

Blockchain's Regulations Trends and Reality Checks (Focus on Israel)



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As regulators and legislators increasingly accept that blockchain technology and cryptocurrencies are far from being an epiphenomenon, legal and fiscal rules are being drafted and implemented at an increasing rate. For those involved in developing or using cryptocurrencies and tokens, it is hard to keep up with the changes and ensure that they are up to date with the latest developments.

Fortunately, some lawyers are generous enough to invest time in giving detailed explanations of the upcoming changes. Adv. Adrian Daniels, Partner at [Yigal Arnon & Co.](#), is one of these individuals.

He began his presentation about “Altcoins—regulatory and legal developments in Israel” at the “Blockchain legal and investors event” hosted by [Rise Tel Aviv](#) on November 6, 2018, with a short evaluation of the state of the crypto-currency market today.

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Blockchain trends in 2018

The Bad News

Daniels began by drawing attention to salient negative sides of the blockchain market tendency in the past year, raising. Has the hype about the bright future heralded by blockchain and cryptocurrencies ballooned and is this promising new market doomed to fizzle out or is it undergoing a fundamental transformation.

Looking at the valuation market of the crypto-market was about \$700 billion in January 2018. By November 5 of the same year, that valuation had plunged to a measly \$204 billion.

Similarly, the volume of trade dropped from approximately \$40 billion in January to about \$13 billion in November.

Moving on with the bad news, he drew attention to the lack of actual use and users of the existing blockchain by indicating that, today, according to various reports, around 60% of the top blockchain projects have no useful function and that, out of over 1000 Dapps built on Ethereum and EOS protocol, only 8 have over 300 active users.

On the face of it, there is far more optimistic news if one looks at the actual amount raised in 2018 compared to 2017. From \$6 billion spread around 350 ICOs in 2017 to a whopping \$20 billion raised by 800 ICOs by the end of October 2018. However, the bulk of the 2018 investments took place during Q1, with a steep decrease during the following two quarters both in terms of the numbers of ICO's and of the amount raised per ICO.

Overall, this does not look particularly heartwarming...

However, there is more to evaluating the health and potential future of the blockchain and cryptocurrency market than looking exclusively at the purely financial trends and current adoption by actual users.

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Reality Check

Daniels then analyzes the underlying reasons behind the apparent looming total collapse of that market.

Between the collapse of Bitcoin and Ethereum that followed last winter's hype, the increased SEC enforcement and the ensuing uncertainties about the regulatory future, the investor's disappointment at the lack of platform materialization, and the understanding the market is bloated with useless digital assets, the market is maturing and coming to grip with reality.

So, has the bubble burst?

Daniels prefers to say it has merely shrunk to a realistic size and is confident that the crypto-revolution is here to stay. He convincingly backs that claim by pointing out at the potential game-changing elements of the blockchain technology. A technology that will revolutionize the way financial transactions are performed and the way we can digitize all our assets and turn them into ways we can generate money that never existed prior to the advent of blockchain.

There are a few signs that the market is actually maturing. Regulators are increasingly effectively regulating, thus removing regulatory uncertainties for investors and entrepreneurs alike.

As a result, the option to issue security tokens and raise funds through STOs is becoming increasingly popular, and the more regulators catch up with the market needs for clearly defined boundaries, the more likely investors' confidence will rise, both from VCs and from individual investors.

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Blockchain regulations in 2018

Location

Now, in blockchain projects as in everything in today's world, location is critical, as each location comes with its own set of rules.

To date, Gibraltar, Malta, Switzerland, and Estonia are among the most ICO friendly jurisdictions.

At the other end of the spectrum, the US has been historically extremely unfriendly towards ICOs with the SEC stating for the first time in November 2018, that they will be providing some guidance on which tokens will be considered securities.

Israel has a different approach, somewhere between the hardline SEC in the US and the ICO friendly jurisdictions mentioned above.

In March 2018 [*my typo in the presentation*], the ISA (Israeli Security Authorities) published a Discussion Paper in which it classified cryptocurrencies tokens into three categories. At this stage, none of the proposals in this document are included into actual regulations, but they are indicative of the line of reasoning followed by the ISA.

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Focus on Israel 2018–2019

Israel Security Authorities (ISA) proposals

The ISA proposes to categorize cryptocurrencies in three main categories

- Pure Currency—These are merely a method of payment, like Bitcoin or Ethereum. As currencies, they do not qualify as a security
- Security Token—Grants the token holder a right of membership, participation or ownership in the company.
- Utility Token—Gives a right to a future service

The main issue for the ISA was whether utility tokens are also security tokens. It suggested several methods for distinguishing between utility tokens which are not subject to securities laws and which will be.

For tokens then categorized as security tokens, ISA is considering different approaches for Offerings of Security Tokens.

a) Crowdfunding

For example, they re considering expanding the rules for crowdfunding in Israel. Currently, the rules for crowdfunding in Israel caps the maximum amount that can legally be raised to NIS 4–5 million and the maximum amount an investor can invest varies between NIS10k and NIS20k depending on the status of the investor.

One of the ISA suggestion is to remove these limitations for investors

outside of Israel, enabling non-Israelis to invest as much as they want and removing the cap on investment, as long as the capital emanates from outside Israel.

b) Dual Listing Mechanics

Currently, companies listed on certain reputable public markets can be listed on the Israeli stock market as well without any material additional filing requirements. The ISA is considering applying the same rules for STOs.

c) Reduced listing requirements

The ISA is also considering adopting a similar approach for STOs already allowed to raise capital in other countries defined as sufficiently reputable by the ISA. The logic behind that reasoning is that, if a company already passed the requirement test in another country, they have already been verified and should be allowed to raise capital in Israel.

d) Sandbox for Tailored Regulations

The Sandbox for Tailored Regulations requires a more hands-on approach from the ISA. Faced with a request from a potential security token issuer regarding the way they can operate legally, the ISA would contact the relevant authorities, fiscal, legal, financial and other, so as to determine together the best way for the applicant to proceed to legally raise money from the public.

