THE VIRTUAL CURRENCY REGULATION REVIEW

SECOND EDITION

Editors
Michael S Sackheim and Nathan A Howell

THE LAWREVIEWS

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PREFACE

We are pleased to introduce the second edition of *The Virtual Currency Regulation Review* (the *Review*). The increased acceptance and use of virtual currencies by businesses and the exponential growth of investment opportunities for speculators marked late 2018 and early 2019. As examples, in May 2019, it was reported that several of the largest global banks were developing a digital cash equivalent of central bank-backed currencies that would be operated via blockchain technology, and that Facebook was developing its own virtual currency pegged to the US dollar to be used to make payments by people without bank accounts and for currency conversions.

The *Review* is a country-by-country analysis of developing regulatory initiatives aimed at fostering innovation, while at the same time protecting the public and mitigating systemic risk concerning trading and transacting in virtual currencies. On 28 May 2019, the International Organizations of Securities Commissions (IOSCO) published a report titled 'Issues, Risks and Regulatory Considerations Relating to Cryptoassets'. This report provided guidance on the unique issues concerning overseeing cryptoasset trading platforms that provide onboarding, clearing, settlement, custody, market making and advisory services for investors under the umbrella of a single venue. IOSCO advised global regulators of these platforms that their goals should be to ensure that investors are protected, fraud and manipulation are prevented, cryptoassets are sold in a fair way and systemic risk is reduced – the same goals that apply to securities regulation. IOSCO also advised that national regulators should share information, monitor market abuse, take enforcement actions against cryptoasset trading platforms when appropriate and ensure that these venues are resilient to cyberattacks. In the United States, the US Securities and Exchange Commission has not yet approved public offerings of virtual currency exchange-traded funds. The US Commodity Futures Trading Commission (CFTC) has approved of virtual currency futures trading on regulated exchanges and the trading of virtual currency swaps on regulated swap executed facilities. US regulators remain concerned about potential abuses and manipulative activity concerning virtual currencies, including the proliferation of fraudulent virtual currency Ponzi schemes. In May 2019, the US Financial Crimes Enforcement Network issued guidance concerning the application of bank secrecy laws relating to financial institutions with respect to identifying and reporting suspicious activities by criminals and other bad actors who exploit convertible virtual currencies (virtual currencies whose values can be substituted for fiat currencies) for illicit purposes. The CFTC also issued an alert offering potential whistle-blower rewards to members of the public who report virtual currency fraud or manipulation to the CFTC.

Fortunes have been made and lost in the trading of virtual currencies since Satoshi Nakamoto published a white paper in 2008 describing what he referred to as a system for peer-to-peer payments, using a public decentralised ledger known as a blockchain and

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cryptography as a source of trust to verify transactions. That paper, released in the dark days of a growing global financial market crisis, laid the foundations for Bitcoin, which would become operational in early 2009. Satoshi has never been identified, but his white paper represented a watershed moment in the evolution of virtual currency. Bitcoin was an obscure asset in 2009, but it is far from obscure today, and there are now many other virtual currencies and related assets. In 2013, a new type of blockchain that came to be known as Ethereum was proposed. Ethereum's native virtual currency, Ether, went live in 2015 and opened up a new phase in the evolution of virtual currency. Ethereum provided a broader platform, or protocol, for the development of all sorts of other virtual currencies and related assets.

Whether virtual currencies will be widely and consistently in commercial use remains uncertain. However, the virtual currency revolution has now come far enough and has endured a sufficient number of potentially fatal events that we are confident virtual currency in some form is here to stay. Virtual currencies and the blockchain and other distributed ledger technology on which they are based are real, and are being deployed right now in many markets and for many purposes. These technologies are being put in place in the real world, and we as lawyers must now endeavour to understand what that means for our clients.

Virtual currencies are essentially borderless: they exist on global and interconnected computer systems. They are generally decentralised, meaning that the records relating to a virtual currency and transactions therein may be maintained in a number of separate jurisdictions simultaneously. The borderless nature of this technology was the core inspiration for the *Review*. As practitioners, we cannot afford to focus solely on our own jurisdictional silos. For example, a US banking lawyer advising clients on matters related to virtual currency must not only have a working understanding of US securities and derivatives regulation; he or she must also have a broad view of the regulatory treatment of virtual currency in other major commercial jurisdictions.

