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BLOCKCHAIN AND CRYPTOCURRENCIES

By James Barna

INTRODUCTION



Cryptocurrency markets are volatile and have very little regulation.

Analytics Insight

Bitcoin (BTC) – a decentralized digital currency. The most valuable cryptocurrency by market capitalization

Cryptocurrency – a digital asset designed to work as a medium of exchange (greenberg, 2014)

Bitcoin (BTC) was first used in 2010 to buy two pizzas for 10,000 BTC at a value of about \$43 (CNBCTV18, 2021). At its peak price, as of May 2021, that amount of bitcoin would be worth roughly \$630 million. Public opinion about bitcoin, **cryptocurrencies**, and other **blockchain technologies** has changed rapidly in the past few years, as massive price increases have legitimized their influence on modern markets and culture. In April 2021, the total market cap of cryptocurrency surpassed \$2 trillion, which is roughly equal to the market cap of Apple, the largest company in the world.

The value propositions of different cryptocurrencies vary widely. For example, bitcoin allows users to remain anonymous to prevent asset seizure from authoritarian governments. Bitcoin has also been documented to help merchants in low-income nations like Zimbabwe and Kenya to avoid steep fees for exchanging currencies and transferring money. Bitcoin is seen by many as a means of economic empowerment in poor countries because it circumvents corrupt governments and inefficient financial systems.

On the flip side, the capabilities of cryptocurrencies have enabled criminal activity including drug trafficking, scams, and large ransomware attacks. The volatility of crypto markets leads to worries that speculators will lose money, or even that crypto price instability could spill into other financial markets if crypto markets get too big. Governments worry that cryptocurrencies could enable tax evasion if it is not judiciously regulated. China has led the way in drafting tough crypto regulation, and many countries will likely follow suit, albeit with less restrictive regulations.

EXPLANATION OF THE ISSUE

Historical Development

In 2008, bitcoin was invented by an unknown person or group of people who used the name Satoshi Nakamoto (S., 2016). Nakamoto released open-source software, which enabled **peer-to-peer (P2P)** processing of bitcoin transactions, creating a fully decentralized digital currency without the need for intermediaries (Antonopoulos, 2014). During the 2010s, bitcoin's price rose to a peak of almost \$20,000 in 2017 (Coindesk, 2021). Following the peak, bitcoin's price crashed by more than 80% and didn't recover until it reached new highs north of \$60,000 in 2021 (Coindesk). The crash highlighted volatility and instability in crypto markets, leading many to believe the high valuations for various crypto assets are solely attributable to a speculative bubble. However, the all time highs in 2021 cemented bitcoin as arguably the best-performing public asset of the past decade.

In the years following bitcoin's creation, other cryptocurrencies and blockchain networks were invented, including Litecoin and **Ethereum**. Throughout the 2010s, new crypto technology was introduced and existing technology was tested and legitimized. For example, the Ethereum network now has numerous apps and subnetworks built on top of it. These developments have enabled new markets to emerge, such as the market for Non-Fungible Tokens (NFTs), used widely to sell and transfer digital art for thousands or even millions of dollars.

History of Crypto Regulation

Most developed nations have not meaningfully regulated crypto because it is completely new technology that does not fit nicely into any of the cleanly defined traditional financial instruments. The legal definition of cryptocurrencies as securities, commodities, or currencies is not yet determined in most jurisdictions. In China, bitcoin is defined as a virtual commodity, but it is not recognized as legal tender and the banking system is forbidden from providing crypto-related services (Reuters, 2021). Many countries including the United States, Australia, and those in the EU, do not have strict restrictions on crypto markets, but have begun to tax crypto trading (Liebkind, 2019).

Scope of the Problem

Tax Compliance

Cryptocurrencies pose a unique challenge for jurisdictions in gathering taxes. A top priority for any government when facing the new world of crypto is to ensure that no new financial technology

Blockchain – the central data structure for cryptocurrencies. A growing list of records (a ledger) linked together by secure codes (cryptography) (The Economist, 2015)

Peer-to-Peer (P2P) – a distributed computing architecture in which users of an application (peers) are equally privileged participants in the application. By sharing resources such as memory and processing power, peers eliminate the need for central coordination.

