Hastings Business Law Journal

Volume 18
Number 2 *Summer 2022*

Article 3

Summer 2022

The Ethics of Cryptocurrency

Gordon Goodman Justice

The Ethics of Cryptocurrency

JUSTICE GORDON GOODMAN*

TABLE OF CONTENTS

In my first article for this journal on the Ethics of Governance,[1] published in 2020, I discussed the need for a Board of last resort to set authoritative financial values during periods of extreme economic stress, primarily in relation to the "derivatives" market. Derivatives are instruments like forwards, swaps, and options that change in value, often in complex ways, with changes in the value of their "underlying" instruments or commodities (e.g., currency, crude oil, interest rates, mortgages, etc.).

Time and recent events have indicated that this new Board is needed, perhaps even more urgently today in 2022, to set authoritative valuations and provide temporary emergency markets for cryptocurrencies during the inevitable busts that will follow current boom markets now developing in cryptocurrencies.

I noted at the time that this new Board was needed to establish values for "… certain financial instruments that are: (1) subject to fair value measurement under generally accepted accounting principles (the 'GAAP'); (2) subject to reporting requirements in standard financial reports for public corporations under SEC rules; but (3) are not valued through a regulated exchange." As discussed below, cryptocurrencies are not considered derivatives and, thus, are not currently subject to fair value measurement (with some exceptions).

---

* Justice Gordon Goodman serves as a Justice on the Court of Appeals for the First District of Texas. Special thanks to Robert H. Herz, former Chairman of FASB (2002-2010) and an original member of the International Accounting Standards Board, for his input and advice on the accounting treatment of cryptocurrency.

1. Justice Gordon Goodman, *The Ethics of Governance*, 16 HASTINGS BUS. L.J. 139 (2020), https://repository.uchastings.edu/hastings_business_law_journal/vol16/iss2/3.

The purpose of this proposed Board, which I have suggested be called the "Independent Treasury Board" (a reference to the 19th century predecessor to the Federal Reserve Board), would be to address valuation uncertainty during bust periods immediately following major financial crises.

The argument I made in my previous article focused on the creation of a repurposed and renewed Independent Treasury Board primarily to meet the need for authoritative valuations and the creation of temporary emergency markets during times of crisis for derivatives. This argument was based on my experiences with the Great Recession era Financial Accounting Standards Board's (FASB's) Valuation Resource Group and a widespread understanding in financial markets that the initial market failures of that period arose in the mortgage-backed derivatives market. But, I now propose that this Board be given jurisdiction over both derivatives and cryptocurrencies during emergency periods.

I. WHAT IS CRYPTOCURRENCY?

I will not try to describe what cryptocurrencies are in any detail in this article but instead refer the interested reader to a comprehensive description of cryptocurrencies given in Professor Michael Abramowicz's "Cryptocurrency-Based Law" article.[2] As he notes, cryptocurrencies like Bitcoin are "… neither a commodity currency (backed by gold or some other commodity) nor a fiat currency (used by convention as a result of a legal edict)"[3] They were designed in part to avoid central bank oversight and can readily be traded and transferred without passing through traditional financial institutions like commercial banks and brokerage firms.

The Federal Reserve has discussed the possible creation of a U.S. central bank digital currency "CBDC") in a recent online research report titled "Money and Payments: The U.S. Dollar in the Age of Digital Transformation"[4] If created, the CBDC would not be considered a cryptocurrency but rather a new digital form of paper U.S. currency and, therefore, another type of fiat currency.

Most importantly, for financial reporting disclosure requirements, cryptocurrencies are not considered "derivatives" as defined by FASB's Accounting Standards Codification (ASC) Topic 815.[5] To qualify as a derivative, a financial instrument or contract must have all the following characteristics:

2. Michael Abramowicz, *Cryptocurrency-Based Law*, 58 ARIZ. L. REV. 359 (2016), https://arizonalawreview.org/pdf/58-2/58arizlrev359.pdf.

3. *Id*. at 361.

4. BD. OF GOVERNORS OF THE FED. RSRV. SYS., MONEY AND PAYMENTS: THE U.S. DOLLAR IN THE AGE OF DIGITAL TRANSFORMATION (Jan. 2022), https://www.federalreserve.gov/publications/january-2022-cbdc.htm.

