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Can cryptocurrency issuers get ‘backed’ into a corner?

Robert A. Schwinger, *New York Law Journal – September 24, 2019*

Some issuers may view being able to offer assurances that their cryptocurrencies are “backed” by something more solid and conventional as being a valuable and effective marketing technique. However, using this seemingly simple word may possibly open up a host of legal questions. In his Blockchain Law column, Robert A. Schwinger explores the issues.

During the July 17, 2019 House Financial Services Committee hearing on Facebook’s proposal to create a cryptocurrency called “Libra,” the following exchange took place between Rep. Alexandria Ocasio-Cortez and Facebook’s head of the Libra project, David Marcus:

> REP. OCASIO-CORTEZ: Libra is, according to your White Paper, a unit of currency “backed” by a reserve governed by the Libra Association. Now, to economists, to Members of Congress, to accountants, the term “backed” has a very specific meaning ... . Yet the Libra white paper does not define “backed.” Rather it states that Libra will be “backed by government currency and government securities.” So what does “backed” mean, in your sense?
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> MARCUS: Congresswoman, it means that it will have a reserve, 1-for-1, for every unit of Libra you will have the corresponding value in stable currencies.

(7/17/19 Hearing video at 3:04:28 to 3:05:07.)

This exchange played out across the backdrop of an issue now being hotly litigated in the New York courts: What does it mean to say that a cryptocurrency is “backed” by some other asset?

‘Backed’ by How Much?

A high-profile dispute over what it means for a cryptocurrency to be “backed” burst into the fore in April 2019, when the New York State Attorney General’s office brought proceedings to enforce a subpoena for an investigation under New York’s antifraud securities statute, the Martin Act (N.Y. Gen. Bus. L. art. 23-A, §§352-353), relating to the cryptocurrency known as “tether.” *In re James v. iFinex*, No. 450545/2019 (Sup. Ct. N.Y. Cnty.). The Attorney General alleged that for several years Tether (the issuer of the “tether” token) had represented to clients that “Every tether is always backed 1-to-1, by traditional currency held in our reserves. So 1 [tether] is always equivalent to 1 USD.” The Attorney General further alleged that Tether represented that its tether cryptocurrency was “fully backed by US dollars that are safely deposited in our bank accounts.”

According to the Attorney General, however, in March 2019 Tether decided to extend a line of credit to a troubled affiliate, under which certain of the tether reserves were transferred to the affiliate. Around that same time, Tether allegedly changed its disclosures to state “Every tether is always 100% backed by our reserves, *which include traditional currency and cash equivalents and, from time to time, may include other assets and*

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receivables from loans made by Tether to third parties, which may include affiliated entities (collectively, 'reserves'). Every tether is also 1-to-1 pegged to the dollar, so 1 [tether] is always valued by Tether at 1 USD" (emphasis added).

The Attorney General alleged that following the issuance of this line of credit Tether had faced difficulties in honoring redemption requests. The Attorney General sought to compel documents for its investigation and sought to enjoin further transfers out of Tether's reserves. Tether opposed the requested injunction.

In its opposition to the Attorney General's request, Tether explained that "Tethers are a form of 'stablecoins,' which means their value is pegged to traditional currency (U.S. Dollars, Euros, or Japanese Yen)[, and that w]ith certain restrictions, tethers can be redeemed on a one-to-one basis for the traditional currency in which they are denominated." It argued that while the Attorney General claimed that "the line of credit needed to be frozen because it improperly impairs the reserves Tether would use for redemptions," the Attorney General "has no authority to dictate how [Tether and its affiliates] do business with one another, or the amount of reserves that Tether must hold," and pointed out that "Tether states plainly on its website that tethers are backed by reserves in various forms, specifically including 'loans' to 'affiliated entities.'"

More fundamentally, Tether argued:

> That Tether does not keep liquid, cash reserves equal to 100 percent of the outstanding tethers is not only disclosed to customers, but hardly a novel concept. Commercial banks operate under a 'fractional reserve' system whereby they keep cash on hand representing only a small fraction of customer deposits, deploying the rest via investments. According to the Federal Reserve website, the banks must keep cash reserves representing, at most, only 10 percent of their liabilities. Tether's cash reserves far exceed that, and the company has never lacked the funds to process a redemption (citations omitted).

Tether thus argued:

> [T]he value of Tether's reserves is more than sufficient to cover the outstanding tether in the market. In fact, Tether's reserves of cash and cash equivalents alone (without the line of credit) would cover approximately 74 percent of the outstanding amount of tether. This sort of "fractional" reserving arrangement is similar to how commercial banks work. No bank holds in liquid cash more than a small percentage of depositors' money. The funds are invested. The markets clearly remain confident in tether, as it currently trades just shy of $1 dollar per U.S. Dollar tether—even after the Attorney General's highly inflammatory and misleading public application. Any suggestion that tether holders face liquidity risk is unsupported speculation.

