JUNE/JULY 2019

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Confusion and challenges

As more U.S. companies employ blockchain technology, lawyers and regulators alike struggle to comply with laws and licenses governing businesses that use it.

Caroline Lynch of Copper Hill Strategies and Dale Werts of Lathrop Gage discuss the regulatory issues that blockchain users can face during a conference on April 24 in Kansas City. Photo by Scott Lauck

By Scott Lauck

At a recent conference on the promises and perils of blockchain, a cartoon by artist Tom Fishburne flashed up on the screen. A business owner asks an employee, "Where should we focus this year?"

"'Blockchain,'" the employee responds. "It will change everything. Everybody is talking about it. The potential applications are endless. We don't want to be left behind."

"What exactly is blockchain?" asks the owner.

"Also, 'artificial intelligence,'" responds the employee in a quick change of subject.

It's an accurate summation of the sentiments of many business owners, as well as the lawyers who represent them. Blockchain seems to be important, maybe critical — but what is it?

It turns out that state and federal regulators might be just as much in the dark as everyone else.

"Right now we don't have a comprehensive body of law that governs blockchain," Caroline Lynch, a lawyer and former congressional aide, said at a conference on the subject on April 24 in Kansas City.

Blockchain is a distributed digital ledger that exists on a decentralized network of computers. It can form the record-keeping basis of everything from supply chains to new forms of currency.

Lynch, who runs Arizona-based Copper Hill Strategies, said blockchain is essentially a form of software. Like the internet, it doesn't necessarily need regulations or laws in order to function. But that doesn't mean the things that happen within it are free from regulation.

"Most of what we're doing is applying existing law to a new animal," added Dale Werts, a partner at Lathrop Gage in Kansas City, the law firm that co-sponsored the conference. "In particular with cryptocurrencies, we're applying a 1933 Securities Act to 2016, '17, '18 technology. It's kind of a square peg going into a round hole."

Blockchain's novelty has caused multiple federal agencies to assert jurisdiction over various uses of the technology. Lynch said the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Internal Revenue Service and the U.S. Treasury all regulate aspects of blockchain applications.

Most of the regulations they are attempting to apply, she said, are based on the assumption that there's a central entity involved.

"For projects that hope to truly achieve decentralization, that hope to eliminate the notion of a central authority or a central intermediary calls into question the extent to which that project can continue to comply with certain reporting and auditing requirements," she said.

It can also be expensive. A major use of blockchain is to facilitate cryptocurrencies, such as Bitcoin. Yet the federal government and most states require "money transmitters" to comply with laws intended to combat money laundering. Compliance costs for a license as a money transmitter nationwide are at about $200,000 "just to keep up with all the paperwork," Werts said.

"So a lot of businesses just don't do it," he said.

The panelists, however, said regulators for the most part aren't cracking down on people using blockchain for non-fraudulent purposes. Some users, however, have faced civil litigation from private parties. Werts said Lathrop Gage recently settled such a case.

"Our client engaged in just a peer-to-peer exchange of tokens. They both went down significantly in value, and my client got sued," he said. "So that kind of thing is happening."

Blockchain also faces challenges outside the legal realm. Transactions on such a platform require electronic signatures — a technology that has been accepted for years in the United States. Yet many companies have transactions that still require a "wet" signature — a pen and ink on paper.

"It becomes a real pain," Werts said.

There's also the nature of blockchain, which depends on ledger entries that are nearly impossible to falsify and are open to anyone on the network. That has implications for the "right to be forgotten" recognized in Europe (and some places in the United States) that can require inconvenient information to be removed from the internet.

"How do you delete something that's immutable?" said Tedrick Housh, another Lathrop partner who moderated the discussion.

Housh noted that such concerns also extended to industries where confidentiality is required, such as law and health care.

"There are some inherent tensions between privacy and blockchain in that context," he said.

But even as the regulatory details wait to be hashed out, many businesses are jumping in. Werts said that in just a six-week span earlier this spring, more than 90 patents had been issued that have to do with blockchain — many by some of the largest companies in the country.

"For those of you who think blockchain is still a risky thing, the big companies in America are getting behind it," he said.