Champing at the Bitcoin: Bitcoin, Regulators and the Law

David Rountree gives an overview of the history of Bitcoin and recent attempts by regulators to deal with this perplexing phenomenon.

Introduction

Welcome to the world of Bitcoin – where banks are obsolete, governments are circumvented and currency goes online. No need for those pesky coins filling your wallet, or even that cumbersome credit card. Now your money can exist entirely in an abstract world, protected by the power of a like-minded community, cryptography, and really complicated maths. This is the brave new world that Bitcoin promises.

Bitcoin is an online digital currency which exists and is stored solely on the internet. Bitcoin is not backed by any asset or linked to any organisation – in fact it exists completely independently of any organisational structure. Bitcoins can currently be used to purchase goods and services, as well as be exchanged for other mainstream currencies.

But where does the law fit in? This article aims to take a brief look at Bitcoin, its history, and how the law and regulators have attempted to deal with it in its brief (and slightly chequered) history. This has recently been given some clarity due to the US Federal Court decision of *Security Exchange Commission v Trenders T Shavers and Bitcoin Savings and Trust*.[1]

What is Bitcoin?[2]

Bitcoin has a number of unique features which distinguishes it from other "mainstream" currencies.

No central bank to print or produce currency - mining

Firstly, there is no centralised bank, such as the Reserve Bank of Australia, which processes, verifies and produces bitcoins. Bitcoins cannot be simply printed like regular money. In fact, in a process designed to mirror the discovery of precious metals, Bitcoins are produced by a process called "bitcoin mining".

A Bitcoin is "mined" on a computer, which by running a program is asked to solve a complex 64 digit algorithm. Successfully solving this algorithm is rewarded by the "miner" receiving 50 bitcoins.

An important feature of bitcoins is that they are finite – the algorithm that produces them will only produce $21 million bitcoins.[3] They are designed to release at a steady rate, but provide diminishing returns, as the algorithm gets increasingly difficult to solve as more bitcoins are mined. Recent figures suggest roughly half of the bitcoins have been extracted, with the production expected to peter out over the next decade until the virtual bitcoin mine is exhausted.

No intermediate financial institution – peer to peer system

Bitcoins are also unique in that there is no need for an intermediate financial institution to transfer them and verify them. In this way, they operate similar to cash. Transactions are processed and verified not by a bank, but by the processing power of computers engaged in mining. The act of mining bitcoins also involves confirming waiting transactions. All transactions on the Bitcoin network are recorded and shared across the network, which are then recorded as part of the mining in the "block chain". The complex mathematical formula is then reinforced by security mechanisms, preventing people replicating or double spending individual bitcoin.

This lack of involvement from government and financial institutions also contributes to another key feature of Bitcoin – their anonymity. Indeed Bitcoin has been heavily associated with the "Silk Road", an online marketplace from which one can purchase a variety of illegal goods. Bitcoin's anonymity has made it the currency of choice of Silk Road sellers, as well as a useful medium for both money laundering and financial schemes. This in turn has attracted the interest of law enforcement and regulators, which is addressed below.

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History of Bitcoin

Bitcoins first hit the internet in 2008, as the subject of a paper by a user by the name of Satoshi Nakamoto, entitled "Bitcoin: A Peer to Peer Electronic Cash System".[4] The first 25 coins, known as the "Genesis Block", were mined in 2009. Since that time, Bitcoin has gathered momentum, at first slowly, and then incredibly rapidly.

At its inception, a bitcoin was virtually worthless,[5] and while the first Bitcoin market was established in February 2010, its value compared with regular currency remained minimal. It was limited to what it could buy, which at this stage was very little. However, it slowly gathered traction, and in February 2011 a bitcoin was equal to a US dollar on a Bitcoin exchange.

Since that time, things rapidly became interesting for Bitcoin.