5. *See* ACCOUNTING STANDARDS CODIFICATION, Definition of Derivative Instrument, § 815-10-15-83 (FIN. ACCT. STANDARDS BD. 2020).

- Underlying instruments or commodities and either notional amount or payment provision (or both);

- Initial net investment (either no initial net investment or a small initial net investment in relation to the value of the underlying); and

- Net settlement capability (terms that permit net settlement, the ability to be readily settled by a means outside the contract, or terms that provide for delivery of an asset).

There is no apparent "underlying" asset or instrument on which cryptocurrencies trade in the way that a crude oil option derivatives contract trades in relation to the value of crude oil or that a currencies derivatives swaps contract trades in relation to the difference or basis between the values of two currencies. (Cryptocurrency values appear to be primarily driven by the creation of artificial scarcities and market sentiments.) Cryptocurrencies also lack many of the other requirements set out above that are needed to be considered derivatives (i.e., initial net investment and net settlement).

One form of cryptocurrency called "stablecoins" has a fixed value in relation to certain reference assets such as dollars or euros. In addition, stablecoins are sometimes used to facilitate transactions involving multiple cryptocurrencies. Though this type of cryptocurrency arguably has an "underlying" asset, it lacks the other requirements to be considered a derivative.

Since cryptocurrency is not classified as a derivative, what is it considered for accounting purposes? The current practice is to designate Bitcoin and several other cryptocurrencies as "intangible assets" that are accounted for under FASB's ASC 350.[6] As such, cryptocurrencies are not subject to fair value measurement like derivatives but rather are measured at "cost" subject to limited downward adjustment through an impairment analysis process. (The exception to this cost-based accounting for cryptocurrencies applies to broker-dealers, investment companies, and similar financial companies that account for cryptocurrency transactions at fair value under their specialized industry GAAP.)

In simple terms, the difference between "cost-based" accounting under ASC 350 for intangibles and "fair value" accounting under ASC 815 for derivatives is the difference between fixed, historical, past-looking analysis (cost-based accounting) and floating, real-time, forward-looking analysis (fair value accounting). Both forms of accounting can be helpful and appropriate depending on circumstances, but the question is which of these analyses is more suitable for specific assets and instruments like cryptocurrencies. Clearly, the need for fair value measurement of derivatives was made obvious during the 2001 Enron failure and then even more bracingly so during the 2008-2009 Great Recession period that began with

6. *See* ACCOUNTING STANDARDS CODIFICATION, Intangibles – Goodwill and Other, § 350 (FIN. ACCT. STANDARDS BD. 2020).

the Lehman failure. I argue that this same need for improved transparency and governance should be applied to cryptocurrencies.

II. NEED FOR TRANSPARENCY IN CRYPTOCURRENCIES

As noted in an article titled "Dire Need for Crypto Accounting Rules, Swaps and Derivatives Group Says"[7] the International Swaps Dealers Association's (ISDA's) Accounting Committee has proposed that:

> FASB should develop an accounting framework to address cryptocurrencies because the value of such assets are not being properly reflected on balance sheets. The [FASB] board should craft rules to allow all entities, not just investment companies and broker dealers, to account for crypto assets at fair value. A more appropriate accounting model for highly liquid crypto assets that would meet the definition of readily convertible to cash, similar to the derivative definition would be to allow the fair value option. Since derivatives, an instrument that is readily convertible to cash and tied to an underlying, is accounted for at fair value, we believe similar instruments such as crypto assets should be permitted as well.

I would go further. Fair value measurement should not be just an option for public companies filing financial statements with the SEC; fair value measurement for cryptocurrencies must become a requirement – as it is for derivatives. Given that cryptocurrencies are purposely designed to be less detectable by central banking authorities (since transactions flow outside of regulated financial mechanisms), the FASB should first make fully transparent the periodic changes in the value of cryptocurrencies held by all public corporations subject to SEC regulation, through the fair value measurement process. I expect the impact of some of these changes to be fairly remarkable once they become visible

I note that although FASB sets the GAAP accounting rules, the SEC is the governmental agency that delegates the authority to FASB to do so. Therefore, the responsibility ultimately lies with the SEC to ensure that FASB takes all necessary and appropriate action in setting GAAP for cryptocurrencies.