Global regulators have taken a range of approaches to responding to virtual currencies. Some regulators have attempted to stamp out the use of virtual currencies out of a fear that virtual currencies such as Bitcoin allow capital to flow freely and without the usual checks that are designed to prevent money laundering and the illicit use of funds. Others have attempted to write specific laws and regulations tailored to virtual currencies. Still others – the United States included – have attempted to apply legacy regulatory structures to virtual currencies. Those regulatory structures attempt what is essentially 'regulation by analogy'. For example, a virtual currency, which is not a fiat currency, may be regulated in the same manner as money, or in the same manner as a security or commodity. We make one general observation at the outset: there is no consistency across jurisdictions in their approach to regulating virtual currencies. That is, there is currently no widely accepted global regulatory standard. That is what makes a publication such as the *Review* both so interesting and so challenging to assemble.

The lack of global standards has led to a great deal of regulatory arbitrage, as virtual currency innovators shop for jurisdictions with optimally calibrated regulatory structures that provide an acceptable amount of legal certainty. While some market participants are interested in finding the jurisdiction with the lightest touch (or no touch), most legitimate actors are not attempting to flee from regulation entirely. They appreciate that regulation is necessary to allow virtual currencies to achieve their potential, but they do need regulatory systems with an appropriate balance and a high degree of clarity. The technology underlying virtual currencies is complex enough without adding layers of regulatory complexity into the mix.

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It is perhaps ironic that the principal source of strength of virtual currencies – decentralisation – is the same characteristic that the regulators themselves seem to be displaying. There is no central authority over virtual currencies, either within and across jurisdictions, and each regulator takes an approach that seems appropriate to that regulator based on its own narrow view of the markets and legacy regulations. We believe optimal regulatory structures will emerge and converge over time. Ultimately, the borderless nature of these markets allows market participants to 'vote with their feet', and they will gravitate toward jurisdictions that achieve the right regulatory balance of encouraging innovation and protecting the public and the financial system. It is much easier to do this in a primarily electronic and computerised business than it would be in a bricks-and-mortar business. Computer servers are relatively easy to relocate; factories and workers are less so.

The second edition of the *Review* provides a practical analysis of recent legal and regulatory changes and developments, and of their effects, and looks forward to expected trends in the area of virtual currencies on a country-by-country basis. It is not intended to be an exhaustive guide to the regulation of virtual currencies globally or in any of the included jurisdictions. Instead, for each jurisdiction, the authors have endeavoured to provide a sufficient overview for the reader to understand the current legal and regulatory environment.

Virtual currency is the broad term that is used in the *Review* to refer to Bitcoin, Ether, tethers and other stablecoins, cryptocurrencies, altcoins, ERC20 tokens, digital, virtual and cryptoassets, and other digital and virtual tokens and coins, including coins issued in initial coin offerings. We recognise that in many instances the term virtual currency will not be appropriate, and other related terms are used throughout as needed. In the law, the words we use matter a great deal, so, where necessary, the authors of each chapter provide clarity around the terminology used in their jurisdiction and the legal meaning given to that terminology.

Based on feedback on the first edition of the *Review* from members of the legal community throughout the world, we are confident that attorneys will find the updated second edition to be an excellent resource in their own practices. We are still in the early days of the virtual currency revolution, but it does not appear to be a passing fad. The many lawyers involved in this treatise have endeavoured to provide as much useful information as practicable concerning the global regulation of virtual currencies.

The editors would like to extend special thanks to Ivet Bell (New York) and Dan Applebaum (Chicago), both Sidley Austin LLP associates, for their invaluable assistance in organising and editing the second edition of the *Review*, and particularly the United States chapter.

Michael S Sackheim and Nathan A Howell
Sidley Austin LLP
New York and Chicago
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Chapter 19

NEW ZEALAND

Deemple Budhia and Tom Hunt[1]

I INTRODUCTION TO THE LEGAL AND REGULATORY FRAMEWORK

Virtual currencies and services related to virtual currencies in New Zealand are regulated by existing, technology-neutral legislation. Given that the rights and functions created in respect of virtual currencies are flexible, each virtual currency or service associated with virtual currencies will be regulated according to its specific properties.

For the purposes of this chapter, the term virtual currencies includes all digital tokens that are recorded on a blockchain ledger.

II SECURITIES AND INVESTMENT LAWS

The Financial Markets Authority (FMA) has responsibility for the regulation of financial products in New Zealand, and the Financial Markets Conduct Act 2013 (FMCA) is the principal piece of legislation that regulates financial products. The primary purposes of the FMCA are to promote the confident and informed participation of businesses, investors and consumers in New Zealand's financial markets, and to promote and facilitate the development of fair, efficient and transparent financial markets.

