

Bitcoin: Regulations and Legal Risks for a New Virtual Currency

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GOALS

- Learn to speak **the Bitcoin language**: what is Bitcoin and how does it work?
- Develop an understanding of current **regulatory and legal issues**

INTRODUCTION

- [Video](#)

What Is Bitcoin?*



*Bitcoin: Questions, Answers, and Analysis of Legal Issues, CONGRESSIONAL RESEARCH SERVICE (Jan. 28, 2015)

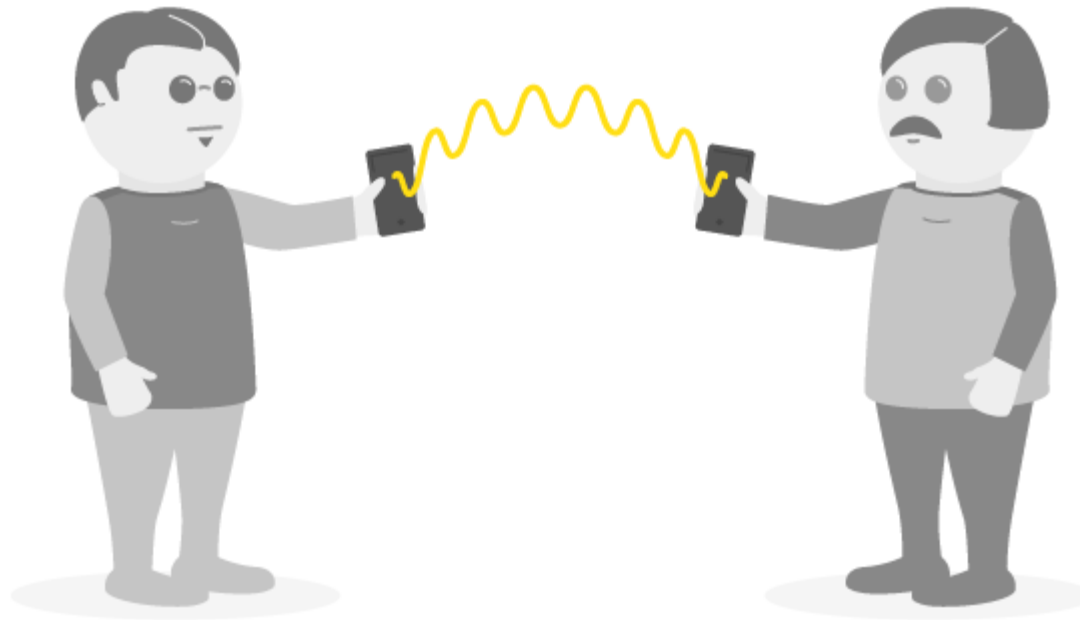
THREE FUNDAMENTAL CHARACTERISTICS

- Digital currency
- Open source
- Peer-to-peer (i.e., decentralized)

COMPARISONS TO OTHER CURRENCY

- No intrinsic value
- No physical form
- Not legal tender
- Not backed by any government or legal entity

How Bitcoin works



HOW DO I GET BITCOIN

- Exchanges



- Accept Bitcoin as payment

- “Mine” new Bitcoin

DIGITAL WALLETS

- Store your **public address** and **private key**
- Desktop, mobile, cloud, and paper



A BITCOIN PUBLIC ADDRESS



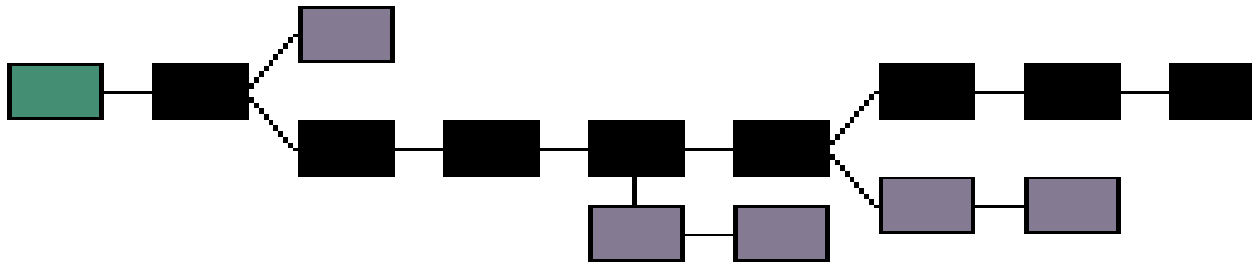
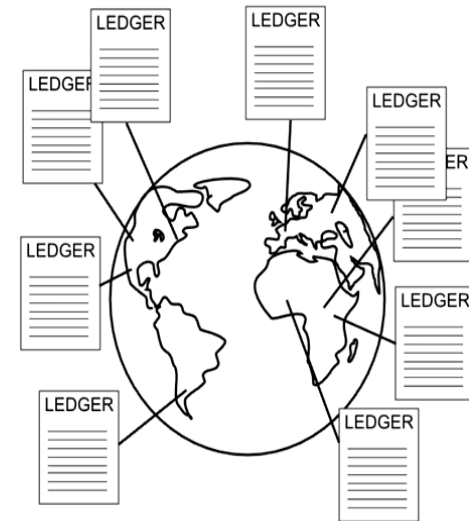
1F1tAaz5x1HUXrCNLbtMDqcw6o5GNn4xqX

