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New ideas on Petros and other cryptocurrency transactions in Venezuela[1]

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On January 23, we published a paper on the Petro and other cryptocurrency transactions in Venezuela, making the disclaimer that very little was known at that time and that as new information and documentation was produced, we would have to update our work. At that time, from the government's perspective, we could only rely on Decree Nº 3.196, by means of which it authorized the creation of the Superintendence on Cryptocurrency and related activities, issued by the President and published in the Official Gazette on December 8, 2017, and several (and sometimes contradictory) declarations by public officials. Additionally, we referred to the "Agreement on the Issuance of the Cryptocurrency (Petro)", issued by the National Assembly on January 8, 2018. Based on such information, we reached certain conclusions which we believe continue to be valid, our position now being complemented by the additional documentation reviewed.

(A) The Petro, rather than qualifying as cryptocurrency or currency, qualifies as public debt.

Article 80 of the Law on Financial Management of the Public Sector defines public debt as including, inter alia, the issuance of securities and the granting of security interests and guarantees. Although specialists have widely criticized the statement that the Petro is backed by oil (because (i) there are a number of constitutional and legal restrictions and procedures involving guarantees on oil reserves that have not been heeded by the Government, and (ii) because in practical terms the costs of extracting such oil –and finding financing for this— makes it practically unviable), the fact is that in legal terms the Venezuelan state has formally declared that Petros have been guaranteed with oil reserves.

The Recitals of Decree Nº 3 describe the Petro as "of crypto-active characteristic, exchangeable for goods and services, and for fiduciary money in the national and foreign crypto currency exchanges, and that it also has attributions of commodities… since it is backed by Venezuelan oil barrels, in the form of a sale agreement with the possibility of being exchanged for physical oil." Further Article 4, indicates that the Petro shall be "physically backed by a sale agreement for one oil barrel". Such Article also indicates that backing for the Petro "shall be Venezuelan oil" as well as other "commodities established by the Nation", reference being made to gold, diamonds, coltan and gas.

The Petro's whitepaper confirms the above, by indicating, under its "Executive Summary", that "the Petro shall be a sovereign cryptoasset backed by oil assets and issued by the Venezuelan state…"

Additionally, Decree Nº 3.292, issued by the President and published in the Official Gazette on February 23, 2018, establishes the potential development of part of the Orinoco Belt as security for "transactions of financial and commercial exchange via cryptoassets". However, such decree refers to "cryptoassets" in general, not to the Petro in particular.

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[1] Published in www.menpa.com on March 14, 2018.

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In any case, a joint reading of all three documents leads to the same conclusion: The government has officially declared that it has guaranteed obligations regarding the Petro with oil reserves. Additional arguments may be made, but this alone, in light of Article 80 of the Law on Financial Management of the Public Sector, could be used to characterize the Petro as a form public debt.

There are a few dissenting voices regarding this qualification, but, technically speaking, from the point of view of legal rules, we believe that the Petro can be characterized as debt, even if an unconventional type of debt.

B) The issuance of Petro is unconstitutional and, thus, null and void.

Both issuing securities and granting security interests or guarantees by the State qualifies as public debt. Public debt, issued without the approval of the National Assembly, is null and void. Further, oil and mineral reserves belong to the State and cannot be encumbered. In very simple terms: Article 312 of the Constitution mandates that debt be approved by law. Article 12 of the Constitution provides that oil reserves and mineral reserves are not subject to transfer (evidently, except if extracted pursuant to the law). Such mandate is repeated by Article 3 of the Organic Law on Hydrocarbons. Further, Article 105 of the Law on Financial Management of the Public Sector indicates credit operations secured by national goods are not permitted. Additionally, Article 25 of the Constitution establishes the nullity of acts that violate the Constitution. Joint and separate application of these rules leave no doubt about the conclusion that the Petro, as well as the legal instruments purportedly creating it, should be considered absolutely null and void.

