

Transcript:

Jeff Neuburger Discusses Bitcoins

Speakers: Jeffrey Neuburger

Jeff: Hello my name is Jeffrey Neuburger. I'm a Partner at Proskauer Rose and Co-Chair of the Technology Media & Communication practice at the Firm. I'm here today to speak about the virtual currency known as Bitcoin. The term Bitcoin can actually refer to two things. First there is the Bitcoin network which is the implementation of a protocol for assuring the proven and verified transfer of ownership without the need for a trusted intermediary third party. Second there's a so-called virtual currency known as Bitcoin which is the most well-known application of the Bitcoin network. A Bitcoin is a virtual storage of value. The Bitcoin network is based on open source software. The software is maintained, updated and released to the general public by a group of individuals and entities around the world. The network is based on public key, prior key encryption and hashing algorithms, using these techniques each transaction is recorded on a decentralized public ledger called a Block Chain that is visible to the world. Despite the public nature of the Block Chain, no personal information about the parties involved in the transaction is revealed.

There are three ways to obtain Bitcoins. First people can obtain Bitcoins through an online exchange. One can buy and sell Bitcoins in exchange for traditional currencies based on supply and demand driven market prices. Second, one can also obtain Bitcoins in exchange for the sale of goods or services, such as a merchant accepting a Bitcoin from a customer. Third, hobbyists and entrepreneurs can also earn Bitcoins through mining which is a process through which Bitcoin transactions are validated. Miners earn Bitcoins as a reward for participating in the process. One of the primary benefits of Bitcoin is the ability to move the currency quickly, cheaply and privately. Bitcoin may be transferred across the globe almost cost free to anyone with an electronic wallet and internet connection. As presently structured, the transactional costs associated with Bitcoin are much lower than those using traditional payment systems. Another perceived benefit is that the Bitcoin transaction does not involve the disclosure of any personal information.

However, given the emerging and Wild West nature of Bitcoin, there are clearly many risks. Because there is no governmental backing for Bitcoins, the value of the Bitcoin at any given moment is purely a function of supply and demand, thus a merchant that accepts Bitcoin or speculator that buys Bitcoin runs the risk that Bitcoin can lose all or some of its value. Bitcoin values have been very volatile. Another major risk relates to Bitcoin storage. Like any electronic information, Bitcoin is susceptible to data loss,

hacking or file corruption. What is the regulatory environment for Bitcoins? So far in the U.S., regulatory actions and statements reflect the sentiment that while money laundering, fraud and other criminal activity using Bitcoin will not be tolerated. U.S. authorities will not seek large-scale restrictions on Bitcoin transactions. For example, on March 24, 2014 the Internal Revenue Service issued guidance on the tax treatment of Bitcoin and other virtual currencies stating, among other things, that they would be treated for tax purposes as property as opposed to a currency. In March 2013, the Department of Treasury Financial Crimes Enforcement Network issued guidance clarifying that anti-money laundering regulations apply to digital currency exchanges. The guidance further stressed that the definition of a money transmitter does not differentiate between real currencies and convertible virtual currencies. Thus, under Phinsen's guidance, a Bitcoin exchange that allows users to buy Bitcoin with real currency and sell Bitcoin for real currency, must file as a money services business with Phinsen.

However, a user who simply obtains virtual currency and uses it to purchase real or virtual goods or services is not a money services business under Phinsen's regulations. In a subsequent ruling in January of 2014, the agency clarified that a Bitcoin minor who uses Bitcoin solely for his own purposes and not for the benefit of another is not a money services business under Phinsen's regulations. There has been at least one Phinsen enforcement action against a Bitcoin exchange based on failure to satisfy regulatory requirements. In May of 2013, Phinsen seized U.S. accounts of Mount Gox a Japanese Bitcoin exchange for failure to register with Phinsen. Mount Gox recently experienced a massive and yet unexplainable loss of approximately three hundred million dollars of Bitcoin and is now bankrupt. It's worth noting that in addition to Phinsen's requirements most states have transmitter licensing requirements that may be applicable as well.

In another regulatory development the SCC in a recent investor alert stated that any investment and securities in the United States remain subject to the jurisdiction of the SCC regardless of whether the investment is made in U.S. dollars or virtual currency. This interpretation was echoed in the case of SCC v. Shavers where the U.S. District Court for the Eastern District of Texas found jurisdiction under the Securities Act of 1933 over a case involving allegations of a Bitcoin based Ponzi scheme because investments bought with Bitcoins satisfied the definition of an investment contract and with securities under the act. The Justice Department has pursued at least two actions against the alleged operative of the rogue website Silk Road and parties from among other things narcotics conspiracy and money laundering with Bitcoin.

In terms of another development, in late 2013 the New York Department of Financial Services conducted a series of hearings into virtual currency to determine what state regulation if any was appropriate. While law enforcement officials recommended regulation to increase transparency, investors and Bitcoin service providers urged restraint to protect the

nascent market. In March of 2014, the Department began accepting formal proposals to operate digital currency exchanges and other related services in New York in conjunction with the agency establishing its oversight of the emerging industry. In March 2014, FINRA, the Financial Industry Regulatory Authority issued an investor alert to caution investors of the significant risks of buying and speculating Bitcoin and other digital currencies as well as the risks of fraud and cybercrime related to online Bitcoin exchanges and other Bitcoin related services providers.

Where's it all headed? Although there are many very sophisticated, experienced and savvy people, who are certain Bitcoin as a virtual currency is here to stay, there are just as many similar sophisticated, experienced and savvy people who predicted the demise of Bitcoin. Although I do not know who is correct, it is fair to say that there are still many unanswered questions about Bitcoin. For example, how will regulators address Bitcoin in the future and how will such regulation affect the Bitcoin economy? Will price volatility and data security lapses eventually destroy confidence in Bitcoin? Will Bitcoins open up new E-Commerce opportunities including new payment options in countries without well-established banking systems? Independent of Bitcoin as a currency, there's also a lot of interest in Bitcoin as in network as an underlying protocol. The question there is what applications will be built to avail itself of that network? Will Bitcoins ultimately become mainstream either as a virtual currency or as a network for other types of transactions? We'll have to find out together.

Thank you very much.