THE RISE OF BITCOIN

By Timothy McTaggart and Matthew Silver

Bitcoin is a virtual currency without physical form or governmental authorization. It trades freely via electronic means. Although rare, bitcoin may also be transferred in person, by a laptop or tablet computer. Bitcoins come in whole or in fractional form – i.e. 0.000001 of a bitcoin is a microbit. There are a finite number of bitcoins. A limit of 21 million bitcoins can be unlocked – more than half of which have already been 'mined.'

The number of initial bitcoin users in 2009 was small. By 2010, daily worldwide bitcoin transactions were generally under a thousand a day.[1] In late 2010, the total worldwide 'market value' of all bitcoin first exceeded $1 million.[2] In 2013, bitcoin is in the news on a daily basis, especially in light of heightened uncertainty toward traditional financial systems such as that resulting from the restrictive actions taken by the government of Cyprus. Interest in bitcoin also increased from fear that select governmental authorities wish to track civilian transactions. Lastly, much press attention has focused on the rise in the value (per unit) of bitcoin. In response to the increase in volume and market value, FinCEN (the Financial Crimes Enforcement Network of the U.S. Treasury) issued advisory guidance on March 18, 2013 concerning virtual currencies. The new rules became effective immediately.

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Bitcoins can be traded for goods or services, sold/exchanged for traditional currency or donated to new owners. The new owners can then, in turn, use the bitcoin as a virtual currency. The FinCEN guidance will have licensing/registration consequences for virtual currencies and will require certain parties transacting bitcoin to establish written anti-money laundering programs. Bitcoin transactors will have to file Currency Transaction Reports and Suspicious Activity Reports and maintain records – including certain records concerning the purchase and transmittal of funds.

According to the October 2012 European Central Bank report on "Virtual Currency Schemes"[3] (the word "schemes" does not necessarily have a negative connotation in Europe,) the following ideas are thought to be generally shared by bitcoin supporters:

- Bitcoin is a mechanism to end the monopoly created by central banks in the issuance of money.
- There is a concern with the current fractional reserve banking system, whereby banks can extend their credit supply above their actual reserves and, simultaneously, depositors can withdraw their funds in their current accounts at any time.
- Bitcoin is inspired by the former gold standard.

As a non-governmental currency as well as a form of payment that exists without a need for a payment processor, bitcoin allows parties to trade. The use of bitcoin or other virtual currency assists parties living in countries with non-liquid currencies. However, the lack of regulation of a virtual currency can have serious downsides.

For example, on April 17, 2013, a bitcoin OTC exchange (bitfloor.com) announced that it was forced to shut down immediately and cease all trading operations indefinitely as their U.S. bank account was scheduled to be closed. Such an action by a traditional securities exchange is rare. Whether all parties will receive a 100% return of their bitcoin and cash (assuming bitfloor.com can even reliably determine a physical address or bank account) remains to be seen.

In addition, lawmakers and policy officials have raised other regulatory issues and public policy concerns.

The October 2012 European Central Bank virtual currency report notes that a "…recurrent issue is whether bitcoin works like a Ponzi scheme or not. Users go into the system by buying bitcoins against real currencies, but can only leave and retrieve their funds if other users want to buy their bitcoins, i.e. if new participants want to join the system. For many people, this is characteristic of a Ponzi scheme."[4] The report ultimately concluded that bitcoin does not meet the SEC standard of a 'Ponzi scheme,' due in part to its decentralized nature as there is no central organizer that can disappear with system funds.

In addition, the October 2012 European Central Bank report noted that in June 2011, two U.S. senators, Charles Schumer and Joe Manchin, wrote to the U.S. Attorney General and to the Drug Enforcement Administration Administrator expressing concerns about bitcoin and its potential use for illegal purposes. Around this same time, Gavin

Andresen, Lead Developer of the bitcoin virtual currency project was asked to give a presentation about the product to the CIA, presumably to explain bitcoin and keep them updated about its potential uses for money transfers that may be of interest to government officials.

Virtual currencies, in contrast to traditional payment systems, are largely unregulated. Virtual currencies can "constitute a challenge for public authorities, as these schemes can be used by criminals, fraudsters and money launderers to perform their illegal activities."[5] On a different note, virtual currency may have a reputational impact – "they are about money and about payments and therefore, for the general public, they clearly fall under the responsibility of central banks, even though this might not be the case from a statutory and legal point-of-view. Therefore, the possibility of a reputational impact in the event of a security incident should be taken into account."[6]

Indeed, legal uncertainty surrounding alternative currency such as bitcoin influenced a prominent online privacy advocacy organization to reject bitcoin donations in 2011. Noting in part that "while EFF [the Electronic Frontier Foundation] is often the defender of people ensnared in legal issues arising from new technologies, we try very hard to keep EFF from becoming the actual subject of those fights or issues. Since there is no case law on this topic and the legal implications are still very unclear, we [EFF] worry that our acceptance of bitcoins may move us into the possible subject role." They also stated that they did not fully understand the complex legal issues involved in creating a new currency system, specifically surrounding the Stamp Payments Act, tax evasion, consumer protection and money laundering concerns.[7]

With the FinCEN Advisory Guidance, the anti-money laundering concerns are squarely addressed, but virtual currencies still need to consider consumer protection, tax evasion and possible issues under the Stamp Payments Act.

1. See chart of the estimated number of bitcoin transactions per day, from 2009 through the current month, available at http://blockchain.info/charts/n-transactions?timespan=all&showDataPoints=false&daysAverageString=1&show_header=true&scale=0&address= (last visited April 24, 2013).
2. See chart of estimated total bitcoin market capitalization, available at http://blockchain.info/charts/market-cap?timespan=all&showDataPoints=false&daysAverageString=1&show_header=true&scale=0&address= (last visited April 24, 2013).
3. Available at http://www.ecb.int/pub/pdf/other/virtualcurrencyschemes201210en.pdf (last visited April 15, 2013).
4. See page 45 of the October, 2012 European Central Bank report on "Virtual Currency Schemes."
5. ibid.
6. ibid.
7. See June 20, 2011 release by the Electronic Frontier Foundation, available at https://www.eff.org/deeplinks/2011/06/eff-and-bitcoin (last visited April 21, 2013).