Part of these arguments have been stated by a new agreement issued by the National Assembly on March 6, 2018, titled "Agreement on the Implementation of the Petro". This Agreement reflects three important conclusions: First, it declares null and void the pre-sale of Petros and all obligations deriving from the circulation of Petros, based on violations of constitutional and legal provisions. Second, it alerts potential investors and cryptocurrency key actors on the unconstitutionality of the issuance of the Petro or any other obligation of the state, which is backed by oil or any other mineral. And, third, it rejects the forced sale of Petros that the government pretends to impose on Venezuelans. In sum, the National Assembly rejects the issuance, sale, acquisition and use of Petros as forced means of exchange.

In addition to the arguments presented above, there are several other considerations regarding the illegality of the mechanisms used to offer Petros but, due to the fact that the issuance itself is illegal, we shall not refer to them.

C) We argued that there is more to the Presidential Decree creating the Petro than the creation of the Petro itself. We believe the same is applicable to the additional documentation that has been published, particularly the Petro's whitepaper, and Decree Nº 3.292, issued by the President, which establishes the potential development of part of the Orinoco Belt as security for "transactions of financial and commercial exchange via cryptoassets". We have identified several issues: First, Venezuela seems to have initiated the process of formally legalizing the concept of Venezuelan cryptocurrencies in general and their mining in particular; second, a parallel foreign exchange market, based in transactions on the Petro and other cryptocurrencies, may follow quickly; third, the government may force the use of Petros in ordinary business, particularly in connection with the payment of its immense and late obligations vis-à-vis oil and other large contractors; and, finally, other cryptocurrencies may help the government circumvent foreign sanctions, but not necessarily the Petro.

1) The government of Venezuela, by enacting the Decree, has expressly granted cryptocurrencies a specific legal status.

We are of the opinion that cryptocurrency transactions were legal prior to the enactment of the Decree, because of the constitutional principle that, for private parties, whatever is not prohibited is actually permitted. Accordingly, since no prohibition to engage in cryptocurrency transactions existed in the Venezuelan legal regime, such transactions were valid under Venezuelan law.

Article 3 of the Decree provides that its object is to provide the regulatory conditions established under the Civil Code for acquisition and sale of financial assets; application, use and development of Blockchain technology; mining; and development of new cryptocurrency in the country. Additionally, the same article indicates that such conditions are deemed "of licit nature".

In other words, the Decree and, presumably, the regulations to be enacted pursuant to the Decree set or shall set the rules applicable to cryptocurrencies, which means that cryptocurrencies are, as of now, expressly recognized as legal by the Venezuelan government. Further, as of today, to the extent that cryptocurrency transactions comply with the few rules established under the Decree, such transactions seem to be deemed legal by the Venezuelan government, including the mining of cryptocurrencies.

But, which are such rules? In order to answer that question, we must first understand the legal nature of cryptocurrency.

We have concluded that the Petro is actually public debt and not a cryptocurrency. Yet, from a legal standpoint, what do other cryptocurrencies qualify as?

We shall try to address the matter briefly below.

The first answer that comes to mind, probably because of its name, is currency. But in order for an asset to qualify as currency certain characteristics must be met, one of which is that everybody should be bound to accept payments made in such currency. Even though cryptocurrency transactions have flourished –although not necessarily in Venezuela— it is clear that parties to any transaction are not bound to accept cryptocurrency.

We believe a more accurate approach would be to characterize cryptocurrency, in general, and tokens, in particular, as securities. Such has been the approach taken by the Securities and Exchange Commission (SEC) in a recent decision, issued on July 25, 2017,[3] as well as by its Chairman Jay Clayton, in a statement published on December 11, 2017.[4] In this regard, the SEC has indicated that each cryptocurrency or token must be analyzed individually and that such analysis may lead to the conclusion that some meet the criteria to qualify as securities and are, thus, subject to the capital markets rules and restrictions.

