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Befuddled by Bitcoin: Regulating Virtual Currency

by STEVE THOMAS

How can something be regulated if no one knows what it is?

In July, New York became the first state to issue proposed regulations governing Bitcoin and other virtual currencies. At about the same time, in *U.S. v. Ulbricht*, judge Katherine B. Forrest of the Southern District of New York called Bitcoin “an anonymous and untraceable form of payment.” Almost a year earlier in August 2013, magistrate judge Amos L. Mazzant of the Eastern District of Texas held that Bitcoin was “a currency or form

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of money” in *SEC v. Shavers*. And earlier this year, the Texas State Securities Board’s Enforcement Division called Bitcoin “a digital currency system that incorporates cryptography.”

But on March 26, the IRS released its Notice 2014-21, stating that Bitcoin and other “convertible virtual currencies” will not be treated as currency but will be taxed like property. That seems in line with 31 Code of Federal Regulations 1010.100(m), where currency is defined as something issued by a government.

Whether currency or mere property, to a great extent Bitcoin has been treated as an investment product and its value has fluctuated from around \$2 near its inception in 2009 to at times more than \$1,000 (at the time of this writing, Bitcoin was priced around \$500, according to virtual currency website CoinDesk). Last year, the association of state securities regulators put digital money on its list of the top 10 threats to investors.

But despite a history of wild swings in Bitcoin value, rampant speculative investment in Bitcoins, and even exchanges created to support such investment, the SEC has taken regulatory action only on certain Bitcoin transactions, stopping short of calling it a security. The Commodities Futures Trading Commission is watching closely as well, but has never called Bitcoin a commodity, yet on Aug. 5, OKCoin of China launched its Bitcoin Futures Trading System. Judith Shaw, the top securities regulator in Maine, said in a Dec. 2013 New York Times story, “In the Murky World of Bitcoin, Fraud Is Quicker Than the Law,” that when it comes to Bitcoin, “[j]urisdiction has not been clearly established” among the various law enforcement agencies.

Bitcoin Explained

Any attempt to describe Bitcoin automatically points out the features that make it popular but also hard to categorize, and that raise concerns for regulators. It’s completely digital, a product of peer-to-peer networking and cryptography. There are no coins or paper bills. The “coins” pictured in the media just have a private key etched on the back. Scribbling the private key on a napkin would serve the same purpose. If an owner’s private key

is stolen, the thief owns the Bitcoins.

Every Bitcoin transaction is recorded on the block chain, a digital record distributed among many different people around the world. A transaction in one place automatically updates the block chain in all of the others. So Bitcoin is completely decentralized.

Once a Bitcoin transaction is complete it cannot be reversed, and Bitcoin is not backed by the credit of any government. Transactions can be completely anonymous, which explains its popularity among both criminals and revolutionaries—for someone trying to finance an Arab Spring or a Somalian pirate network, Bitcoin might be the payment medium of choice.

Back in New York, the proposed regulations issued in July contain separate definitions for virtual currency and fiat currency (government-issued currency) and would prohibit anyone from engaging in a “virtual currency business activity” without a license. The definition is broad enough to include just about every commercial activity involving Bitcoins except a merchant accepting them as payment.

The proposed rules include disclosure and capital requirements similar to those for banks, but also technology requirements such as more robust cybersecurity protections. Last month, the

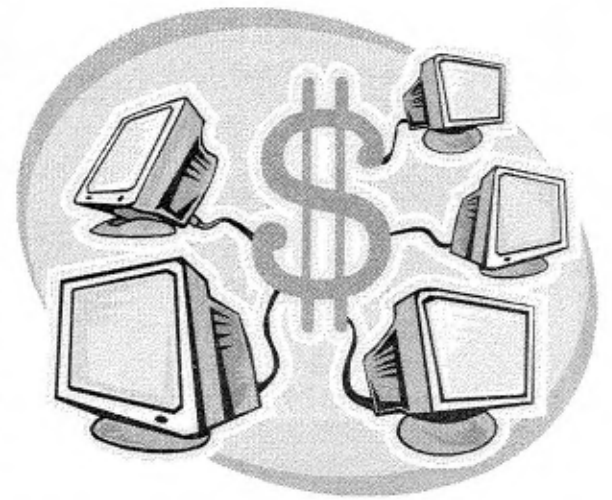
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Bitcoin Foundation sent a letter to the New York regulatory agency asking for an extension of up to six months over the standard 45-day comment period because “the Bitcoin community is not well-versed in New York financial services law or regulation” and “[i]t takes time to gather the meanings of legal terms of art and to compare them with emerging technologies, processes and business models in the Bitcoin world.”

Double SHA-256 Merkle trees of 32-bit asymmetric cryptographic algorithms—no problem. But all those laws and regulations—very confusing.

Admittedly, many of the involved companies are startups developing innovative technologies within the Bitcoin ecosystem, which is based on open-source software and specifically designed to support such technological development.

But at the same time, more than 30 instances of theft or illegal transfers with values in excess



of \$1 million had occurred as of December 2013, according to that same New York Times story, “In the Murky World of Bitcoin, Fraud Is Quicker Than the Law.” Bitcoin has been used for black market and illicit deep web transactions, such as sales of narcotics and malware through Silk Road as discussed in the *Ulbricht* case. The spectacular failure in February of the Mt. Gox Bitcoin exchange—resulting from a hack that reportedly stole more than \$400 million in Bitcoins—now has come to a Dallas bankruptcy court and creditors from all over the world are clamoring for lost money.

The reason regulators impose disclosure and capital requirements on companies handling money in any form is to lessen the risk that those companies will fail or be compromised.

But regulators and the investment community should not lose sight of the fact that technologies such as Bitcoin and other virtual currencies or trading systems have enormous potential for good around the world. Micropayments with little or no transaction fees can help third world countries nurture startups and innovation. Instantaneous transfers and nonphysical payments help boost online commerce. And the sheer exercise of the technology in the marketplace opens doors for other technological innovations built on its proven capabilities.

For now, regulators and the financial world are struggling to decide what Bitcoin really is. But twenty years from now, Bitcoin might have a status like today’s cellphones—how did we ever live without them? **END**



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