TRANSACTIONS

- Transferring value between Bitcoin wallets
- Private key is used to sign transactions
- Broadcast to the Bitcoin network

BALANCES: THE BLOCK CHAIN

- Bitcoin's shared public ledger
- Global verification process

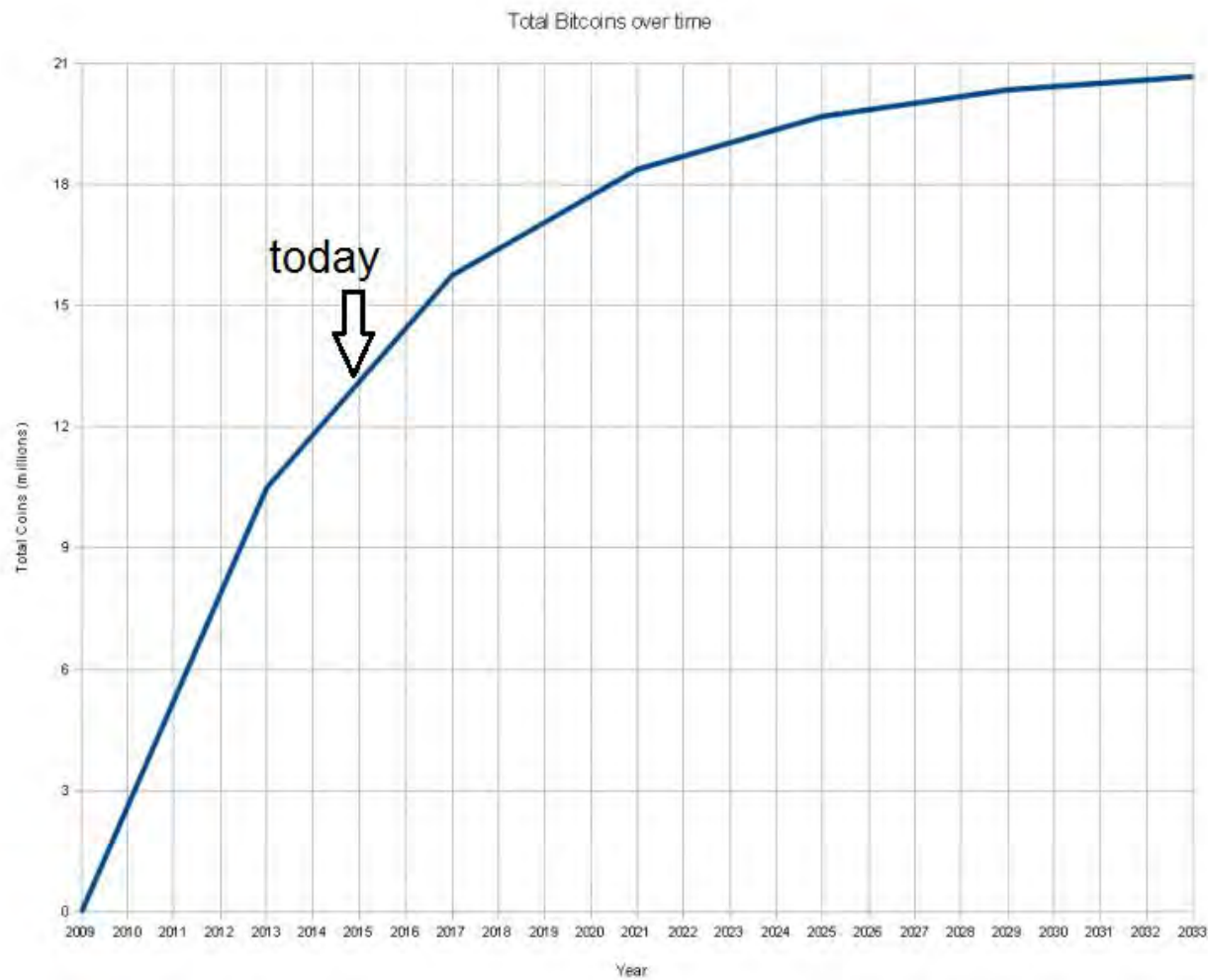


BITCOIN MINING

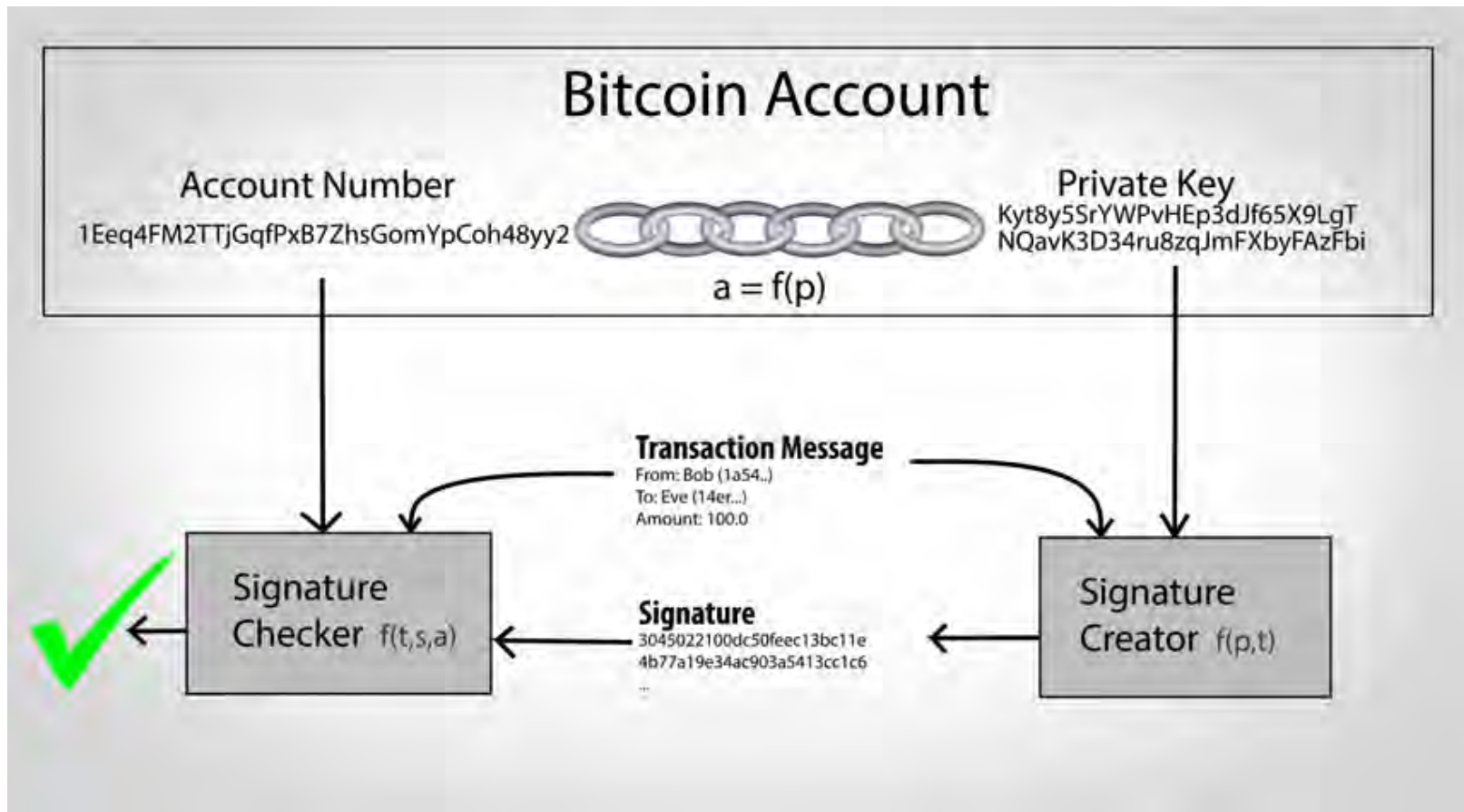
- “**Miners**” confirm waiting transactions
- The **digital gold rush**: rewards for processing