Offers of financial products in New Zealand are regulated by the FMCA and regulations made under the FMCA (the Regulations). The FMCA and the Regulations:

a impose fair dealing obligations on conduct in both the retail and wholesale financial markets;

b set out the disclosure requirements for offers of financial products;

c set out a regime of exclusions and wholesale investor categories in connection with the disclosure requirements;

d set out the governance rules that apply to financial products; and

e impose licensing regimes.

In general under the FMCA, issuers of financial products must comply with various fair dealing obligations and certain disclosure, governance and operational obligations (subject to certain exceptions). The fair dealing provisions are concerned with misleading or deceptive conduct, and false, misleading or unsubstantiated representations. Failure to comply with the appropriate obligations may result in criminal or civil liability, or both, under the FMCA, and may result in material financial penalties, imprisonment, or both.

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1 Deemple Budhia and Tom Hunt are partners at Russell McVeagh. The authors would like to acknowledge the contributions of Hamish Journeaux, Michael van de Water and Young-chan Jung.

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At a high level (and subject to the detail below), the disclosure and governance provisions of the FMCA will only apply to the offer of a virtual currency if:

a it is offered in New Zealand;

b it is made under a regulated offer; and

c the relevant virtual currency falls within one of the categories of financial product in the FMCA, or is otherwise designated as a financial product by the FMA.

i Offers in New Zealand

The obligations imposed under the FMCA apply to offers of financial products in New Zealand, regardless of where the issue occurs or where the issuer is based. An offer is deemed to have been offered in New Zealand if it is received by a person in New Zealand (including electronically), unless the issuer can demonstrate that it has taken all reasonable steps to ensure that persons in New Zealand to whom disclosure would otherwise be required under the FMCA may not accept the offer.

ii Regulated offers

An offer of financial products that requires disclosure under the FMCA is a regulated offer. An offer of financial products for issue requires disclosure to investors unless an exclusion applies to all persons to whom the offer is made. Certain specified offers of financial products for sale will also require disclosure to investors. The form and content of the disclosure required in relation to each financial product is set out in the Regulations and is tailored according to the characteristics of the particular financial product being offered.

The FMCA provides that a person must not make a regulated offer unless the issuer has prepared a product disclosure statement (PDS) for the offer, has lodged that PDS with the Registrar of Financial Service Providers (the Registrar) and has prepared an online register with the prescribed information.

An offer that is not a regulated offer will still be subject to the fair dealing provisions in the FMCA. As noted above, these provisions prevent people from making false or misleading statements or unsubstantiated representations. Similar obligations are imposed under the Fair Trading Act 1986.

iii Types of financial product

There are four categories of financial products under the FMCA: debt securities, equity securities, managed investment products and derivatives.

Virtual currencies are regulated by the FMCA only to the extent that a particular virtual currency meets the definition of one these categories of financial product. The FMCA sets out a hierarchy of financial products, such that a virtual currency that would prima facie satisfy the definition of more than one category of financial product will default into only one category.

Debt securities

A debt security is defined as a right to be repaid money, or paid interest on money, where that money is deposited, lent to or otherwise owing by any person. Importantly, for the purposes of the definition of debt security, money does not include money's worth. Several prominent virtual currencies, such as Bitcoin and Ether, do not constitute debt securities because there is not a right to be repaid money or to be paid interest by the issuer, or anyone else.

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Equity securities

An equity security is narrowly defined in the FMCA as a share in a company, an industrial and provident society, or a building society, but does not include a debt security.

While a blockchain could mimic a traditional share register (with each unit of the virtual currency representing a single share, and shareholders being able to represent trades in those shares by trading in those units), the virtual currency itself would not constitute a share in a company, an industrial and provident society, or a building society. As such, a virtual currency could not be an equity security as defined in the FMCA. This is the case even where a virtual currency gives holders rights traditionally associated with equity (such as certain profit and governance rights).

Managed investment products

A managed investment product refers to an interest in a managed investment scheme, which is broadly defined to include any scheme:

a the purpose or effect of which is to enable participating investors to contribute money to the scheme to acquire an interest in the scheme;

b where the interests are rights to participate in or receive financial benefits produced principally by the efforts of others; and

c where participating investors do not have day-to-day control over the operation of the scheme.

If a product is classified as a debt security or an equity security it would not be a managed investment product.