We believe that cryptocurrencies, including tokens, probably qualify as securities under Venezuelan law, since each type of cryptocurrency is issued *en masse*, has similar characteristics and grants its holders the same rights, thus meeting a generally acceptable definition of securities. However, we believe it may be argued that even if considered as such, in Venezuela they should not be subject to the control of the capital markets authority,

[3] Securities and Exchange Commission, United States of America, Release No. 81207, July 25, 2017, at https://www.sec.gov/litigation/investreport/34-81207.pdf.
[4] SEC Chairman Jay Clayton, Statement on Cryptocurrencies and Initial Coin Offerings, December 11, 2017, at https://www.sec.gov/news/public-statement/statement-clayton-2017-12-11.

Superintendencia Nacional de Valores, nor should they fall within the scope of application of the Capital Markets Law currently in force.

The Capital Markets Law provides (i) a list of securities, under Articles 46, 47, 49 and 52, which include derivatives, bonds, commercial papers, and asset-backed securities; and (ii) a residual definition of securities: "financial instruments that represent property or credit rights over the capital stock of a company, issued short, medium or long term and *en masse*, that have the same characteristics and grant the same rights".

So, securities not specifically listed, would have to fall under the general definition provided for under Article 46.[5]

It is possible to argue then that cryptocurrencies qualify as securities under the law, yet when subject to further analysis we must reach a different conclusion.

First, the Capital Markets Law seems to address the matter from the perspective of there being an issuer, that is, a corporation that is responsible for the issuance of securities and for the fulfillment of the obligations attendant to such securities, such issuer being liable in case of breach of said obligations, including failure to pay. However, in the case at hand, even if initially organized or designed by a corporation, foundation, etc., who actually prepare and publish the corresponding white papers, cryptocurrencies are not properly issued by them. In fact, the creation of cryptocurrencies responds to decentralized digital mechanisms. To illustrate the case, even though a white paper provides that a certain cryptocurrency will be created, such creation does not correspond to the author of the white paper (in principle, the issuer), but to "miners" around the world, who work on complicated algorithms that result in new units of such cryptocurrency. This seems very far from the general concepts provided by the rules in the Capital Markets Law regarding securities and their issuers.

Second, in very simplistic terms, the Capital Markets Law seems to describe or characterize securities as something whose value is connected to the assets of the issuer, to the issuer's intrinsic value, to the issuer's capacity to pay or to assets put together by the issuer. In the case of shares, for example, they represent a stake at the company's equity. In the case of secured bonds, the security backing the bonds and the issuer's capacity to pay. In the case of other asset-backed securities or titularizations, subjacent assets are linked to such securities.. These types of securities merit regulation because people investing in them are expecting assets or the financial health of the issuer to directly or indirectly secure or guarantee their investment. However, in the case of cryptocurrency, investors seem to be paying to buy simply a **medium of exchange,** but not something that has an asset-backed or issuer-backed value, as in the case of shares, bonds or titularizations. We must insist, cryptocurrency is something you buy for purposes of making payments or even accumulating value unconnected to an issuer or a guarantor. So cryptocurrency transactions have elements generally attributable to currency or some highly tradeable commodities, such as gold, but, as indicated, cryptocurrency is not legal currency.

[5] Please note that such definition has an important characteristic: It establishes a link between securities and the capital stock of corporations. In our opinion, this is a mistake. Although property rights over capital stock is possible in securities (such is the case of shares), credit rights over capital stock is not. We believe that the definition of securities should probably be read as follows: "financial instruments that represent **property rights over the capital stock of a company** or credit rights, issued short, medium or long term and en masse, that have the same characteristics and grant the same rights."

