Divining the Regulatory Future of Illegitimate Cryptocurrencies

BY VIVIAN A. MAESE

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I have been very lucky to have had a career at the cutting edge of technology in the financial services industry. As one of the first technology lawyers on Wall Street, I have worked through many cycles of innovation that has disrupted the status quo. My brilliant clients have always pushed the edges of technology enabled financial products and services into places that the law had not yet considered. My role has been to advise innovators and to position them for the future based upon my own predictive analytical model. The purpose of this article is very similar. It is an exploration of how existing regulatory paradigms could serve to impart cryptocurrency with legitimacy.

Bitcoin, so-called "virtual currencies" and other cryptocurrencies are a financial and technological innovation that integrates existing concepts about money, accounting, networks, and remittances in one holistic invention. Virtual currencies are part of a larger social change that I call "power-to-the-people." The ubiquity and facile utility of technology have provided anyone with a smartphone anywhere in the world with the power equivalent to the data centers that operated Wall Street firms 25 years ago. This social trend is made evident in other individual and essentially cooperative people-to-people activities that are changing the way that capital flows such as crowdfunding, alternative payment systems, and peer-to-peer lending.

In order think clearly about the future of cryptocurrencies, it is helpful to revisit the basic elements of how we define money. Economists generally agree that money is a store of value, a unit of measure and a medium of exchange. As a society, we accept and acknowledge worth in the symbols that represent generally accepted value. We suspend belief and to the extent that we perceive value, the symbol is imbued with value. In 1871, Western Union devised a way to transfer money using the telegraph. By 1995, more than 90% of financial transactions in the United States were made by using electronic symbols.[1] Digital currency is not such a new idea. We have been legitimately transferring money in electronic form for decades.

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Among early adopters, Bitcoin and other cryptocurrencies are being imbued with perceived value and used like money by people and organizations. The cryptocurrencies store value, and albeit volatile, they are used in payment for goods and services. Their quantity is mathematically limited, and they can be used as a unit of measure.

However, in the United States cryptocurrencies are not "lawful money." The Department of the Treasury Financial Crimes Enforcement Network (FinCEN) has clarified that cryptocurrency is not money, but that existing Anti-Money Laundering and Know Your Customer regimes do apply to the administration and exchanges of virtual currency.

The Federal Reserve Act which authorizes the Board of Governors to issue Federal Reserve notes has not been modified to include virtual currency. Fed Chair Janet Yellen recently had the chance to opine on Bitcoin when she responded to questions from U.S. Sen. Joe Manchin (D-

WV) when he called on Federal regulators to ban Bitcoin.[2] Chair Yellen responded thatBitcoin is a payment innovation that is taking place outside of the banking industry. To the best of my knowledge there is no intersection at all between Bitcoin and banks that the Federal Reserve has the ability to supervise and regulate. So the Fed doesn't have the ability to supervise or regulate Bitcoin in any way.[3]

However, Bitcoin has characteristics of a currency and it also has characteristics of a value transfer network. Because Bitcoin is an invention that integrates both things and processes, it is hard for it to fit it neatly into the special purpose regulatory silos that we created in a simpler time. It is clear that Bitcoin is not lawful currency in the United States. So, what is it?

The cryptocurrency ecosystem includes different kinds of participants—participants who have wallets containing stored Bitcoin value, network transmitters, exchanges, etc., as a part of an integrated but distributed and decentralized system for moving and recording value transfers from point to point around the network. At a distance, the network itself is similar to the network created for the securities markets when the Securities and Exchange Commission (SEC) enacted Regulation National Market Structure (Reg NMS), although the cryptocurrency technology is much more advanced and sophisticated by orders of magnitude. The BlockChain Protocol (BCP) technology that forms the network is the kind of value transfer network that you could dream about creating if existing businesses had the luxury of a fresh start. It is brilliant and has many applications within a wider, established business and financial context.

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A regulatory direction that can be taken concerning cryptocurrencies would be to bifurcate the functional features and apply a different regime to each. For example, Bitcoin could be considered a legitimate foreign currency—the currency of the digital realm. Our individual activity on the Internet creates a separate, digital, shadow existence for all of its participants. We simultaneously live in the physical world and also have a shadow presence in the digital world. (The idea of a dual existence is gaining acceptance in an unlikely place, the Estates and Trust bar. Forward-thinking lawyers have begun to advise clients to consider directions for the disposition of their digital lives when contemplating the disposition of their property upon their physical demise.)