If a virtual currency is classified as a managed investment product, the FMCA imposes significant disclosure and governance requirements on the underlying managed investment scheme. These requirements include registering the scheme with the Registrar; complying with reporting and governance requirements; and requiring the appointment of a licensed manager and licensed independent supervisor, each of which owe statutory duties of care to investors.

In practice, the nature of a virtual currency may make it impractical or impossible to fully comply with these additional requirements. For example, one of the functions of the manager of a managed investment scheme is to manage the scheme property and investments. This requirement is not compatible with a decentralised blockchain where the scheme property is held in (for example) an Ethereum account associated with a smart contract. If there were a manager who had overall control over this account, the decentralised nature of the blockchain and the autonomous nature of the smart contract would be undermined.

By way of example, the DAO and DAO tokens, which were the subject of a report in 2017 by the United States' Securities and Exchange Commission, could have been characterised as a managed investment scheme and managed investment products (respectively) under the FMCA.[2]

2 https://www.russellmcveagh.com/getattachment/Insights/August-2017/Initial-Coin-Offerings-not-immune-from-regulatio/Initial-Coin-Offerings.pdf.

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Derivatives

A derivative is defined as an agreement under which consideration is, or may be, payable to another person at some future time and the amount of the consideration is ultimately determined, is derived from or varies by reference to (in whole or in part) the value or amount of something else (including an asset, interest rate, exchange rate, index or commodity). A derivative does not include, inter alia, a debt security, equity security or managed investment product. Certain virtual currencies that are tied to the value of fiat currencies, or that are tied to commodities such as gold (stablecoins), could constitute a derivative under the FMCA.

iv FMA designation and exemption powers

The FMA has certain designation powers under the FMCA, including the power to designate:

a that a security that would not otherwise be a financial product is a financial product of a particular kind. A security is an arrangement or facility that has, or is intended to have, the effect of a person making an investment or managing a financial risk. The FMA has expressed the view that all digital tokens issued in an initial coin offering (ICO) will constitute a security for the purposes of the FMCA; or

b that a financial product is, or is to become, a financial product of a particular kind. For example, if a virtual currency fell within the definition of managed investment product, the FMA could designate such interests as equity securities. In that case, the issuer would still be required to provide disclosure to investors, but would not be subject to the prescriptive governance obligations described above.

Alternatively, the FMA has the power to exempt any person or class of persons, or any transaction or class of transactions, from compliance with certain obligations imposed under the FMCA. For example, the FMA could exempt an issuer of a virtual currency classified as a managed investment product from some of the provisions that would otherwise apply to the issuer.

III BANKING AND MONEY TRANSMISSION

The Reserve Bank of New Zealand (RBNZ) has responsibility for the prudential regulation of registered banks, non-bank deposit takers and insurers in New Zealand. The RBNZ does not directly regulate virtual currencies. However, as New Zealand's central bank, the RBNZ is responsible for promoting the maintenance of a sound and efficient financial system.

Money transmission services in New Zealand are regulated separately by the Financial Service Providers (Registration and Dispute Resolution) Act 2008 (the FSP Act) and the Anti-Money Laundering and Countering Financing of Terrorism Act 2009 (the AML/CFT Act). As the anti-money laundering regime is discussed in Section IV, this section is limited to the FSP Act.

Subject to certain limited exceptions, the FSP Act applies to any person who carries on the business of providing a financial service (a financial service provider) and:

a is ordinarily resident in New Zealand or has a place of business in New Zealand;

b is required to be a licensed provider under a licensing enactment (which includes registered banks, authorised financial advisers, licensed insurers and certain licensed supervisors); or

c is required to be registered under the FSP Act by any other enactment.

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The core requirement of the FSP Act is that financial service providers must be registered for the relevant financial service on the Financial Service Providers Register (FSPR). Financial service providers that provide financial services to retail clients must also join an approved dispute resolution scheme, subject to certain limited exceptions.

The term financial service includes, inter alia, operating a money or value transfer service, and issuing and managing means of payment.

The FMA has issued guidance (the Guidance) stating that in the context of virtual currency services, exchanges, wallets and ICOs may be considered financial services under the FSP Act.[3] By way of example, exchanges allowing virtual currency trading will, according to the Guidance, be operating a value transfer service under the FSP Act. Similarly, the Guidance states, a wallet provider that stores virtual currency or money on behalf of others, and facilitates exchanges between virtual currencies or between money and virtual currencies, will also be operating a value transfer service. The Guidance also points out that trading of virtual currencies that are financial products may also trigger the need for a licence to operate a financial product market under the FMCA.