Even if, using a very wide concept of securities, cryptocurrencies could be characterized as such, cryptocurrencies can hardly fall within concept regulated by the Capital Markets Law. We believe this excludes, as the law now stands, cryptocurrencies from the regulatory power of the *Superintendencia Nacional de Valores.*

Further, such an approach seems consistent with Article 3 of Decree, which, as indicated, refers to the Civil Code –and not the Capital Markets Law or any regulations on the matter— as being the source of the rules on cryptocurrencies and all related transactions. However, reference to the Civil Code should also have included reference to the Commercial Code, applicable to securities in general. Actually, pursuant to Articles 1 and 2 of the Commercial Code, sale, acquisition and swap of securities are commercial activities, subject to such code; and, pursuant to Article 8, the Civil Code shall only apply residually.

This discussion probably merits its own paper, but we propose the preliminary idea that in Venezuela cryptocurrencies –other than Petro— should be treated as securities, not subject to the control of the *Superintendencia Nacional de Valores*, and which may be bought, sold or exchanged, by applying the Commercial Code and –if needed— the Civil Code.

It is important to take into account that, pursuant to Article 46, the *Superintendencia Nacional de Valores* has the power to determine if particular assets qualify as securities subject to its control, so this may change if such authority takes a different view. Also, cryptocurrency as a concept is a very new one and changes may be introduced into national legislation or regulations in order to create rules that better adapt to it.

2) The Petro –and other cryptocurrencies— may be used for parallel market transactions.

Article 5 of the Decree provides that holders of Petros may exchange Petros for another cryptocurrency. They may also exchange them, pursuant to such provision, for the equivalent in Bolivars at the exchange rate published by the "national crypto-active exchange" (casa de intercambio de crypto-activo nacional) or for other "fiduciary" currency.

The above implies two limitations:

First, the Bolivars/Petro rate may be fixed by the national exchange, rather than float freely. If this were the case, Petro transactions may still take place, to the extent that other cryptocurrency enters the game by bond currency swaps, as explained below.

Second, the Decree creating the Petro, in theory, establishes that Petros may only be exchanged, abroad, for "fiduciary money". The reference to fiduciary money in this context is confusing. One concept of fiduciary money is that it is exchangeable for a fixed amount of gold, silver, money in a bank account, etc.; while fiat money has no underlying value, that is, no entity is under the obligation of exchanging it for something of value; its use derives from the order of the issuing government, which makes fiat money the legal currency. From what we have been able to find out, we do not believe the Decree used the term "fiduciary money" as opposed to "fiat money". We believe the Decree used the term "fiduciary money" as opposed to cryptocurrency. It is absurd to expect that the government even expects to be able to control, in foreign exchanges, that the Petro only be sold for "fiduciary money", in strict sense. Accordingly, we believe that reference to fiduciary money was included to indicate all currency other than cryptocurrency, which is the way many papers on cryptocurrency refer to money (technically, fiat money). Therefore, our interpretation is that this second limitation does not really exist, because the Decree would allow the Petro to be exchanged for cryptocurrency and any other currency.

In any case, in practical terms, securities are exchangeable for other securities or for national or foreign currency. As provided for under Article 5, the Petro shall be exchangeable for cryptocurrencies (without any limitation on rates or types of currency), and cryptocurrencies in turn are exchangeable into any currency. Additionally, the fact that Article 5 recognizes this must not be understood in practical terms, but in legal ones. As a matter of fact, the Presidential Decree creates a specific authorization to conduct such exchanges, which does not contradict higher hierarchy rules (such as those established by law).

This is particularly important from the perspective of the foreign exchange controls which are in force in Venezuela.

Early versions of the Law on Foreign Exchange Crimes (now replaced by the Law on Foreign Exchange Regime and Illegal Acts) both (i) criminalized exchange transactions and (ii) created an exception to such crime, by allowing swaps of Venezuelan bonds to obtain Bolivars or foreign currency –that is, bond currency swaps. However, this exception was later eliminated and even some swap transactions, conducted during the life of the exception, were persecuted criminally. Finally, the latest version of the law eliminated the prohibition of conducting exchange transactions, other than those involving exchange authorities (Article 10), and allows for transactions between private parties to the extent they comply with applicable regulation (Article 11). For a few years, no regulation was issued regarding transactions between private parties, so many –including us—argued that parallel market transactions did not contravene legal rules. Yet, this changed with the enactment of Exchange Agreement Nº 39, which regulated private transactions under Articles 28 and 30, mandating that they be conducted at the DICOM rate. We believe the legal authority to issue such provision rests with the legislative power and not with the executive power and that the authority invoked by the executive to issue the provision is, at the very least questionable, so, the provisions themselves should be declared null and void. But that has not happened yet. Accordingly, it can be argued that the parallel market may not roam freely, as it could do before.