Foreign currencies are valued and traded on the foreign exchange market (Forex) which is a global, decentralized market that works through financial institutions, non-bank foreign exchange companies and money transfer organizations. One participant makes a bet that another participant's currency will increase or decrease in value based on a number of risk factors such as the stability of the sovereign that legitimized the currency, the sovereign's economic conditions, inflation levels, etc. The Forex market is a very speculative market with very little sovereign or cross-border regulation and no centrally cleared market.

The BCP could be separately regulated. Many years ago, bank regulators who concerned themselves with safety and soundness published guidance that supervises technology development and information security to this day. More recently the SEC proposed Regulation Systems Compliance and Integrity (SCI) to address technology "glitches" in the securities markets. To be clear, I am not proposing that the weightiness of bank regulation or of SCI be applied to tech start-ups. However,

I am suggesting that the codification of development standards that good developers already use could help the network become safe. A page from securities regulation could be applied to Bitcoin and a self- regulatory organization (SRO)—perhaps The Bitcoin Foundation—could be created to oversee and examine the participants and in particular the engineers who create the code. The open-source nature of the developer population provides opportunities for frivolous or criminal behavior that can damage the participants in the same way that investors can be misled by promises of get rich quick schemes. An SRO could qualify and register developers and participants in the Bitcoin ecosystem.

Safety should be part of the BCP engineering. Regulations that reduce operational risk in the system would have a positive impact. Regulations could address the way that code is developed, tested and made operational. Regulations could ensure that cybersecurity requirements are engineered into the code and could ensure that the network would recover from a failure by building in redundancy. Regulations cost money to implement, but they provide a measure of safety that reduces risk.

One of the biggest risks that we face as a society in the digital age and in the so-called "Internet of Things" is the quality of the code that will be used to run our lives.

The absence of a legitimate authority recognizing and attributing value to Bitcoin provides supervisory opportunity to the Consumer Financial Protection Bureau (CFPB), which has as a mandate ensuring consumer financial safety. Coinbase, a digital wallet that allows users to store and use Bitcoins, has 1 million wallet owners; and Blockchain.info, has 1.5 million users of their web services. There are different business models in the virtual currency space. Some models like Coinbase and Mt. Gox rely on trust and others like Blockchain.info allow users to control their virtual funds. The environment is currently "buyer beware." The CFPB stepped up to Bitcoin last year when it required more disclosure when sending payments, and they have an opportunity to do more. At a minimum the CFPB should mandate that cruptocurrencies come with a warning label.

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Harkening back to Chair Yellen's comments, "Bitcoin is a payment innovation happening outside of the banking industry…" that is part of the problem. One of the unintended consequences of the rigorous and voluminous regulations that comprise the Dodd Frank Act is that financial innovation now is taking place away from the consolidated regulatory structure idealized by the creation of the Financial Services Oversight Counsel (FSOC) and the Office of Financial Research (OFR). The number of users of virtual currency is growing rapidly. Virtual Currency expansion is also being fueled by venture money enamored of the potential for the technology. FSOC should be paying attention to cryptocurrency as a potential systemic risk. There are more than a million users and it is possible that the entire system can blink out of existence overnight. Bitcoin is the ultimate shadow banking system.

The right regulations should help this fascinating and useful technology find its place in the physical world before too long. It does not matter if the CFPB steps in and provides robust market structure regulation or state gaming commissions equate Bitcoin with poker chips, so long as we understand the rules of the game and the value in a context.

NOTES

1. IEEE.org-Timeline: The Evolution of Modern Money; *See* http://spectrum.ieee.org/static/timeline-the-evolution-of-modern-money.
2. Sen. Manchin's letter to regulators calling for the ban of Bitcoin can be viewed here: http://www.manchin.senate.gov/public/index.cfm/press-releases?ID=237cbd66-6a26-4870-9bcb-20177ae902b0.

3. Sen. Manchin's question and Chair Yellen's response came during Yellen's address to the U.S. Senate Committee on Banking, Housing, and Urban Affairs on February 27, where she delivered the Fed's "Semiannual Monetary Policy Report to the Congress."