BITCOIN AS A MEDIUM OF EXCHANGE

By Timothy McTaggart and Matthew Silver

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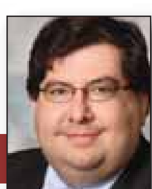

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Bitcoin, when used as a medium of exchange, rather than as an investment vehicle, shows users many potential benefits. Part of the appeal is that bitcoins cannot be created at will and the supply of bitcoin, while large enough to function as a medium of exchange, is still finite.

Bitcoins are effectively "created" by solving specific mathematical puzzles using computer processing power. Over time, remaining bitcoin puzzles take increasing amounts of computer power to solve. Parties can independently "mine" for bitcoins using their own computers, or as part of easy-to-join online collectives in which each person's individual computer does some of the work and receives part of the payoff or via rented networks. As such, "mining" bitcoins comes with associated real-world hardware and electrical costs, which also helps to provide for at least a level of price stability.

Bitcoin, as an independent currency, at least until recently, had no significant legal restrictions and existed as a form of payment without a need for a payment processor. As noted by *The Wall Street Journal,* firms that exchange bitcoin will now generally be regulated in a similar manner as traditional money-order providers such as Western Union, and, in the U.S., have bookkeeping and mandatory reporting requirements for transactions of more than $10,000. Moreover, firms that receive legal tender in exchange for online currencies, or anyone conducting a transaction on someone else's behalf, would be subject to a new level of U.S. government scrutiny – all concepts in opposite to the bitcoin ideal in which a level of anonymity while conducting transactions (purchases, donations, transfers, etc.) is favored.

Unlike many virtual currencies, bitcoins are useful well beyond the online gaming environment as a method of payment. Indeed, bitcoin allows parties to trade (including parties living in a country with a non-liquid or almost non-existent currency.) As has been noted, someone in Rwanda who builds a compelling service can instantly start taking payments from the rest of the world, with the same fee structure as the biggest retailers. Bitcoin users have grown accustomed to the freedom to do as they please, with no credit card agreements, no attempt to get acceptance from PayPal, no required commissions, no chance that payment will be blocked by a payment processor and potentially no official records tying the seller and purchaser together. This is one reason why the U.S. government agency, FinCEN, issued anti-money laundering guidance to establish a baseline regulatory framework for virtual currencies, such as bitcoin.

In the marketplace today, bitcoin competes in the mobile payment space with companies such as Square and iZettle (entities that provide dongles that plug into smartphones via their headphone jacks and tablet computers and act as credit card readers.) While Square and iZettle avoid any layer of exchange into a "real" currency and may be more secure by default, bitcoin transactions do not require a hardware dongle, and allow for offline transactions. If two parties are offline or in a remote area without steady Internet access, the parties can still trade if the buyer is trusted. For bitcoin, a temporary loss of Internet access does not result in business coming to a dead stop. However, according to *Forbes*, even though the acceptance of bitcoin payment could potentially boost sales, for example, of Apple mobile hardware, Apple sees bitcoin as a threat to its partnerships with dongle players like Square and iZettle, as it allows purchasers to bypass credit card companies (e.g. Visa,) and other payment processing networks.

By comparison, the BitPay processing system is more limited than that of credit card companies but does allow online merchants to accept bitcoin payments, just as they accept payments from conventional sources. Under the BitPay platform, merchants can keep revenue in bitcoin form or choose to automatically convert it into hard currency – which is then directly deposited daily into the merchant's bank account. Under the new regulatory regime, BitPay and similar firms might be classified only as payment processors and not money transmitters to the extent that they: (a) contract with sellers only for transaction processing, clearance and settlement, and (b) attempt to limit their involvement with the senders of funds/customers.

It seems highly unlikely that bitcoin would ever develop as a mass retail substitute to the existing (evolving) third-party payment systems. Nonetheless, in marketplaces experiencing a loss of confidence in the local currency or for reasons of convenience, bitcoin may emerge as a viable, ongoing niche player to provide medium of exchange functions. ■