However, we believe that the Decree creating the Petro changes this. This Decree should also be considered part of the regulations applicable to private transactions and it provides for an exception to this rule mandating that the DICOM rate apply to all exchange transactions.

To explain this we should begin by referring to Article 3 of the Law on Foreign Exchange Regime and Illegal Acts, which defines exchange transactions as acquisition or sale of any foreign currency for a price in Bolivars. The same article establishes that foreign currency is to be understood broadly, since it includes any asset expressed in foreign currency or that may be liquidated in foreign currency. The idea is that any transaction by means of which Bolivars are directly or indirectly exchangeable for foreign currency constitutes an exchange transaction. So swap transactions, including those between Petros and other cryptocurrencies, probably qualify as exchange transactions.

We believe the Decree expressly authorizes a different exchange rate to be applied to them: In the first place, the rate at which Petros are received by the national exchange. Accordingly, it could be interpreted that the Decree has introduced an exception to the rule that exchange transactions being conducted at the DICOM rate if such transactions are conducted in Petros, pursuant to Articles 5, 6 and 7 of the Decree. But this national exchange, which has not been defined or regulated, may not even define the real rate of exchange.

It is now possible, for example, to buy Petros with bolivars, exchange the Petros for one of the many cryptocurrencies in the market and then sell the cryptocurrency for any hard currency, thus having the last transaction fix, in effect, an implicit parallel market rate for the bolivar. So the parallel exchange rate may be back in business.

Further, recent declarations by the Vice-President have suggested that Petros shall be sold in the platform used to auction DICOM, further linking Petros –even if only in practice— to exchange transactions.

Again this probably merits its own paper, but we believe that in practical terms, one of the (few) incentives of using Petros is that, in the context of a currently regulated exchange market, Petros –to the extent their price is not imposed, but reflects market value— may be used to conduct exchange transactions, under the express authorization contained in the Decree.

3) The Venezuelan government may force the use of Petros in its ordinary business, particularly in connection with the payment of its large debt to public contractors. These, in practice, are not being paid in any way, so they will probably end up accepting Petros rather than nothing at all, despite the fact that, as the Constitution stands, Petros may not substitute Bolivars.

The Petro's white paper formally introduced the idea that Petros would be acceptable to comply with obligations vis-à-vis the Venezuelan state and state-owned companies, and also that Petros may be used to make payments due by them. These are some extracts from the white paper that support this statement:

"The State shall promote and encourage the use of Petro with a view to consolidating it as an investment option, savings mechanism and means of exchange with State services, industry, commerce, and citizens in general."

"The Bolivarian Republic of Venezuela guarantees that it will accept Petros as a form of payment of national taxes, fees, contributions and public services…"

"The use of the Petro will be promoted by PDVSA and other public and joint ventures, as well as national public entities and regional and local governments."

"The payment of extraordinary labor commitments and benefits in Petros will be encouraged, as well as of accumulated social benefits, provided they have the expressed individual approval of the benefitted worker."

"In addition, the Venezuelan government is committed to promoting the use of the Petro in the domestic market…"

Further, these ideas have been reinforced and complemented by statements of public officials, who have made declarations in the same line. For instance, the President indicated that PDVSA, Pequiven and CVG companies shall use Petros for selling and buying goods and services. The President also added new ideas, indicated that the following goods or services shall also be payable in Petros: gas sold by gas stations in the Colombian border and to foreign airlines, Venezuelan consular services around the world, and certain tourism services (possibly including airline tickets).