Enforcing the provisions of the FSP Act in relation to public blockchains is somewhat difficult in practice. The primary issue is that a public blockchain may not be managed by one particular entity, but instead may be managed by the relevant blockchain community. As the core requirement of the FSP Act is that financial service providers are registered, this may prove to be difficult as there may not be one person or organisation who is able to register.

IV ANTI-MONEY LAUNDERING

New Zealand's anti-money laundering regime is set out in the AML/CFT Act, which applies to reporting entities. A reporting entity includes, inter alia:

a financial institutions, which are defined as any person who, in the ordinary course of business, carries on one or more of the financial activities listed in the AML/CFT Act. Those financial activities include transferring money or value for, or on behalf of, a customer, issuing or managing the means of payment, and money or currency changing; and

b any other person or class of persons deemed to be a reporting entity under the regulations or any other enactment.

The AML/CFT Act imposes customer due diligence, reporting and record-keeping requirements on reporting entities. It also requires reporting entities to develop and maintain a risk assessment and a risk-based AML/CFT programme. The AML/CFT Act provides for external supervision of reporting entities by the FMA, the RBNZ or the Department of Internal Affairs. The functions of an AML/CFT supervisor are to, inter alia, monitor the level of risk of money laundering and the financing of terrorism involved across all the reporting entities it supervises; and monitor the reporting entities it supervises for compliance with the AML/CFT Act.

Obligations under the AML/CFT Act generally apply to a reporting entity only to the extent that it provides one of these financial activities to a customer. The term customer is

3 https://fma.govt.nz/compliance/cryptocurrencies/cryptocurrency-services/.

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very broadly defined. By way of example, an exchange that allows virtual currency trading could be a reporting entity under the AML/CFT Act, and entities that trade on the exchange could be its customers.

The AML/CFT Act does not specify the territorial scope of the Act. The AML/CFT supervisors have issued guidance on the territorial scope, which states that the relevant financial activities caught by the AML/CFT Act 'must be carried on in New Zealand in the ordinary course of business', and that this implies a place of business in New Zealand. The guidance is difficult to apply to blockchain-based technologies where the technology is online and therefore is not necessarily carried on in New Zealand even though it is accessible to persons in New Zealand.

In the case of virtual currencies, compared to more conventional circumstances contemplated when the AML/CFT Act was enacted, it can be challenging to interpret the legislation to determine who constitutes a reporting entity and a customer. More practically, the inherent anonymity that comes with using many virtual currencies may impose significant challenges for reporting entities to realistically be able to conduct customer due diligence on customers.

In addition, the issues discussed above in relation to the FSP Act also apply to the AML/CFT Act. The lack of a clear owner or manager of a particular virtual currency may make it difficult for regulators to identify the entity that should be complying with the obligations under the AML/CFT Act, and to bring a claim for a breach of obligations.

V REGULATION OF EXCHANGES

Exchanges are regulated by the FMCA if the exchange constitutes a financial product market. The FMCA defines a financial product market as a facility by means of which:

a offers to acquire or dispose of financial products are made or accepted; or

b offers or invitations are made to acquire or dispose of financial products that are intended to result, or may reasonably be expected to result, directly or indirectly, in:
- the making of offers to acquire or dispose of financial products; or
- the acceptance of offers of that kind.

Virtual currency exchanges could therefore be regulated if the relevant virtual currency being exchanged constitutes a financial product under the FMCA.

A person must not operate, or represent to others that the person operates, a financial product market in New Zealand unless such person has a licence to operate the market under the FMCA or the market is exempt from licensing. A financial product market is taken to be operated in New Zealand if:

a it is operated by an entity that is incorporated or registered in New Zealand or by an individual who is ordinarily resident in New Zealand;

b all, or a significant part of, the facility for the financial product market is located in New Zealand; or

c the financial product market is promoted to investors in New Zealand by or on behalf of the operator of that market, or by or on behalf of an associated person of that operator. However, a financial product market is not promoted to investors in New Zealand merely because it is accessible by those investors.

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As noted in Section III, the Guidance indicates that the FMA considers that the licensing regime under the FMCA could apply to virtual currency exchanges.

Licensed market operators must have FMA-approved market rules, and comply with certain disclosure and reporting obligations to ensure that every licensed market is a fair, orderly and transparent market.