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In the US, the SEC announced during the D.C Fintech Week conference earlier this November that they intend to release guidance as to when

cryptocurrencies should be classified as securities and that, in the meantime, queries regarding the proper classification of tokens can be made with the SEC's new [FinHub](#).

The Financial Services Laws of 2016

The Israeli Financial Services Laws of 2016 aimed to regulate non-institutional currency services and credit markets. They define the regulations that apply to providers of custodianship, conversion, transmission, and management of financial assets and became applicable in October 2018.

For the first time, on October 1st, cryptocurrencies have been defined in Israel as financial assets. As a consequence, those provided the services listed above have to become licensed.



Anti-Money Laundering (AML)

The Israeli Financial Services Regulator is working on the creation of what may be the most exhaustive and effective set of AML regulations in the world. Those were supposed to come into effect this October, but delays occurred, and a future date has not yet been confirmed.

In the meantime, we already know that they contain a list of disclosure and documentation requirements for financial service providers regarding the source of crypto-funds they receive.

They will need to report the source of crypto assets by disclosing

- 1) The Address (Public Key) of the person or entity depositing funds
- 2) Their IP Address

3) Any Transaction involving any of the following (which would automatically qualify that transaction as suspicious)

- **Transactions using crypto-funds based on ZKP** (Zero Knowledge Protocol). ZKP's involve technology which results in high or even complete levels of anonymity of its users, making it effectively impossible to securely record the identity of the person or entity using their services. ZCash and Monero are example of such ZKP currencies and, though it not illegal to transact with these currencies, such transactions would likely be listed as suspicious and have to be reported.

- **Transactions from Mixer Platforms**—on mixer platforms, funds are all mixed together and randomly assigned to wallets, preventing proper identification of the source of the crypto funds.

- **Transactions from Dark Net**

- **Transactions with inconsistencies** between IP Address and other geographical indicators

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Taxation of crypto-assets

In March 2018, the ITA (Israeli Tax Authorities) produced two circulars regarding the taxation of digital assets, one covering virtual currencies and, for the first time in the world, one covering utility tokens issued by ICO.

- **Virtual Currency**

—Unlike Fiat currencies, digital currencies are defined by the ITA as digital assets. This has fiscal implications as the taxation rules applying

to Fiat currencies differ from those applied to assets. For example, the sale of dollars following an increase in the value of the dollar compared to the Israeli shekel would not be subjected to taxes on capital gain. On the other hand, due to its definition as an asset, a tax on the benefit derived from the sale of a cryptocurrency would be taxed as capital gain for companies at corporate rates and for individuals at private rate, and financial service providers will be liable to VAT.
—Miners will also have to pay taxes on the basis of it being a business (rather than a periodic investment).

· **Utility Tokens**

—Utility token issuers will not have to pay taxes at the time tokens are issued, or, in other words, at the time they receive money. The tax on the proceeds from the sale of the issued tokens will be deferred until the platform begins to provide services, or if the company goes bankrupt, if that occurs earlier.—Employees receiving utility tokens as part of their compensations will generally not have to pay taxes at the time they receive the promise for those tokens. Taxes on these tokens will be due at marginal rates upon the earlier of the sale or exercise of those tokens. However, the employee can request from the tax authority to tax employees upon the grant of the tokens, at marginal rates, based on the value of the tokens, and any sale thereafter will be taxed as capital gain on the difference in value between the time they received the token and the time they sell the tokens.

This approach to taxation of token given to employees as incentive is probably the first in the world and might very well constitute the base for similar taxation system in other parts of the world.

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Banking and Virtual Currencies

Despite the progress on the regulatory sides, in Israel, banks are still reluctant to receive the proceeds of crypto-transactions.

For example, Bits of Gold, is an Israeli currency exchange enabling exchanging cryptocurrencies for fiat money and vice versa, since around 2013. In 2014 a joint press release by the Bank of Israel, Ministry of Justice and other financial regulators warned that cryptocurrencies were high risk. They made no attempt to indicate how to mitigate those risks.

As a result, Bank Leumi blocked all the activities of Bits of Golds bank account. Bits of Gold took the matter to Court. The Court ruled in favor of Bank Leumi, but again, failed to provide any suggestion for remedial measure that bit of gold could enact to lower the risk level. The matter is currently on appeal with the Supreme Court of Israel, which has issued a temporary order requiring the bank to permit certain banking activities of Bits of Gold. Bank Hapoalim is currently following Bank Leumi's case by case system.

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Predictions for the next 12 months and conclusion

Predictions

Israel is at a rather good place inasmuch as regulations are concerned

1. ISA finalizes rules for distinguishing the different types of cryptocurrencies and ISO
2. The AML proposed regulations will be passed into law

3. The ITA will issue a circular on the taxation of security tokens
4. The Supreme Court will rule on Bits of Gold and, hopefully, the Bank of Israel and the Ministry of Finance will issue guidelines as to how banks should be able to process cryptocurrency transactions.

Conclusion

The apparent cooling down of the blockchain/cryptocurrency market, rather of being a sign of bubble bursting, is a sign of market maturation.

Israel hopped on the regulation train rather early in the game, and it is likely that all the regulation efforts currently underway will coalesce in 2019 to provide a solid base for the future growth of the market.

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