However, in legal terms, Petros may not substitute Bolivars as national currency. Article 318 of the Constitution provides that the official currency of the Bolivarian Republic of

Venezuela is the Bolivar. This would make any national currency –other than Bolivars— unconstitutional.

Further the recitals of the Presidential Decree refer to the need of creating an "international currency", implying that the Petro is such currency. We are not sure what an "international currency" is meant to be under the Decree. However, such reference to the currency not being Venezuelan –but international— may respond to an attempt by the government to bypass the aforementioned limitation imposed by the Constitution. But the fact is that, regardless of the government's characterization of the Petro, as international currency or as cryptocurrency, in legal terms, the government does not have the authority to force payments in Petros. It may create enough incentives to make use of Petros advantageous (for instance, by recognizing a selling price favourable to Petro holders, or by creating tax benefits). Further, in contractual relations, the government may try to force acceptance of Petros by contractors or partners. But forcing acceptance outside of its commercial relationships would, in our opinion, constitute a violation of Article 318 of the Constitution, since it would make Petros an "unofficial" legal currency.

4) The use of cryptocurrencies –other than the Petro— might eventually help the Venezuelan government to make payments, circumventing the application of sanctions imposed by the government of the United States of America.

In principle, the sanctions imposed under Executive Order 13808 only apply to (i) financing the Venezuelan State, including its State-owned companies, such as PDVSA; (ii) trading in Venezuelan bonds –not excepted from the sanctions—; and (iii) making payments of dividends or other capital distributions from Venezuelan State-owned companies. However, many financial institutions have taken very conservative positions, which have in practice forbidden receiving or making any kind of payment by the Venezuelan State.

Introducing payments via cryptocurrency may help the Venezuelan State make payments –even debt payments already due— bypassing the aforementioned Executive Order or the very restrictive interpretation of such order.

However, we believe this not to be the case regarding the Petro. As indicated above, there has been much discussion regarding the Petro's nature but, in the end, the least controverted position is that the Petro is actually sovereign debt. If this were the case, then the limitations under Executive Order 13808 would be applicable if maturity is more than 30 days, which is a difficult issue to ascertain if the Petro is deemed foreign debt payable on demand. Accordingly, the Petro transactions involving United States persons –as defined by the Executive Order— or taking place in the United States, would fall within the scope of application of such order.

The U.S. Treasury Department, through OFAC, has warned American individuals and corporations that acquisitions of Petros violate Executive Order 13808, since a "currency with these characteristics would appear to be an extension of credit to the Venezuelan government."[6] It indicated that United States persons that deal in Petros may be exposed to sanctions.

However, as indicated above, this would not only apply to United States persons, but also to transactions taking place in the United States, which may include money changing hands

[6] OFAC, U.S. Treasury Deparment, FAQs: Venezuelan Sanctions, on January 19, 2018, at https://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_other.aspx#venezuela.

through the financial institutions of the United States or cryptocurrency exchanges being located in the United States.

Accordingly, in general and even before the issuance of the Decree, cryptocurrencies –other than the Petro— may help the Venezuelan government make foreign payments, circumventing limitations deriving, in law or in practice, from Executive Order 13808. But Petro transactions –depending on maturity time— may actually be restricted by such order.

5) There are other issues to consider, which complicate the implementation of Petro sales. For instance, contradictions between the blockchain platform being used, references to the number of Petros sold or to the amounts received by the government. Yet, due to the nature of this paper, we shall not refer to them, although we must say, at the very least, that they have the effect of compromising even more the transparency of the issuance, sale and circulation of Petros.

Summarizing our opinion, Petros are illegal debt issued by the Venezuelan State, but the documents regulating Petros have implications regarding many other issues, including cryptocurrency transactions, exchange controls operations and even foreign sanctions.