Digital currencies:

the good, the bad and the ugly

Geraldine Fabre, a corporate lawyer at Russell-Cooke LLP, examines all sides of the digital coin

In August 2014, Chancellor George Osborne announced a new initiative that will explore the potential role of cryptocurrencies, such as Bitcoins, in Britain's economy, and commissioned the Treasury to produce a programme of work on cryptocurrencies, examining their potential risks and benefits. London is one of the biggest financial hubs in the world and is by far the largest financial centre in Europe. Venture capital firms around the world are prepared to invest in Bitcoin startups with record levels of financing, betting that some of these companies will become the Google and Facebook of the financial sector, and revolutionise the way in which financial transactions work.

Meanwhile, more businesses seem to be prepared to accept Bitcoins as a payment method for the purchase of goods or services (although few retailers in the EU have put systems into place to accept them as payment). Divorce and succession lawyers also worry about assets being hidden in Bitcoins as a mean to reduce a spouse or family's wealth, or to transfer funds to an offshore destination. A substantial increase in fraud, theft and tax evasion has been noted when it comes to realising or selling a digital currency back into fiat money – that is currency which derives its value from central banks, government regulation or law, or commodity monies such as gold or silver.

Cryptocurrencies are becoming popular enough that regulators around the world are considering the need to create rules that can encourage their growth and protect customers whilst limiting illegal activity. Digital monies are often perceived as a fast-paying tool, cheaper than a credit or debit card and potentially providing greater privacy protection (there is no disclosure of important data to initiate the transaction).

However, virtual monies are not stable in value, are susceptible to speculation and manipulation, and the confidentiality of their users opens the door to illicit and illegal activities, which could have a negative impact on the use of Bitcoins for fundraising (such as crowd funding) or other investment activities.

Uncharted legal territory

The broader issue seem to be (a) the uncharted legal territory surrounding digital currencies and (b) the fact that the treatment of cryptocurrencies is different from one country to another. Some countries such as China or Japan consider it illegal to transact using digital monies, citing concerns about money laundering amongst other reasons. Others, such as the US, allow these types of transactions to take place but consider Bitcoins not as a currency but rather as a payment mechanism and an asset or a commodity (not as income in their own right).

In the UK, the legislative landscape makes the issue of electronic money (real money) a criminal offence, unless authorised by the Financial Conduct Authority (FCA). However, the general consensus is that cryptocurrencies such as Bitcoins are not created against real monies. They are the product of 'computation work' of a collective of software programmers or 'miners': upon being issued, they are not a claim for value against an identified issuer (such as a central bank) for which a receipt of funds is received. Bitcoins may subsequently be traded for money, and then possibly exchanged against the purchase of low value goods for example, or even refunded, but they still do not represent a money claim on an identifiable issuer.

There are also legal uncertainties in the UK as to the applicability of the protection afforded by the laws on Internet payment, such as those regulating and supervising payment service providers, to the exchange of Bitcoins. The protection of consumer rights in relation to refund processing when goods are purchased by a consumer with Bitcoins is also potentially reduced. The value of Bitcoins is rather volatile and in transactions using Bitcoins, the relevant merchant's refund policies should be reviewed carefully. Not all merchants may convert the Bitcoins immediately into Sterling value or accept a refund in the Sterling value at the time of the purchase.

The different tax treatments of crypto currencies around the world raises even more confusion. In the UK, the creation and trading of Bitcoins and other virtual currencies is currently exempt from VAT on the basis that it is a payment service or a digital asset with monetary value, rather than a currency. When it comes to determining liability for income tax, capital gains tax or corporation tax, consideration will include, among other things, an assessment of both the activity and the parties involved in the transaction.

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The future

The future of digital currencies will depend on how central banks and governments regulate them to protect consumers (and governments themselves) from the plagues of cybercrime, tax evasion, loss of value due to drop in demand or manipulation of the currency possibly due to collusion of holders of large amounts of Bitcoins. The FCA recently launched a project called 'Project Innovate' with the aim of ensuring 'positive developments' in the tech and financial sector such as cryptocurrencies are supported in the UK. The European Banking Regulator is also due to appoint an EU task force to advise as to whether or not 'virtual currencies' should be regulated in the EU. Although it may be premature to make a definitive statement on cryptocurrencies' lifespan, they are showing a clear potential to establish themselves as a rival payment system to traditional forms such as bank wires and credit cards, and many entrepreneurs and their investors remain positive of the Bitcoin ecosystem and its potential. ■

CRYPTOCURRENCIES

Good prospects for securing the Wild West

New technology inevitably reshapes society. Nicolas T. Courtois, a former crypto engineer in the smart card industry and now a Senior Lecturer at University College London in the areas of information security, applied cryptography and computer security and payment technology looks at questions of payment security in the new financial landscape

Security in the traditional sense is all about the physical dimension with bank vaults, safes and armed guards. But increasingly it is about new technology, such as cryptography or smart cards. Technical innovation not only brings better security and cost reduction, but is also crucial for adapting to the changing threat landscape. As new threats emerge, security is a race against time. Money goes where it can be safely stored, value is created on secure and trustworthy platforms, which connect people and enable business activity.

Enter the geek money – Bitcoin, in existence since 2009, and proof that whatever people accept as money, is money. Bitcoin allows people to send monetary units directly to each other without holding deposits at a bank through the magic of cryptography. It makes middlemen such as banks less relevant, and the monopoly of traditional banks on money and payment is now being eroded. However is Bitcoin good enough, or secure enough?

Security and trust

Money, as we understand it, is about security and trust. Governments with their armies stand behind their money. The cost of running the monetary systems that underpin our economy is incredibly high, and governments spend huge amounts on policing fraud and crime. As a result, the counterfeit rates involving coins and paper money are actually very low – roughly 1,000 times smaller than the rates of fraud that occur with all modern payment methods, for example bank card fraud such as skimming and credit card fraud.

While Bitcoin cannot ever hope to be as secure as paper money, its adoption would result in a dramatic