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Bitcoin: Crypto-Currency or Bust

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Since it’s creation in 2009, Bitcoin has been the source of scandal, speculation, and financial meltdowns. Most recently, Bitcoin-based black markets (http://money.cnn.com/2013/11/18/technology/bitcoin-regulation/index.html), the alleged suicide of Bitcoin’s CEO (http://nypost.com/2014/03/05/bitcoin-firm-ceo-found-dead-in-suspected-suicide/), and the three fallen Bitcoin exchanges (http://www.zdnet.com/bitcoin-confidence-game-is-a-ponzi-scheme-for-the-21st-century-7000027181/) have made headlines internationally. However, amid the scandal surrounding this crypto-currency, there are still a growing number of businesses and individuals using Bitcoin all over the world. Referred to as the “Wild West” (http://www.washingtonpost.com/business/technology/bitcoin/2014/03/08/0b1ad2f0-a631-11e3-8466-d34c451760b9_print.html) of decentralized virtual currencies, Bitcoin’s nature makes regulation extremely difficult for international governments. The currency’s resistance to regulation also makes it appealing to people who want freedom from government or central bank control. However, given the rapidly moving growth and emerging uses of Bitcoin, governments will need to take action sooner rather than later, to prevent fraud and protect Bitcoin users.
Bitcoin is the world’s first decentralized peer-to-peer payment network where transactions can be made through the global trade system anonymously, with no third party involvement, and no regulation. Bitcoin is currently the most successful implementation of “crypto-currency” (https://bitcoin.org/en/faq) which is a new form of money that uses cryptography to control its creation and transactions, instead of a central authority. To its users however, it is essentially cash for the Internet. Users exchange their money for Bitcoins, and store their Bitcoins in a “digital wallet” (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/) which contains a public address and a private key for each Bitcoin. Users have complete control over their “wallet,” and can store them on their hard drive, online in the cloud, or with a Bitcoin exchange (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/). However, because Bitcoins are only tracked by their private keys, users run the risk of permanently losing their Bitcoins if their keys fall victim to hackers, viruses, or a broken hard drive.

Because users must store their Bitcoins virtually, there is no guarantee for the currency’s security. With no fail-safe security mechanism, the currency is highly susceptible to being stolen by hackers. Recently, Mt. Gox (http://www.zdnet.com/bitcoin-confidence-game-is-a-ponzi-scheme-for-the-21st-century-7000027181/), Bitcoin’s largest exchange, declared bankruptcy and reported losses of over $400 million in Bitcoin to hackers. Shortly thereafter, Polinex, another Bitcoin exchange, reported a hacker’s theft of 12.3 percent of the Bitcoin it stored, and Flexcoin, a Bitcoin bank in Canada, declared bankruptcy because of a loss to hackers. Because the Bitcoin market is still relatively small and completely user based, events such as these have made the price of Bitcoin rise and fall significantly. The resulting volatility of Bitcoin’s value lends to the insecurity of this crypto-currency for its users. Furthermore, because Bitcoin is not insured by the FDIC (http://money.cnn.com/infographic/technology/what-is-bitcoin/), there is no legal recourse or protection in cases of lost or stolen (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/) Bitcoin.

Bitcoin has been effectively used for many legitimate business transactions, including the funding of startups (http://arstechnica.com/business/2014/03/move-over-small-time-bitcoin-exchange-startups-wall-street-has-arrived/) and M&A deals. Among the legitimate businesses that accept Bitcoin, many have begun installing Bitcoin ATMs in their shops, including a local gun shop (http://www.forbes.com/sites/andygreenberg/2014/03/09/inside-americas-first-bitcoin-friendly-gun-store-video/) in Texas. However, Bitcoins are also increasingly being used for illicit activities.

Bitcoin “wallets” have an ID that allows users to send or receive Bitcoins and make purchases anonymously, making it extremely difficult for law enforcement to trace illicit transactions. This feature is why Bitcoin has become the currency of choice for individuals that want to buy drugs or engage in other criminal activities online. Many have begun using Bitcoin (http://money.cnn.com/2013/11/18/technology/bitcoin-regulation/index.html) to anonymously buy drugs, hire assassins, trade child pornography, traffic humans, and dodge taxes. Recently, the FBI shut down Silk Road (http://money.cnn.com/2013/11/18/technology/bitcoin-regulation/index.html), an online black market for illicit drugs and services, and seized over $100 million in Bitcoin. In connection, criminal charges (http://www.justice.gov/usao/nys/pressreleases/January14/SchremFaiellaChargesPR.php) were filed...
in Manhattan federal court against Robert M. Faiella, an underground Bitcoin exchanger, and Charlie Shrem, the CEO of an underground Bitcoin exchange, for engaging in a scheme to sell over $1 million in Bitcoins to criminals for trafficking narcotics on Silk Road.

As Bitcoin has gained global attention, some international governments have reacted by issuing guidance and regulations or completely banning its use, while others have remained silent. The Japanese government has banned banks (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/) from selling Bitcoin. Russia and China have issued crackdowns on Bitcoin regulation. Conversely, in the EU Bitcoin transactions are generally not regulated at all. In the United States, Bitcoin regulation has been scarce and with little guidance, and there remain a significant number of questions surrounding its use. FinCEN, an agency of the U.S. Department of Treasury, has provided some rules requiring those engaging in the business of creating and selling the virtual currency to register and report to the government, while everyday Bitcoin users remain unregulated (http://money.cnn.com/2013/11/18/technology/bitcoin-regulation/index.html).

However, given that Bitcoin can be used in a number of different ways that would fall under different schemes of regulation, there remain unanswered regulatory issues.

For example (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/), if Bitcoin is considered a currency, it must be regulated by FinCEN, if it is considered a commodity, it may be regulated by the Commodities Futures Trading Commission, if it is packaged as a security, such as the Bitcoin-backed ETF currently under review, it would be regulated by the Securities and Exchange Commission, and if ever reaches mass adoption, it may reach consumer protection regulators. These different characterizations also give rise to questions of liability for tax purposes and U.S. taxpayers’ reporting of worldwide income. However, there has been no direct guidance from the IRS.

Furthermore, as a result of the anonymous nature of Bitcoin, exchanges for services or goods are virtually untraceable, rendering it almost impossible to regulate. The DOJ (http://money.cnn.com/2013/11/18/technology/bitcoin-regulation/index.html) has stated that it needs more help catching criminals that use this secretive currency, and the Senate has held hearings regarding Bitcoin; however, Congress (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/) has yet to provide any specific guidance regarding the currency.

There is universal acknowledgement (http://techcrunch.com/2014/03/12/goldman-sachs-bitcoin-is-not-a-currency/) that Bitcoin exemplifies tremendous potential as a financial transaction system, as well as the fact that there are inherent risks involved with virtual currencies. Given that one of the most appealing aspects of Bitcoin is freedom from government or central bank control, the future of Bitcoin regulation is unsure and largely unwanted. However, the need for government action regarding this rapidly evolving currency may arise sooner than it can be taken.

Tags: Bitcoin, Currency, department of justice