First, its founder, Mr Nakamoto, who had also contributed heavily in online forums to the technical literature surrounding Bitcoin, vanished without a trace. All efforts to discover the true identity of this user have so far proved fruitless.[6]

Secondly, there was a marked jump in interest in bitcoins. The mainstream internet became more aware of this idea, reputable online retailer began accepting it, and buzz was generated. This buzz even captured the imagination of the Cameron and Tyler Winklevoss

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1 Memorandum of Opinion Regarding Courts Subject Matter Jurisdiction, Case No 3:13-CV-416 (Eastern District of Texas, Sherman Division) (***SEC v Shavers***)

2 Technical explanations regarding the operation of Bitcoin can be found in a number of places, including http://www.weusecoins.com/en/; http://bitcoin.org/en/how-it-works; http://www.economist.com/blogs/economist-explains/2013/04/economist-explains-how-does-bitcoin-work; http://www.theguardian.com/technology/2011/jun/22/bitcoins-how-do-they-work.

3 This may not seem like a lot, but they are divisible and tradeable down to 8 decimal places. See http://bitcoin.org/en/about.

4 The original paper can be found at http://bitcoin.org/bitcoin.pdf.

5 Bitcoins were worth so little that at some point in May 2010, someone used 25,000 bitcoins to purchase a pizza. This would later prove to be a poor investment, as at the current value of a bitcoin, this pizza cost $3 million.

6 http://motherboard.vice.com/blog/who-is-satoshi-nakamoto-the-creator-of-bitcoin

(or the Winklevii), the former Olympic rower entrepreneurs made famous by their involvement in the foundation of Facebook (and subsequent legal battle). The Winklevii invested heavily in Bitcoin, and in July of 2013 they announced plans to create a Bitcoin fund.[7]

Finally, the value of Bitcoin began to increase – at first steadily and then far more rapidly. At the beginning of 2013, a bitcoin was worth roughly USD $15. However, across 2013, Bitcoin has faced a roller-coaster ride, with a bitcoin peaking at over $250, falling to $70, and then recovering to $160, before falling and rising again. At the time of writing, a bitcoin was available for exchange for $120 USD.[8]

How Bitcoin and the law interact going into the future may partly depend on the continued pace and uptake of them as a form of currency, as well as the ability for governments to develop the technical capacity to trace and monitor them

Bitcoin and the Regulators

The question remains as to how Bitcoin will be dealt with by the law. The concerns surrounding potential money laundering and other financial crimes using Bitcoin has not gone unnoticed by the regulators.

The approach taken in relation to Bitcoin by the central bank of Thailand to date has been relatively straightforward. On 31 July, Thai Bitcoin exchanges suspended trading after the central bank declared that trading in Bitcoins, or using them to buy or sell goods, was illegal. The central bank stated that, due to lack of existing laws to deal with the virtual currency, and its nebulous place in the financial industry, they were outside of applicable existing laws and therefore illegal.[9] This approach was a tacit admission by Thai authorities of the difficulties existing laws were having grappling with this new concept of virtual currency.

In the US, more nuanced approaches have been taken. The first sign that Bitcoin was being taken seriously by law enforcement authorities was when US Treasury issued a guidance note in March of this year which clarified that the financial crimes regulations will also apply to "virtual currencies".[10] These rules were specifically designed to capture products such as Bitcoin and included references to trading in "e-currencies or e-precious metals". The regulations are aimed at monitoring "administrators" or "exchangers" of virtual currencies, targeting Bitcoin exchange organisations as potential areas of money laundering.

Bitcoin exchanges have been subject to several subpoenas, with some having accounts frozen by US regulators.[11] In July, Mt Gox, the largest Bitcoin exchange, registered with the US Treasury Financial Crimes Enforcement Network as an official currency exchange for the purpose of US regulation.[12]

In Australia, while there has been little formal action to regulate Bitcoin, the Australian Taxation Office recently indicated that it was monitoring the currency, and that it considered that it could still be subject to taxation in a similar manner to any other currency, including GST or income tax.[13]

Bitcoin and the Courts

The position of regulators in Australia and the US appears to be that Bitcoin is money or a financial product capable of coming under their oversight, whereas Thailand has taken the opposite view. The choice between these two views was exactly what was put before a judge in the recent US Federal Court case of *Security Exchange Commission v Trendon T Shavers and Bitcoin Savings and Trust*.[14]

In this case, handed down on 6 August 2013, the defendant (a self-proclaimed online "pirate") owned and operated Bitcoin Savings and Trust (formerly known as First Pirate Savings and Trust), an investment scheme which had lost large amounts of money through Bitcoin-related investment. The US Security Exchange Commission (***SEC***) accused the pirate, Mr Shavers, of running a Ponzi scheme in breach of US federal *Securities Act 1993* and *Exchange Act 1934.* Mr Shavers, in a daring move, countered that the court had no jurisdiction to hear the matter.