Ethereum – a decentralized blockchain with smart contract functionality, allowing legally relevant events to execute automatically. The cryptocurrency Ether (ETH) is native to the Ethereum network.



*California engineer
Dorian Satoshi
Nakamoto was named
as the Bitcoin inventor
by Newsweek, although
he denies having any
connection with
Bitcoin.*

*Damian Dovarganes/AP
Photo*

Mining – a validation of transactions that ensures stability and continuity on a blockchain. Miners are rewarded for their “proof” with new cryptocurrency.

Security – a tradable financial asset or investment agreement, usually with the expectation of profit (e.g. public equity, fixed income assets). Regulated against fraud by the Securities and Exchange Commission

enables tax evasion. In order to solidify crypto tax policy, governments must develop legal definitions of the many financial instruments in the crypto space. Bitcoin, as the first and largest cryptocurrency, is an easy and familiar case that illustrates difficulties in classifying all digital assets. Bitcoin’s legal definition varies in different jurisdictions. In some countries, like Pakistan, Bolivia, and Egypt, bitcoin is banned such that using bitcoin is a criminal offense (Library of Congress, 2018). Other countries must decide whether to classify bitcoin as a currency, a security, or a commodity (property). In the United States, in absence of explicit laws, officials have treated bitcoin as property and crypto **mining** is taxed as income (Gensler, 2018). Most countries followed suit, though a few have classified bitcoin as a currency.

Preventing Illicit Activity

Bitcoin and other cryptocurrencies in some cases enable illicit activity and money laundering. In the first few years following the invention of bitcoin and other dominant cryptocurrencies, it seemed like these new technologies gave criminal networks new tools for anonymity such that their crimes would go unnoticed or be unstoppable. A widely known example is the Silk Road darknet market, which used bitcoin to sell illegal drugs. However, in the past decade, law enforcement and intelligence organizations have grown to understand crypto technologies, and blockchain ledgers are now widely seen as a useful tool for tracking and monitoring criminal activity. Silk Road was shut down in 2013, the founder was sentenced to life in prison without parole, and the US government seized more than \$1 billion worth of bitcoin connected to the marketplace in 2020 (The Guardian, 2020). In guarding against money laundering and tax evasion, the greatest challenges that crypto poses to governments are pseudonymous addresses, privacy coins that use cryptography to enhance anonymity, and crypto to crypto transactions (as opposed to dollar to crypto transactions), which do away with the need for intermediary banks and exchanges, and many of the government’s tools to enforce tax compliance (Gensler, 2018).

Investor Protection

Historically, the United States has benefited greatly from enforcing investor protection laws, which account for the information asymmetry between the investor and the issuer of a **security, commodity**, or derivative. Laws that explicitly prohibit fraud and deceptive sales prices are crucial in laying the groundwork for effective investor protection, and they benefit not only investors, but also issuers and sellers of assets (Gensler, 2018). The legal classification of cryptocurrencies will impact agencies’ abilities to enforce laws. In the past, executive officials have treated bitcoin, and therefore most other cryptocurrencies, as property, like a

Commodity – an economic good or resource that is fully fungible (e.g. corn, gold, cobalt) (Merriam Webster, 2018). Bitcoin has been historically treated as a commodity, which means it is considered to be property rather than an investment.

ICO – an Initial Coin Offering is a form of crowdfunding for new crypto assets. In an ICO, a quantity of a new cryptocurrency is sold in exchange for more stable currencies (Wikipedia, 2021). ICOs initially fell outside existing regulations until the SEC began to treat them as an instance of issuance of new securities.

Example of an ICO: A Swiss company which created a management platform for decentralized organizations raised about \$25 million in a 2017 ICO that gave buyers voting rights on how the system was developed (Wilson, 2020).

commodity. Although officials have considered many **ICOs** to be new issuances of securities, the Securities Exchange Commission (SEC) has found some ICOs to be fraudulent (Gensler, 2018). Congress has the power to lay out more deliberate and reasoned classifications to ensure that investors are protected in all the broad circumstances that crypto technology may create. However, lawmakers must balance protection of investors with the possibility that the lack of regulation in ICOs and crypto investment more generally have fueled innovation in this sector.