VI REGULATION OF MINERS

Miners are not expressly regulated in New Zealand. However, there are certain criminal offences, discussed in Section VIII, which relate to accessing computer systems for dishonest purposes. In that case, miners who choose to improperly access the processing power of another person's computer system to mine a virtual currency would be committing an offence under New Zealand law.

VII REGULATION OF ISSUERS AND SPONSORS

New Zealand has a disclosure-based approach to the offer of financial products to the public. An offer of financial products for issue will require full disclosure to investors under the FMCA, unless an exclusion applies (as discussed in Section II.ii).

In addition, certain offers of financial products for sale (secondary sales) also require disclosure. For example, if financial products are issued (but not, inter alia, under a regulated offer) with a view to the original holder selling the products and the offer for sale is made within 12 months of the original issue date, that secondary offer will require disclosure.

As discussed in Section II.ii, for a regulated offer of financial products a PDS must be prepared, and certain information relating to the offer must be contained in a publicly available register entry for the offer. The PDS must be lodged with the Registrar, and the register entry must contain all material information not contained in the PDS. Material information means information that a reasonable person would expect to, or to be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer, and is specific to the particular issuer or the particular financial product. Investors to whom disclosure is required must (subject to certain exceptions) be given the PDS before an application to acquire the relevant financial products under a regulated offer is accepted or the financial product is issued.

The Regulations set out detailed requirements for the timing, form and content of initial and ongoing disclosure for financial products, including limited disclosure for products offered under certain FMCA exclusions. The content requirements for a PDS are prescriptive and include prescribed statements and page or word limits. The Regulations impose different disclosure requirements for different types of financial products.

The FMCA includes an exclusion for offers to wholesale investors, which include:

a investment businesses;
b people who meet specified investment activity criteria;
c large entities (those with net assets of at least NZ$5 million or consolidated turnover over NZ$5 million in each of the two most recently completed financial years);
d government agencies;
e eligible investors;
f persons paying a minimum of NZ$750,000 for the financial products on offer;
g persons acquiring derivatives with a minimum notional value of NZ$5 million; and
h bona fide underwriters or sub-underwriters.

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Even where an exclusion (including the wholesale investor exclusion) applies, certain disclosure requirements may still apply.As discussed above, the application of these provisions to offers of virtual currencies turns on whether they are a financial product or are designated a financial product by the FMA.

VIII CRIMINAL AND CIVIL FRAUD AND ENFORCEMENT

The New Zealand courts have held that intangible property is capable of being property for the purposes of criminal law. Accordingly, under the Crimes Act 1961 (the Crimes Act) – the primary piece of legislation that prescribes criminal offences in New Zealand – there are a number of criminal offences that could apply to the use of virtual currencies. These include theft, obtaining property or causing loss by deception, as well as crimes involving computers.

It is an offence to obtain property or valuable consideration by deception, or cause loss to another person by deception. This could cover circumstances in which a person is scammed by a malicious issuer of an ICO (where the issuer purports to raise money for a project by issuing virtual currency in an ICO with no intention of honouring its obligation to deliver certain products or services to the investor who purchased the virtual currency). In this particular situation, the FMCA also provides for offences for misleading or deceptive conduct in relation to disclosure of information made by the issuer under the FMCA.

It is possible that the general offence of theft could also apply to virtual currencies. However, if that theft was procured by a person hacking another's computer or accounts, prosecution as a crime involving computers may also apply. These include accessing a computer system for dishonest purposes and accessing a computer system without authorisation. This could cover the recent trend of viruses that hijack a target computer's processing power for the purposes of mining virtual currencies. As with other parts of New Zealand law, this crime is not concerned specifically with virtual currencies, but is drafted broadly enough that the kind of activity above would be covered.

The New Zealand police have authority to investigate alleged crimes and to prosecute individuals charged with an offence under the Crimes Act in a court (with Crown solicitors as required). The New Zealand courts may impose fines, prison sentences and other penalties prescribed in the Crimes Act where an offender is found guilty (maximum penalties are prescribed by the Crimes Act).

As far as civil law is concerned, the same legal analysis is likely to apply whether cash or virtual currencies are obtained by fraudulent means. The difference is more likely to be practical, and in particular the practical difficulties of identifying, or enforcing a judgment against, the defendant.

In these circumstances, an innocent party may wish to consider remedies against third parties (who may be more readily identifiable). For example, if a third party comes into possession of fraudulently obtained virtual currency, and was not a purchaser for value, then a claim of knowing receipt, a proprietary restitutionary claim or a claim for unjust enrichment may be available. However, if the third party was a bona fide purchaser for value, then these remedies will likely not be available.