BITCOIN MINING



THE ENTIRE TRANSACTION



WHAT IT REALLY LOOKS LIKE

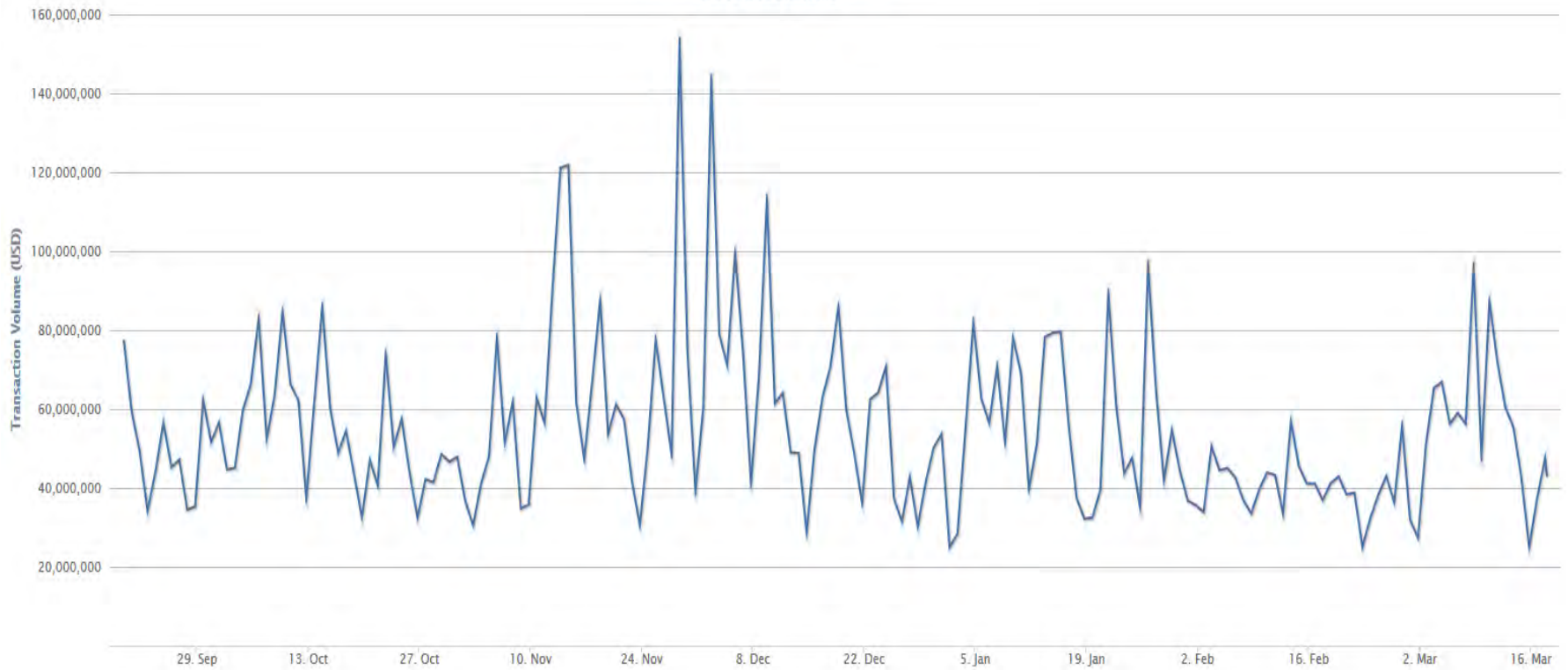


Why Bitcoin matters



Transaction volume (USD) - 6 months

Estimated USD Transaction Volume
Source: blockchain.info



BENEFITS AND DRAWBACKS

- **Two primary benefits:**
 - Lower transaction costs
 - Privacy (pseudonymous, not anonymous)
- **Drawbacks:**
 - Not legal tender
 - Still only ~2.5 million “wallets”
 - Price volatility
 - Network security

PRICE & VOLUME – PAST THREE YEARS



DATA BREACHES

- **2013:** Mt. Gox is hacked.
850,000 BTC (\$400 million) stolen.
- **2015:** Bitstamp security breach.
19,000 BTC (\$5 million) stolen.