Congressional Action

There has been very little congressional action on this set of issues. For a long time, Congress was advised by experts and economists that crypto markets, while interesting and novel, were too small to warrant deep analysis and legislation (Gensler, 2018). Now, after the massive bull run in 2021, in which the total market cap of cryptocurrencies breached \$2 trillion, new legislation may be warranted.

On March 9, 2020, HR 6154 – Crypto-Currency Act of 2020, was introduced. It was referred to the Committee on Financial Services and the Committee on Agriculture. The bill sought to establish agency oversight of certain digital assets and to require these agencies to publish the exchanges trading digital assets and the requirements to create or trade digital assets. It laid the framework to establish the Commodity Futures Trading Commission (CFTC) as the primary regulator of cryptocurrencies, along with the Financial Crimes Enforcement Network (FinCEN) and the Office of the Comptroller of the Currency (OCC). It also sought to establish the Securities and Exchange Commission (SEC) as the primary regulator of crypto-securities and **synthetic stablecoins** (Gosar, 2020). The language in the bill proposal is clearly very vague and looks to the referred committees to analyze and deliberate in order to solidify agency oversight in this new industry. The proposal is unclear how the CFTC would regulate cryptocurrencies along with the FinCEN and OCC; a complete bill would have to add significant specificity and granularity because the involvement of these multifarious agencies implies classification of cryptocurrencies simultaneously as commodities, securities, and currencies.

Other Policy Action

Some countries have taken a more active approach than the United States to prevent illicit activity enabled by cryptocurrencies. For example, Australia and Canada have enacted laws that require cryptocurrency transactions and institutions that facilitate them to keep extensive records in accordance with money laundering and counter-terrorist financing laws. Others go further to restrict

Stablecoin – a cryptocurrency designed to peg its price to another currency or commodity. They are useful in bridging digital asset markets to more stable physical markets, but officials fear that stablecoins can defraud investors. Legislation should provide a means to regulate

investments in cryptocurrencies, while some such as Pakistan, Nepal, Vietnam, Bolivia, and more, outright ban all crypto activity. Countries like Spain, Switzerland, Belarus, and Luxembourg have very few restrictions and encourage development of new crypto and blockchain technologies (Library of Congress, 2018). Clearly, the approach to regulating this new industry varies as widely as one can imagine from one jurisdiction to the next. Countries’ approaches also vary widely on the question of how to tax cryptocurrencies and digital assets. For instance, Israel and Bulgaria tax cryptocurrencies as assets, while Argentina and Spain tax them as income, and Switzerland taxes them as a foreign currency. A small group of countries and municipalities accepts cryptocurrencies as a means of payment (Library of Congress, 2018).

In the United States, at the state level, approaches to cryptocurrency policy range from supportive to restrictive. States like Wyoming and Colorado have passed laws that exempt cryptocurrencies from state securities laws. Ohio began accepting taxes in cryptocurrencies and Oklahoma introduced a bill that would authorize cryptocurrencies to be accepted as payment to government agencies. These states are taking a promotional approach to encourage innovation and bring in new crypto businesses. More restrictive states are legislating in the other direction. Iowa has introduced a bill that would prohibit state agencies from accepting cryptocurrencies as payment and New York considered requiring companies to acquire a “BitLicense” before dealing in cryptocurrencies (Global Legal Insights, 2021).



Switzerland has very positive and accepting policies regarding blockchain and cryptocurrencies. It is clear that the Swiss government sees the potential for increased efficiency and seeks to be a global leader in this space.