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IX TAX

New Zealand has no specific tax regime for virtual currencies. Instead, the taxation of virtual currencies is governed by the existing legal framework. It is necessary to consider both the Income Tax Act 2007 and the Goods and Services Tax Act 1985 (the GST Act).

i Income tax

Broadly, a person may become subject to income tax on amounts derived from virtual currencies in circumstances where the amount is derived from:

a a business of the person and is not a capital receipt;

b carrying on or carrying out an undertaking or scheme entered into or devised for the purpose of making a profit; or

c disposing of personal property of the person if the property was acquired with the purpose of disposing of it.

The Inland Revenue Department (IRD) has issued limited guidance on the tax treatment of virtual currencies, in which it states that virtual currencies should be treated as personal property (not currency) for income tax purposes. The IRD has also engaged in public consultation on certain other discrete tax issues arising from the use of virtual currency, however no detailed guidance has yet been published.

In relation to provisions that refer to a person's purpose, it is the person's subjective dominant purpose at the time of acquiring the property that is relevant. Therefore, if at the time of acquiring virtual currency a person does so with the purpose of later disposing of it, any amounts derived from the disposal (e.g., for a sale or exchange) will be treated as income (and therefore be subject to income tax). The IRD's guidance suggests virtual currencies will generally be acquired with the purpose to sell or exchange because (in general) virtual currencies do not produce an income stream or any benefits, except when sold or exchanged. However, each amount derived from virtual currencies should be considered separately to determine whether the virtual currency was acquired for the purpose of disposal and whether the amounts derived from the disposal are income to which income tax will apply.

New Zealand has a regime known as the 'financial arrangements rules'. These rules require a party to a 'financial arrangement' to spread income and expenditure over the term of the financial arrangement for tax purposes. The financial arrangements rules disregard the traditional distinction between capital and revenue, and instead have regard to all consideration paid or received under the financial arrangement.

Broadly, a financial arrangement is an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person (1) at a future time or (2) on the occurrence or non-occurrence of a future event.

A virtual currency or a transaction involving virtual currency may be subject to the financial arrangements rules if the definition of financial arrangement is satisfied.

ii Goods and services tax

Goods and services tax (GST) is imposed under the GST Act, and is charged on supplies in New Zealand of goods and services by a registered person in the course or furtherance of a taxable activity.

A person makes supplies in the course or furtherance of a taxable activity if the supplies are in the course of an activity (whether or not for pecuniary profit) carried on continuously

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or regularly by the person involving the supply of goods and services for consideration. The term 'taxable activity' includes any activities of business or trade, and therefore it may be relevant to determine whether the supplier is a person carrying on business for income tax purposes.

For the purposes of GST, virtual currencies are best classified as choses in action, which are included in the definition of services. The sale of virtual currencies would therefore be a supply of services and subject to GST if the supply is made in New Zealand by a registered person, and in the course or furtherance of a taxable activity carried on by that person.

As virtual currencies are arguably services, not money, for the purposes of the GST Act, any transaction involving the exchange of virtual currency for goods or services will be treated as a barter transaction. Under the GST Act, this involves two separate supplies: the supply of virtual currency from person A to person B; and the supply of goods or services from person B to person A.

Therefore, GST could be chargeable in respect of the supply of goods and services (for which the payment in virtual currency is consideration) as well as the supply of the virtual currency. Given that the virtual currency is functionally a means of payment, this would seem to be the wrong outcome in policy terms. In 2017, Australia amended its GST legislation to address this issue; New Zealand is yet to announce whether it will follow suit.

Supplies made in New Zealand

In general, goods and services are deemed to be supplied in New Zealand if the supplier is resident in New Zealand, and are deemed to be supplied outside New Zealand if the supplier is a non-resident.

However the supply of a virtual currency may in many circumstances meet the definition of a remote service for the purposes of the GST Act. A remote service is defined as a service that, at the time of the performance of the service, has no necessary connection between the place where the service is physically performed and the location of the recipient of the services.

Where the services (the virtual currency) being supplied are remote services, the recipient of the services is a person resident in New Zealand, and the recipient of the service is not registered for GST, or is registered for GST but does not acquire the virtual currency for the purposes of carrying on his or her taxable activity, then a supply made by a non-resident is treated as being made in New Zealand unless the services are physically performed in New Zealand by a person who is in New Zealand at the time that the services are performed. In the context of virtual currencies, it is difficult to determine how the service could be physically performed, and therefore this exclusion is unlikely to apply. If the non-resident is, or is required to be, GST-registered (see below), non-residents will be required to account for GST on such supplies.