Mr Shavers argument was that investments in the Bitcoin Savings and Trust were not securities because, simply, Bitcoin was not money, and not anything regulated by US law. Since all transactions were in Bitcoin, no money ever changed hands. In response, the SEC argued that these investments were both investment contracts and notes for the purpose of US security legislation.[15]

Judge Mazzant briefly described the nature of Bitcoin in his judgment, noting that it is "an electronic form of currency unbacked by any real asset and without specie, such as coin or precious metal". He described its peer to peer system of users validating transactions, outside of central banking or government authority.

Under US securities legislation, a "security" includes an "investment contract". An "investment contract" involves, among other elements, an "investment of money". The question to consider was whether Bitcoin was "money". Judge Mazaant responded as follows:

> *It is clear that Bitcoin can be used as money. It can be used to purchase goods or services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can also be exchanged for conventional currencies, such as the U.S dollar, Euro, Yen and Yuan. Therefore, Bitcoin is currency or a form of money, and investors wishing to invest in BTCST provided an investment of money.*[16]

Given this decision, it was held that the court did have subject matter jurisdiction. The case against Mr Shavers and his piratical ambitions will continue.

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7 "Winklevoss twins launch Bitcoin fund", The Guardian, 3 July 2013, accessible from: http://www.theguardian.com/technology/2013/jul/02/winklevoss-twins-launch-bitcoin-fund.

8 Bitcoin Charts, accessible from: http://bitcoincharts.com/

9 Trotman, A. "Bitcoins banned in Thailand", *The Telegraph*, 29 July 2013, accessible from: http://www.telegraph.co.uk/finance/currency/10210022/Bitcoins-banned-in-Thailand.html.

10 See FIN-2013-G001, Guidance: Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, 18 March 2013, accessible from http://fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html.

11 Toor, A. "US seizes and freezes funds at biggest Bitcoin exchange", *The Verge*, 15 May 2013, accessible from: http://www.theverge.com/2013/5/15/4332698/dwolla-payments-mtgox-halted-by-homeland-security-seizure-warrant/in/3709249.

12 Kastrenakes, J. "Bitcoin trader Mt. Gox registers as currency exchange to comply with US money laundering laws", *The Verge*, 1 July 2013, accessible from: http://www.theverge.com/2013/7/1/4483266/mt-gox-fincen-registration-us-regulation-following-account-seizure.

13 "ATO targets Bitcoin users", *Financial Review*, 24 June 2013, accessible from: http://www.afr.com/p/technology/ato_targets_bitcoin_users_oawpzLQHDz2vEUWtvYLTWI.

14 *SEC v Shavers*

15 ***SEC v Shavers***, p 2-3

16 *SEC v Shavers*, p 3

Conclusion

The place of Bitcoin in the world of financial products and currencies remains uncertain. It is associated with libertarian ideals, of commerce and the digital age. Mr Shavers' argument goes to the core of what Bitcoin considers itself to be – a medium of exchange free from the yoke of government authority, operating in a free and unfettered digital world. However, it is also contradictory to any attempts to legitimise it as a form of alternative currency. The more mainstream Bitcoin becomes, the harder it will be to live up to its promises about freedom, becoming just another form of financial product that is capable of being regulated and (most importantly) taxed.

Staying in the shadows will not help either, as governments will not continue to tolerate a mechanism used largely for illegal means. Recently, bitcoins were seized from a Silk Road drug dealer by US law enforcement.[17] How Bitcoin and the law interact going into the future may partly depend on the continued pace and uptake of them as a form of currency, as well as the ability for governments to develop the technical capacity to trace and monitor them.

The formative years of Bitcoin have been interesting and their relationship with the law will continue to develop. At least for now, Bitcoin is money. How useful it will be as money going forward remains to be seen.