TheNextWeb.com

IDEOLOGICAL VIEWPOINTS

Conservative View

Since bitcoin and cryptocurrencies arose out of an internet ideal of anarchy and libertarianism, ideological viewpoints toward crypto vary more on the libertarian vs. authoritarian spectrum than on the conservative vs. liberal spectrum. In fact, the early groundwork for crypto legislation has been a broadly bipartisan effort, with most proposed bills cosponsored by both democrats and republicans (Brett, 2020). Many conservatives likely support mild rather than strict regulations because they recognize the innovation and economic benefits that a more unfettered crypto market will bring. However, a small group of more traditional conservatives likely worry about crypto’s potential to destabilize markets and government fiat currencies, and therefore advocate for more strict regulation.

Liberal View

Liberals' emphasis on liberty leads to strong liberal support of competitive innovation in crypto markets. Moreover, liberal support of socioeconomic equality and personal freedoms leads democrats to widely support crypto technologies, which empower individuals economically. However, this support of economic equality can also lead liberals to advocate for strict regulations and hefty taxes to generate more government revenue for social welfare. It is clear that in the broader economy, rapid technological growth during and after the COVID-19 pandemic has stimulated economic inequality. Liberal lawmakers may find crypto technologies to contribute to that trend and seek to tax and heavily regulate the industry with hopes of tipping the benefits more toward low-income Americans. There is always a trade off with new technologies between equality and innovation, so Liberals must grapple with the expected costs and benefits of cryptocurrencies and crypto assets in order to decide a degree of regulation and taxation.

AREAS OF DEBATE

Taxation

As with any new tech-driven market, the most effective tool at regulators' disposal is taxation. Congress should seek to establish a taxation system for digital assets that aligns incentives toward sustainable economic growth. Cryptocurrencies are currently taxed as property, so if a cryptocurrency is held for longer than a year before it is sold, any appreciation of the asset will be taxed at a relatively low rate compared to income. Capital gains of an asset that is held for longer than a year are typically taxed at a lower rate so that investing decisions are better correlated with expectations of profit and growth (Hicks, 2021). If investors know that they will make a better return by holding stock long-term, they are more likely to allocate their money toward companies that they believe in, rather than the trendy "meme" or momentum stocks that may not contribute to real economic growth. This principle could favorably translate to crypto assets if the lower long-term tax rate incentivizes investors to hold currencies that they believe will remain viable and bring value to society. This would likely expedite the adoption of strong and valuable currencies and hasten the failure of currencies that are built on poor fundamentals or are conceived as an expedient money grab. However, Congress must debate whether these incentives in the crypto market are valuable to the government and the public. Cryptocurrencies do not pay taxes or dividends or employ laborers like corporations do, so the government and the public derive less benefit from encouraging growth of crypto technology



*Vitalik Buterin
proposed **Ethereum**
in 2013, when he was
only 19 years old.*

Twitter, [vitalik.eth](https://twitter.com/vitalik.eth)

than business growth. Still, many crypto businesses emerge as cryptocurrency adoption accelerates; the US could boost its tailwind in crypto innovation by retaining its current pro-growth tax policies. Ideally, the best taxation scheme will continue to support growth and innovation while increasing tax revenue and encouraging responsible investment practices.

Political Perspectives on this Solution

Bitcoin price has increased by roughly 50,000% since 2013 (Coindesk, 2021)

Many in Congress would elect to gather more tax revenue and simultaneously cool off the volatility of crypto markets by taxing crypto capital appreciation at a higher rate than capital gains from traditional assets. This could be done by treating returns on digital assets as income or by creating a new taxation system for digital assets. This change would likely be supported by more traditional conservatives who prioritize stability over personal freedom and economic growth and by liberals who prioritize economic equality over personal freedom and economic growth. It may be faced with strong opposition from legislators on both sides of the aisle who believe that this would result in taxes that are too high and stifle the burgeoning crypto industry. Many businesses that use cryptocurrencies and offer crypto services, like Square, Paypal and Coinbase, would likely lobby against and publicly denounce increased taxation as an infringement on personal freedoms and a damper on economic empowerment provided by these technologies.