To complete a successful transition to full transactional transparency in the marketplace, not only should FASB impose a fair value measurement requirement for cryptocurrencies (as was done starting in 1998 for derivatives with FASB's implementation of FAS 133[8]), but Congress should

---

7. Denise Lugo, *Dire Need for Crypto Accounting Rules, Swaps and Derivatives Group Says*, THOMSON REUTERS (June 11, 2021), https://tax.thomsonreuters.com/news/dire-need-for-crypto-accounting-rules-swaps-and-derivatives-group-says/.

8. Statement of Financial Accounting Standards No. 133 (FAS 133), *Accounting for Derivative Instruments and Hedging Activities* (FASB June 1998), was effective for all fiscal quarters beginning after June 15, 1999. Fair value measurement of derivatives is currently governed, however, by FASB's

also consider implementing something like a "clearing" requirement for cryptocurrencies (as was done starting in 2010 under the Dodd-Frank Act[9] for derivatives). However, given the significant technical differences arising from blockchain protocols and architecture utilized by cryptocurrencies, I do not make a current recommendation as to what a similar "clearing-equivalent" should or could be for cryptocurrencies.

As noted by Professor Lynn Stout in her 2011 analysis of the response to failures during the 2008-2009 time period,[10] the Dodd-Frank Act effectively "imposes a 'clearing requirement' on all speculative financial derivative contracts. The clearing requirement is the functional equivalent of the old CEA requirement that speculative commodity futures be traded only on organized exchanges." The changes imposed by the Dodd-Frank Act's clearing requirement for derivatives were valuable additional controls for the derivatives market, and something similar may be needed in the future for cryptocurrencies.

III. GOVERNANCE OF CRYPTOCURRENCIES UNDER THE PROPOSED INDEPENDENT TREASURY BOARD

Once the holding and trading in cryptocurrencies by public corporations has been made more transparent through implementation of mandatory fair value measurement accounting (and possibly through the adoption of a "clearing-equivalent" requirement), then the same methodology described in my previous article for the governance of derivatives during emergency periods[11] would apply to the role of the proposed Independent Treasury Board with respect to cryptocurrencies.

The Board would provide advisory valuation opinions during ordinary times when trading in cryptocurrencies is liquid and valuations can readily be determined through transactions in the marketplace. (This advisory role is similar to the one played by FASB's Valuation Resource Group, on which I served, following the adoption of fair value measurement for derivatives).

But during emergency bust periods, i.e., when liquidity "black holes" emerge as was the case in 2008-2009, the Independent Treasury Board's valuation of cryptocurrencies (and derivatives) should become authoritative for all required governmental filings with the IRS, the SEC, etc.

The Board's authoritative valuations issued during emergency periods would be realized in the marketplace through limited buying and selling of cryptocurrencies (and derivatives) by a newly created sub-Treasury that would make temporary markets for cryptocurrencies (and derivatives) at

---

subsequent adoption of the ACCOUNTING STANDARDS CODIFICATION, *see* FIN. ACCT. STANDARDS BD., *supra* note 6.

9. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929-Z, 124 Stat. 1376, 1871 (2010) (codified at 15 U.S.C. § 78o).

10. Lynn A. Stout, *Derivatives and the Legal Origin of 2008 Credit Crisis*, 1 HARV. BUS. L. REV. 1, 34 (2011), http://scholarship.law.cornell.edu/facpub/720.

11. *See* Goodman, *supra* note 2, at 144.

values set by the Independent Treasury Board. (This would be similar to the Federal Reserve's function in making markets for bonds during both normal and emergency periods.)

Finally, the Chairman of FASB and the Secretary of the Treasury should appoint the Board's members. The Board should also meet with and advise the FASB Board at its Norwalk, CT headquarters during ordinary times but meet with and report directly to the Secretary of the Treasury in Washington, DC, during emergency periods.

Acting now, during relatively normal times in the marketplace for derivatives and cryptocurrencies, will mitigate the inevitable bust periods that will occur in the future. Though we cannot prevent future financial crises, hopefully, they will be as orderly and as brief as possible for investors and lenders. Now is the time to protect the public from potential future risks arising from the lack of transparency and uncertain governance that currently exist in the emerging cryptocurrency market.