David Rountree is a lawyer at Allens. The views expressed in this article are personal to the author and do not represent any organisation.

17 Biggs, J. "The DEA Seized Bitcoins In A Silk Road Drug Raid", *Techcrunch*, 27 June 2013, accessible from: http://techcrunch.com/2013/06/27/the-dea-seized-bitcoins-in-a-silk-road-drug-raid/.

Postscript:

On 2 October, the FBI and other US regulators shut down the Silk Road website, arrested its alleged founder and seized approximately 26,000 bitcoin (worth around 3.6 million) belonging to Silk Road customers (footnote 1). This is the largest ever seizure of Bitcoin. The issue at play is concerned with the illegal activities of the website, not the use of bitcoins themselves. However, bitcoin prices suffered a dramatic dip in the immediate aftermath (though no more dramatic than any other price change in Bitcoin's history) (footnote 2). This prosecution and investigation by US regulators will play an important part in determining whether Bitcoin goes takes a path hand in hand with, or away from, the illicit activities of the Silk Road, and will be an important phase in the future of digital currencies.

Footnote 1: http://www.theguardian.com/technology/2013/oct/02/bitcoin-silk-road-how-to-seize

Footnote 2: http://www.theguardian.com/technology/2013/oct/03/bitcoin-price-silk-road-ulbricht-value

Thank you to all who celebrated the 25th anniversary of the Communications and Media Law Association (CAMLA) and the CAMLA Cup at Doltone House in August

It was a wonderful evening incorporating the ever popular and always fun CAMLA Cup trivia night hosted by dynamo Debra Richards. We thank Debra and the organising committee – Anita Cade, Cath Hill, Marlia Saunders and Gulley Shimeld and to the staff at Doltone House who took good care of us.

Bruce Meagher, Director of Corporate Affairs at Foxtel delivered a highly entertaining state of the nation address and CAMLA President, Caroline Lovell presented lifetime memberships to CAMLA legends:

- Mark Armstrong (CAMLA founder)
- Victoria Rubensohn (Former CAMLA President)
- Ros Gonczi (Former CAMLA Administrative Secretary)

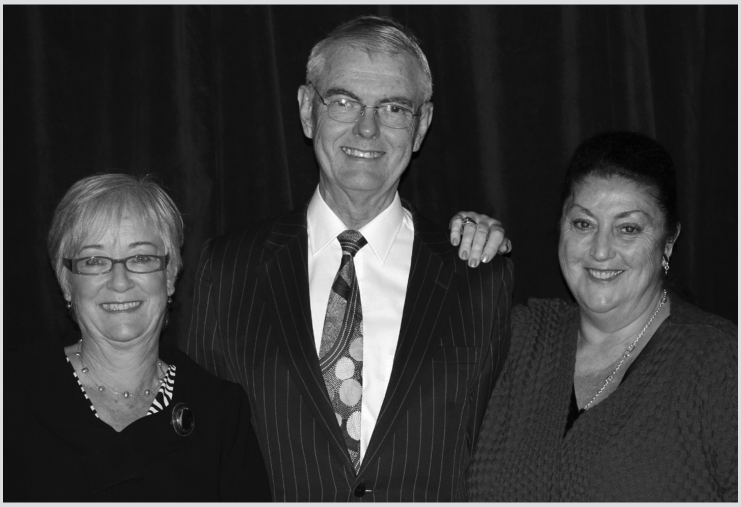
Congratulations to the CAMLA Cup winner: McCullough Robertson's "TelMacs" team!

A special mention goes out to Deanne Weir for taking out two 'Who am I' questions.

A photo gallery of the evening can be viewed on the CAMLA website www.camla.org.au.

Thank you to Louisa Vickers from Beyond International who kindly stepped in to take some excellent shots for us.

The annual CAMLA Cup could not be possible without the support of our prize donors. CAMLA would like to thank the following firms and organisations for their generous contribution:



L to R: CAMLA lifetime members: Ros Gonczi, Mark Armstrong and Victoria Rubensohn

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We hope to see you again next year and here's to the next 25 years of CAMLA!