Restrictions on Individuals

In equity markets, only individuals with sufficiently high net worth or income are permitted to invest in private companies, which are generally riskier. This *accredited investor* policy exists to protect individuals with less wealth from losing money in risky investments and to promote stability in naturally volatile markets. A policy similar to this one may have positive effects in crypto markets, where there are currently no regulations preventing individuals from participating in new crypto investments, no matter how small, shady, and volatile. Many cryptocurrencies and ICOs are far riskier than investing in private companies, so by introducing restrictions on investment in small cryptocurrencies, Congress can mitigate any worry of instability and investor losses in a volatile market. However, an *accredited investor* policy significantly restricts individual freedom and can be regressive because wealthy individuals are permitted to seek capital appreciation, while less wealthy individuals are barred from the market. This could further exacerbate inequality brought by this new technology.

Political Perspectives on this Solution

Accredited investor restrictions in crypto markets would likely be supported by traditional conservatives and centrists who prioritize

stability over personal freedoms and economic growth. Fewer liberals would likely support these restrictions because of liberal emphasis on personal freedom and economic equality. Accredited investor restrictions, while now unpopular among low net-worth investors, have been supported and accepted with relatively little pushback for decades, so it is certainly possible to pass legislation to extend them to even more volatile crypto markets. This legislation, unsurprisingly, would be very unpopular in the crypto community, among individuals as well as corporations that work with this technology, because it would restrict individual ability to profit from crypto assets and it would likely dampen growth. It may be popular among more wealthy Americans who are not affected by the policy and who are interested in ensuring economic stability.

Regulation on ICOs and fraud

By explicitly classifying digital assets and laying out a framework to regulate introduction of new cryptocurrencies, Congress can ensure that investors are protected from losing big on risky assets and fraudulent schemes. For instance, Congress can explicitly classify crypto tokens issued in an ICO as a security and task the SEC with oversight of all ICOs. While the SEC has already begun to enforce securities law on a few questionable ICOs, this would give them the greenlight to really clean up the industry and refine the public's notion of what is legal and what is not. This could make markets more efficient and protect legit investors and companies who compete with dishonest ICOs and fraudulent schemes. However, ICOs can vary greatly in their nature and purpose. Many ICOs likely are not planned in order to raise capital for a business venture but are rather simply an introduction of a new digital asset into the market—one that, perhaps, works more as a currency than as a security. Should the SEC have blanket oversight even when crypto assets are not acting as securities? Congress should debate these cases and decide whether it is best to give full power to the SEC or to split regulatory power between agencies such as the SEC, the CFTC, and FinCEN. Congress may decide to simply initiate further research into the best solution to this big problem by creating a commission or a new agency.

Political Perspectives on this Solution

This question is not as political as the previous ones because all policymakers are interested in effectively enforcing laws and preventing fraud and consumer and investor harm. It is clear that more specific regulations and more targeted oversight are needed; the question is how best to systematize regulatory oversight. Skeptics of crypto technology generally, who may fall in the camp of traditional conservatives or socialistic liberals, may support giving full power to the SEC in order to regulate crypto markets as much as



Jared Rice is the former CEO of a fraudulent crypto banking startup whose ICO was halted by the SEC, erasing more than \$600 million of value in an example of the risk and instability of unregulated crypto markets (Kauflin, 2018).

Jared Rice

possible from a presumption of fraud and excessive risk in new issuance of crypto assets. More moderate legislators who are more optimistic about the prospects of crypto technology's effects on society will likely advocate a more nuanced approach and a deep examination into the most effective policies. Most lawmakers likely agree that the SEC will play a large role in regulation, because it is clear that some ICOs and crypto tokens act as securities. By examining cases and the trends of growth in the market, legislators can decide whether other agencies and methods may be better suited for oversight of different parts of the market.

Leverage Blockchain for Government Projects

As regulators learn more about blockchain technology and its applications, they may wish to leverage crypto to streamline government procedures. In a period of high government spending, it may be reasonable to push for development of blockchain infrastructure in government agencies. One application that is very popular among software developers and investors in the crypto community is a cryptographic electronic voting system for federal elections. Many Americans felt that the 2020 presidential election highlighted the absurdity of in-person and mail-in paper voting in a new world where banking, work, and social life had all successfully moved online. The closeness of the 2020 and 2016 elections, requiring many recounts and precipitating cries of fraud and rigging from every direction, further signaled the need for a more elegant, transparent, and tamper-proof system.

