Governments want to regulate bitcoin – is that even possible?

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All that glitters is not gold. Credit: Antana, CC BY-SA

The UK government has shown its intention to regulate bitcoin and other digital currencies, drawing them into the realms of financial regulation applied to banks and other financial services. But bitcoin is not a bank or a financial company based in the City. How would regulation apply to something that exists in the cloud?

George Osborne's announcement in his pre-election budget contained three measures. First, to apply anti-money laundering regulation to digital currency exchanges, for which formal consultation will begin soon after the election. Second, for the British Standards Institution and the digital currency industry to work together to develop voluntary standards for consumer protection. And third, £10m funding for the Research Councils, Alan Turing Institute and Digital Catapult to partner with industry to research the opportunities and challenges posed by digital currencies.

Balancing innovation and regulation

The government faces the familiar problem of needing to provide a suitable environment for innovation to flourish, while also ensuring that firms working in the same industry performing similar functions are regulated in the same way. All of this needs to be done in such a way as to protect the consumer and, in this case, perhaps the wider financial system itself. Heavy-handed regulation risks stifling innovation and driving away potential digital currency-based businesses. After all, as a truly global currency that exists in the cloud, the physical location of a digital currency-based business is irrelevant.

Too little regulation may leave digital currencies vulnerable to criminality – and the effect of this criminality on consumers and the economy. The digital currency industry already faces problems that include theft from digital currency exchanges, malware and attacks on third-party websites, as well as the potential to aid money laundering. For example, within a week of Osborne's announcement, another bitcoin exchange, Paybase, ceased allowing withdrawals and its administrator disappeared.

The realms of the possible

The regulation of digital currency is important in order to mitigate these sorts of risks and prevent abuse that destroys trust in the system. It is essential if digital currencies are to develop a major role in the UK economy. However their nature presents serious regulatory challenges: there is no central issuer, no control over supply and demand and no central organisation to impose regulatory requirements upon.

This might suggest the very idea of bringing them within the regulator's embrace is futile. However, the aspect in which digital currencies are accepted as payment for goods and services seems a point at which to apply anti-financial crime measures – for example, customer due diligence measures when high-value goods are purchased using digital currency. In this sense they come under the same regulatory umbrella as cash, as defined in the Money Laundering Regulations 2007.

Striking where the virtual becomes real

A further approach favoured by the government is to focus on the digital exchange services – the sites where digital currencies are exchanged for real-world dollars, pounds or euros. Two key anti-money laundering initiatives are customer due diligence and suspicious activity reporting.

Customer due diligence – where banks or financial services must require proof of their customer's identity – is one of the most significant aspects of anti-money laundering regulation. Without this there is no paper trail leading back to the criminal, but this cannot be applied in all instances as it would be too much of a burden. So it will have to be applied where there is most risk, an approach that reflects the different aspects that warrant regulation, but which treats all companies within the sector equally by creating a level playing field.

Suspicious activity reports would be more difficult to implement, not least because at present there is limited legitimate use of digital currencies. A main use for digital cryptocurrencies has been for purchasing illegal goods and services from markets in the dark net, such as Silk Road. This makes it difficult for an exchange to identify a "suspicious transaction".

Consumer protection measures could be brought in by the introduction of a US-style licensing system for digital currency exchanges. A side effect of this approach is that it may simply drive businesses overseas to evade regulation. Ultimately, digital currencies are not restricted by national borders and, in that sense, it is not important from where they operate.

Another challenge is how to apply sanctions in the event regulations are breached. Sanctions are important to deter crime, but without the information gained from applying measures such as customer due diligence there may not be sufficient information to trace someone to punish. One of the key characteristics of bitcoin is the pseudonymity it affords users. But if your bitcoin wallet address is ever linked to your identity then every transaction will be linked to you – although there are methods such as bitcoin mixing services that can completely disguise the trail.

Given the difficulties of effectively regulating digital currencies, any research into the field is to be welcomed, as it's clear there are considerable challenges to overcome before digital currencies can become an integral part of the mainstream economy.

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