A non-resident person making supplies of remote services must treat the recipient of the supply as a person resident in New Zealand if any two items of a specified list of indicia are non-contradictory and support the conclusion that the person is resident in New Zealand. However, in cases where the non-resident also has certain evidence that the person is resident in a country other than New Zealand, the supplier must use the more reliable evidence to determine the person's residence.

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Supplies made by a registered person

GST is only chargeable in respect of supplies made by a registered person. Broadly, a person is liable to be registered for GST if the total value of supplies made in New Zealand exceeds, or is expected to exceed, NZ$60,000 in a 12-month period. The registered person definition includes a person who is required to register for GST. Therefore, failure to register for GST does not exempt a person from compliance with obligations imposed under the GST Act. Persons selling virtual currencies exceeding NZ$60,000 in a 12-month period may therefore be liable to be registered.

If a non-resident who makes supplies of remote services determines that the recipient of the supply is a New Zealand resident (as described above), the supplier must treat the recipient as not being a registered person unless the recipient notifies the supplier that he or she is a registered person, or provides his or her registration number or New Zealand business number.

X LOOKING AHEAD

Public and regulator interest in virtual currencies continues to grow in New Zealand and globally. The FMA is the key regulator in New Zealand in respect of virtual currencies, and its position in respect of developments in this area has been clearly stated in the Guidance.

One of the purposes of the FMCA is to promote innovation and flexibility in the financial markets, and the FMA has stressed that its job is not to stop innovative businesses from succeeding. However, promoting innovation does not mean that the FMA will allow risks of new technology and products to be passed on to retail investors in a manner that investors do not understand. Accordingly, the FMA's position is that open and early communication is vital for persons seeking to launch blockchain-related products and technology in New Zealand.

i Territorial scope of the FSP Act

In April 2019, Parliament enacted the Financial Services Legislation Amendment Act 2019 (FSLAA), which will, inter alia, impose more stringent requirements for entities wanting to register on the FSPR. Entities will only be able to register if they are in the business of providing financial services to persons in New Zealand or otherwise required to be licensed or registered under any other New Zealand legislation.

These amendments are intended to prevent abuse of the FSPR by entities using registration on the FSPR to imply that they are subject to licensing or other regulatory obligations in New Zealand (which is often not the case). The provisions of the FSLAA affecting the scope of the FSP Act will come into force on the earlier of 1 May 2021 or a date appointed by the Governor-General.

ii Cryptopia

In January 2019, Cryptopia (a cryptocurrency exchange based in New Zealand) suffered a major security breach, with more than NZ$20 million of cryptocurrency reportedly stolen. At its height, Cryptopia had peak daily trading volumes greater than the New Zealand Stock Exchange.

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Cryptopia was subsequently placed into liquidation on 14 May 2019. The liquidators have noted that significant direction will be required from the courts because of the lack of legal precedent on the treatment of crypto assets in a liquidation. The liquidators have also sought recognition of the New Zealand liquidation proceedings in the United States, and have filed a petition in a New York Bankruptcy Court to preserve information stored on servers in the United States.

Cryptopia has been working with the New Zealand police and digital forensic investigators from New Zealand and overseas to establish who is responsible for the security breach. While the identity of the hacker has yet to be established, the security breach is a timely reminder for cryptocurrency exchanges and other entities handling customers' money of the importance of having robust security arrangements in place.

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Appendix 1

ABOUT THE AUTHORS

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Russell McVeagh

Deemple Budhia is a partner in Russell McVeagh's finance and fintech teams. Deemple has 21 years' experience in financial regulation (including anti-money laundering, consumer credit, financial advice and prudential regulation of financial institutions) and debt capital markets. She has worked in both New Zealand and the United Kingdom. Prior to joining Russell McVeagh, she spent several years in London working in Allen & Overy's securitisation team, and as an originator in Citibank's European commercial property and securitisation team.

TOM HUNT

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Tom is head of Russell McVeagh's fintech team and a partner in the finance team. Tom has a broad range of banking and financial regulation experience gained in New Zealand and the United Kingdom. He is regarded as a leading expert on New Zealand's Anti-Money Laundering and Countering Financing of Terrorism Act 2009, with particular expertise in relation to financial adviser legislation, and all aspects of the prudential regulation of banks and insurers.

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