Cryptography enables the creation of unique virtual packets of information (colloquially called “tokens”) that cannot be duplicated or changed. These non-fungible tokens (NFTs) have naturally developed in markets for digital art and collectibles. This technology could be applied to create a system that transparently records votes that cannot be fraudulent because each individual is allotted a single NFT to vote with. Costs of elections would be greatly reduced because voters would not need to go in person or mail in ballots, and votes would not need to be counted manually. However more transparent this new system would be to the technologically literate, it may seem more shrouded and esoteric to many Americans, which is a factor that must be considered in our current political landscape rife with conspiracy theories and radical political sects. But in real terms, it is very possible to build a sustainable system that will reduce costs and risk of fraud permanently for future federal elections. While a voting system is the most popular idea for government use of crypto technology, there are innumerable potential applications.

Political Perspectives on this Solution

Legislators who are skeptical about crypto technology, both conservative and liberal, will oppose these projects. Our government



Cryptopunks are a popular series of NFT digital art. Unique NFTs of cryptopunks have sold for millions of dollars in online marketplaces.

Larva Lab

is reasonably risk averse and therefore tends to take longer to adopt new technologies than the private sector. Lawmakers who are not open to new ideas and technologies may see elections as too crucial a function in our democracy to take any risk in improving systems. Conservatives would likely oppose this project more than liberals because their constituency consists of an older and less educated population, with less literacy in new technologies. Liberals, whose constituents are generally more educated, would likely be more open to developing superior infrastructure enabled by blockchain technology or at least to laying a framework for investigating potential projects once this technology is more established and accepted in American life.

BUDGETARY CONSIDERATIONS

The government stands to gain considerable revenue in taxes by precisely classifying regulatory procedure and tax law for these new assets. As a side effect, a more streamlined system for detecting fraud and conducting due process will lead many valuable assets to be seized by the SEC, the FBI, and other agencies. There is a considerable monetary benefit to the government by tightening restrictions on crypto businesses and newly-issued crypto assets. If the government elects to restrict individuals from investing in crypto markets, taxes from crypto transactions and revenues will decrease.

Initiating government projects to leverage crypto and blockchain technology would be very costly. Many would be opposed to government blockchain development on the basis of the costs. Therefore, it may be worthwhile to group in the same bill blockchain development spending and policies which seek to regulate crypto markets so that costs of development can be covered from new tax revenues. The costs may not be as much of a barrier in the current political climate, in which massive stimulus and infrastructure bills are debated and passed. Still, the costs of blockchain development plans are an important factor to consider.

CONCLUSION

In an era where radical new technologies sprout up all around us, lawmakers have assumed a creative position—like the dawn of the internet in the 1990s, the future course of crypto technology is from this vantage point unclear and largely dependent on government policies. Legislators have recent history to show them the benefits of policies which support growth and allow new technologies to flourish, but cryptocurrencies, abstracted upon previous

technological development, may be more esoteric, chaotic, and unpredictable than what preceded them.

Your task is to balance risk and stability, growth and regulation, efficiency and equality. As you survey information about crypto technology, think about how you can protect and support your constituents. Think about the potential benefits of crypto technology while being honest about the risks and dangers that it poses if unchecked. Be specific about the best ways to regulate cryptocurrency markets to protect consumers and investors while encouraging healthy growth.

GUIDE TO FURTHER RESEARCH

Information about crypto bill proposals can be found on Congress.gov. There is an excellent blockchain and cryptocurrency MIT open courseware course made up of video modules by Gary Gensler, the chairman of the SEC. That course can be found at <https://ocw.mit.edu/courses/sloan-school-of-management/15-s12-blockchain-and-money-fall-2018/> and is cited with more details in the bibliography below. Reuters has published many useful articles on bitcoin and cryptocurrency since 2017, and Wikipedia pages on bitcoin, cryptocurrency, blockchain, and US financial regulations are very useful to provide an overview and quality sources for research.

GLOSSARY

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