ‘monetary instrument’ in certain US anti-money laundering statutes, as it includes ‘funds stored in a digital format’ in the requirements. In addition, Representative Kathleen Rice of New York recently called for a study by Homeland Security into the threat of digital currency use in terrorism financing.

Earlier this year, the U.S. Financial Industry Regulatory Authority (FINRA) published a report on DLT and the implications of blockchain on the securities industry and requested comments from the industry regarding the technology and FINRA’s findings. The Report was intended to begin a dialogue with the industry regarding the potential risks and opportunities of blockchain technology in the financial services industry.

In addition, the Internal Revenue Service has also explored this area, issuing guidance in 2014 explaining that digital currencies should be taxed as intangible property. The IRS seems to be looking at digital currency transactions anew, however, as indicated by its recent demand that virtual currency exchange Coinbase provide records of all of its customer transactions over the past several years. Earlier this month, members of the Blockchain Caucus sent a letter to the IRS asking the agency to provide additional guidance on the tax consequences and basic tax reporting requirements for digital currency transactions. There has not yet, however, been much discussion at the federal level regarding blockchain and smart contract enforcement certainty.

States respond to perceived federal inaction

States appear to be more than willing to be the legislative first movers in this space and are taking matters into their own hands. In particular, states often assert that money transmission and related customer protections most appropriately fall within their purview, as evidenced by strong state opposition to proposals by the Office of the Comptroller of the Currency to grant special-purpose national bank charters to FinTech companies. The proliferation of state laws addressing blockchain has been somewhat inconsistent, with states setting varying and conflicting standards for how blockchain is treated, in particular whether digital currencies constitute money. For example, a July 2016 Florida state court decision ruled that Bitcoin was not currency, while a September 2016 Southern District of New York decision interpreted Bitcoin as currency.

Fortunately, the laws passed in Arizona, Nevada, and Vermont are not inconsistent, and those of Arizona and Nevada are largely similar in scope. If the passage of these recent bills is indicative of further state action in this area, companies can tentatively expect more predictability regarding the use of blockchain technology and the enforceability of smart contracts on a blockchain, with the caveat that future bills may impose varying standards. This balance is always a tightrope walk, with certain regulations necessary and welcomed, as they can provide the certainty necessary for emerging industries to have confidence to invest and grow. However, over-regulation, overreaching regulation or conflicting regulations in multiple jurisdictions can dramatically inhibit growth. For example, New York State passed the first ‘BitLicense’ regulations, which industry had hoped would be helpful by providing regulatory clarity. However, many in the industry view the final regulations as onerous and burdensome, and as having effectively halted digital currency and digital ledger technology innovation in the state of New York. Numerous companies have relocated and/or will not offer their products to customers located in New York as a result.

Industry consistently advocates for clear, fair, and proportionate regulations that will protect customers and facilitate business and transactions, regardless of the form of currency or technology. FinTech industry participants often encourage lawmakers and regulators to adopt a ‘do no harm’ approach to regulation and legislation by allowing technologies to develop freely, and for companies to innovate prior to enacting any technology specific laws.

Rather than rewarding or penalising certain technologies, regulations should focus on regulating functions and behaviour, such as how the Nevada Law confirms the enforceability of contracts, whether they are in an electronic (blockchain) or other format. This approach echoes the philosophy behind the E-Sign Act, whose supporters emphasised that contracting solutions should be technology neutral and market based.

Implications

States and the federal Government increasingly are becoming informed regarding and engaging with blockchain. Numerous regulators have already requested information from industry participants in fact gathering efforts, but industry should be ready for the possibility of more aggressive regulatory efforts, as regulators become more educated and as the industry becomes more mainstream. Regulators will hopefully continue to engage with industry participants regarding emerging technologies in order to produce appropriate, consistent and proportionate rules that protect users but do not cripple technologies that have the potential to provide new efficiencies and revolutionary technology solutions.
The federal Government may be becoming more interested in being proactive with regard to blockchain and digital currency policies.