Is Tether's argument correct? Can a cryptocurrency legitimately be said to be "backed" by reserves—so that such an assertion is not "fraudulent" within the meaning of the Martin Act—if those reserves are not 100% liquid but rather consist in part of debt obligations? If so, what percentage level of liquid reserves is needed so that it is not "fraudulent" under the Martin Act to say that a cryptocurrency is "backed" by reserves? Does the answer to this depend at all on the nature and quality of the other assets that make up the cryptocurrency's non-liquid reserves?

More questions abound. Who gets to decide what the appropriate level of reserves should be if a cryptocurrency is said to be "backed" by something else? Must it be 100%? Do the reserve requirements applicable to ordinary commercial banks under federal law have any relevance in this context? Should they be controlling? Should comparisons to commercial banks using fractional reserving also take into account the impact of other protections those banks enjoy, such as FDIC depositor insurance, that cryptocurrencies do not? Should the question turn on whether there have been any actual instances where holders of the cryptocurrency were unable to successfully redeem their holdings? Is the appropriate level of liquid reserves needed for a cryptocurrency to be able to say that it is "backed" simply a matter to be assessed by the Attorney General in light of all the facts and circumstances developed in her Martin Act investigation? Is it ultimately a question to be decided by the trier of fact in a Martin Act proceeding?

In the case of Tether, it is still too early to have answers to these questions. The Attorney General's Martin Act proceeding is in its early stages, with the court only just last month having rejected personal and subject matter jurisdictional challenges to the Attorney General's ability to proceed with her investigation and seek documents. *In re James v. iFinex*, 2019 WL 3891172 (Sup. Ct. N.Y. Cnty. Aug. 19, 2019).

'Backed' by What?

As noted above, Tether had stated that for its stablecoins, "their value is pegged to traditional currency (U.S. Dollars, Euros, or Japanese Yen)" and "can be redeemed on a one-to-one basis for the traditional currency in which they are denominated."

But can a cryptocurrency be said to be “backed” by fiat currencies when the value that is claimed to stand behind that cryptocurrency does not in fact consist of any single or particular fiat currency, in any particular amount?

This question was posed by the plan for Facebook’s proposed Libra cryptocurrency. As Facebook’s David Marcus explained in his July 16, 2019 prepared remarks to the Senate Banking Committee on July 16, 2019:

> Unlike existing stablecoins—digital currencies designed to minimize volatility by being “pegged” to a single asset—Libra will not have a fixed value in any single real-world currency. Instead, Libra will be fully backed on a one-to-one basis through the Libra Reserve, which will hold a basket of currencies in safe assets such as cash bank deposits and highly liquid, short-term government securities. These currencies will include the U.S. dollar, the British pound, the euro, and the Japanese yen. This approach will minimize exposure to fluctuations from a single region, … .

Echoing Rep. Ocasio-Cortez, what does it mean for a cryptocurrency to be “backed” by a basket of currencies if the cryptocurrency “will not have a fixed value in any single real-world currency”? Mr. Marcus stated in his testimony before the House committee that the Libra Reserve would not, for example, be populated with a greater amount of Canadian dollars merely because there were more Canadian purchasers or users. (7/17/19 Hearing video at 3:05:10-42.) So what do Libra purchasers get in the event of a redemption?

Apparently the intention is not that a person redeeming Libra will receive a proportional slice of the various fiat currencies and other asserts in Libra’s “basket of currencies.” The Libra White Paper states that “anyone with Libra has a high degree of assurance they can convert their digital currency into local fiat currency based on an exchange rate,” but cautions that “one Libra will not always be able to convert into the same amount of a given local currency (i.e., Libra is not a ‘peg’ to a single currency). Rather, as the value of the underlying assets moves, the value of one Libra in any local currency may fluctuate.”

While Libra thus may have stated its intentions plainly up front, a question may still remain as to whether this scenario is what a reasonable cryptocurrency purchaser would associate with a claim that the cryptocurrency is “backed” by a “reserve” of stable currencies, or whether such a purchaser might contemplate something very different. If there is such a disparity of expectations, might that lead the Attorney General to investigate under the Martin Act similar to the investigation now being pursued with respect to Tether?

Conclusion

Cryptocurrencies have been a turbulent space in the market for several years, with some number of cryptocurrency ventures or purported cryptocurrency ventures having turned out badly for those who placed their money into these new assets, even with the improved security and other features that the use of blockchain technology promises to offer. See, e.g., CipherTrace, Cryptocurrency Anti-Money Laundering Report, 2019-Q2 (July 2019) (estimating approximately $4.26 billion in losses from cryptocurrency thefts, hacking, exit scams and other misappropriations in 2019). In this environment, some issuers may view being able to offer assurances that their cryptocurrencies are “backed” by something more solid and conventional as being a valuable and effective marketing technique.

However, using this seemingly simple word may possibly open up a host of legal questions. As shown by a plethora of examples that are in the market or under development today, an express claim of a cryptocurrency being “backed” by fiat currency or other conventional assets is hardly an indispensable element for every kind of cryptocurrency or stablecoin venture. At least until the issues raised by the Attorney General’s suit against Tether are better sorted out, cryptocurrency issuers may need to think carefully about whether they want to use such claims to promote and market their currency, lest they unexpectedly find themselves “backed” into a legal corner by what this seemingly simple term might be found or held to imply.