BITCOIN GAINING LEGITIMACY

- **Oct. 2013:** First Bitcoin ATM installed in B.C.
- **2013-2014:** Mainstream websites begin accepting Bitcoin.
- **June 2014:** U.S. government auctions almost 30,000 BTC seized from Silk Road.



BITCOIN GAINING LEGITIMACY

- **Nov. 2014:** Bitcoin ATM installed in Pioneer Place by local company BitcoinNW.



Legal and Regulatory Issues



IMPORTANT REGULATORY CONCERNS

- Taxation
- Illegal money transfers
- Consumer abuse
- Bitcoin's effect on the Federal Reserve's ability to meet its objectives

FEDERAL TAXATION

- Bitcoin received as payment for goods and services: included in **gross income**.
- **Capital gains** and losses apply when Bitcoin is treated as a capital asset.
- Miners must include **new Bitcoin** as gross income.



TREASURY DEPARTMENT



- **FinCEN issued guidance in 2013:**
 - Bitcoin exchanges are running a “money services business” - must register, record, and report
- **Recent administrative rulings:**
 - A virtual currency trading platform is an MSB.
 - Money transmission between company and seller and company and buyer
 - A company that accepts and converts “real” currency into Bitcoin for payment is an MSB.
 - Irrelevant that company stored a cache of Bitcoin

2013 SEC ENFORCEMENT ACTION



- *SEC v. Shavers*
 - Shavers sold fake Bitcoin-related investments, promising a 1% daily interest return.
 - All transactions were conducted using Bitcoin.
 - SEC alleged violations of **Securities Act § 17(a)** and **Rule 10b-5** (fraud in connection with sale of security) and **Securities Act 5(a) and 5(c)** (offer of securities without a registration statement).

2013 SEC ENFORCEMENT ACTION

- Bitcoin investments are “securities”
 - Shavers contested subject-matter jurisdiction because the investments were not securities (e.g., investment contracts).
 - Investment contracts require an investment of money.
 - E.D. Tex.: “Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money.”

2013 SEC ENFORCEMENT ACTION

- Summary judgment for the SEC
 - **10b-5 and Securities Act § 17(a):** Shavers knowingly and intentionally operated his company as a Ponzi scheme, making misrepresentations to investors.
 - **Securities Act §§ 5(a) and 5(c):** Shavers sold non-exempt securities without registering.
 - **Remedy:** \$40 million disgorgement; civil penalties; and a permanent injunction.

SEC SANCTIONS

- **Illegal operation of exchange:**
 - SEC recently sanctioned a computer programmer operating securities exchanges with virtual currency.
 - Exchanges not registered.
 - Programmer barred from the securities industry and subject to penalties.

INVESTMENT ALERTS

- **FINRA Alert (2014): “Bitcoin: More than a Bit Risky”:**
Warns of investment risks and risks of fraud.
- **North American Securities Administrators Ass’n:**
Digital currency added to list of top 10 threats to investors in 2013.
- **SEC:** Alerts in 2013 and 2014 warning of Bitcoin-related Ponzi schemes and risky Bitcoin-related investments.

CONSUMER FINANCIAL PROTECTION BUREAU

- **2014 Consumer advisory warning:**
 - Unclear costs, volatile exchange rates, hacking, and scams. “[C]onsumers are stepping into the Wild West when they engage in the market.”
 - Now accepting consumer complaints about exchange services and online digital wallets.
 - Threatens enforcement of consumer financial laws.



FEDERAL BANKING REGULATORS

- No guidance or regulations.
- Federal Reserve Chair Janet Yellen sees no intersection between Bitcoin and banks.
- Federal Reserve Bank Examiner Mark Williams presented the **top-10 risks** associated with Bitcoin:
 - **Sovereign attack risk:** “Bitcoin has the potential to undermine the longstanding bond between sovereign and its currency.”



A PEEK AT THE STATES - CALIFORNIA

- Paving the way:

- A 2014 law clarified existing law so that virtual currency can be issued and circulated.



- **FinCEN-like regulations:**

- A new bill would require virtual currency businesses to be licensed by the Commission of Business Oversight.
- \$5,000 fee.

A PEEK AT THE STATES – NEW YORK

- **Still drafting “BitLicense” requirements:**
 - Sets minimum capital requirements.
 - Companies must store physical addresses of their own customers.
 - Only impacts companies that transmit or store Bitcoin – not retailers or miners.

