Designed to avoid regulation – the real roots of bitcoin

As regulators increased actions against the e-gold currency because it helped criminal activities run more smoothly, a new cryptocurrency named bitcoin came alive. ***Martin C. W. Walker*** *writes that the timeline of the e-gold prosecution and birth of bitcoin seems more than coincidental. He says that decentralisation, the model for avoiding accountability, has been used over and over again to avoid regulation.*

If you read recent comments from both regulators and leaders of the cryptocurrency industry you might get the impression they are heading towards a meeting of minds, perhaps followed by the final legitimisation of cryptocurrencies as a mainstream financial asset.

In August, Gary Gensler, chair of the US Securities and Exchange Commission (SEC) told the Financial Times:

"At about $2tn of value worldwide, it's at the level and the nature that if it's going to have any relevance five and 10 years from now, it's going to be within a public policy framework. History just tells you; it doesn't last long outside. Finance is about trust, ultimately."

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CEOs of cryptocurrency businesses such as Brad Garlinghouse of Ripple Labs have been calling for regulatory clarity for some time, as they saw regulatory uncertainty damaging their businesses.

"…I have called for the increased need for clarity and certainty about how the regulatory framework is going to work here. I give credit to markets like Singapore and even the parts of Korea where there really has been a thoughtful government lead effort to define and have clear regulatory frameworks around cryptocurrencies."

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Some people may see irony in the CEO of a cryptocurrency firm currently being sued by the SEC for breaches of securities laws asking for regulatory clarity. Garlinghouse and others may have a point, though. The cryptocurrency industry, including related areas such as stablecoins, DeFi (decentralised finance), and initial coin offerings (ICOS), did not appear overnight. This is an industry that has been growing and developing since 2009. So, the key question is why it has taken so long for regulators and central banks across the globe to understand the need for clear and effective rules for the industry.

To be fair to the regulatory world, there are usually a great many demands on their time, they have limited resources, and they are often faced with trying to understand multiple opaque and complex problems at the same time. It can take years to understand how to regulate new products or to determine what is the appropriate action to take, even in seemingly clear-cut cases of malpractice. Many delays are caused by the need for either legislatures to pass new primary legislation or for courts to provide the precedents that allow regulators to act. Both processes that can take years. A very pertinent example was e-gold, an early digital currency backed by gold that was launched in 1996. It took five years for regulators to start investigating some of the concerns around e-gold and another eight years before the founders were criminally prosecuted.

There is, however, another major factor in the delay of regulators getting to grips with cryptocurrencies, from the perspective of providing regulatory clarity and prosecuting wrongdoers. A factor that becomes most obvious if you look at the historical context around the creation of bitcoin (the first cryptocurrency) and its technical design. What rapidly becomes apparent is that bitcoin was specifically designed to avoid effective regulation, a theme that has been continued across multiple other cryptocurrency-related businesses.

When the historical background is normally recounted, it describes bitcoin's creation in 2009 as a reaction to the great financial crisis (GFC). Contained in the first block of the bitcoin blockchain were the words "The Times 03/Jan/2009 – Chancellor on brink of second bailout for banks". The pseudonymous inventor of the first cryptocurrency clearly implied his invention was the solution to problems of the banking industry. However, the financial crisis was caused by excess credit, complex derivatives beyond the understanding of many bankers and in many cases outright fraud. His invention was a peer-to-peer payments system that had nothing to do with problems of the GFC. It was rather someone pointing to an ongoing plague but instead of inventing a vaccine created a new form of plaster.

The disconnect between the real problems of the financial system in the mid-to late 2000s and the claimed objectives of Satoshi Nakamoto become even more apparent on reading the white paper that launched bitcoin. It attacks the general principle of having financial intermediaries because it claims that having intermediaries increased transaction costs to the point where small casual transactions are impossible (something clearly disproved by the spread of mobile and contactless payments in many countries). It also claimed that having non-reversible payments increased the risk of fraud when in fact the ability of financial institutions to block or even reverse transactions has been an important tool in fighting fraud.

The more meaningful context for the creation of bitcoin was the tightening noose around the owners of the e-gold system. Over its existence, e-gold, a form of electronic money backed by gold bullion, had grown to become a favourite method of payments for international criminals. E-gold had prospered amongst criminals because it offered a relatively stable value, there was a worldwide network of agents who could convert it into local currencies (or vice versa) and anyone could sign up for an account simply by providing an email address. The use of gold also had advantages in terms of regulatory arbitrage. Most laws relating to international payments were specific to money, not precious metals, something that greatly delayed regulatory action.

The lengthy and public action against e-gold gave plenty of time to those who wanted to create an alternative. The timeline of the e-gold prosecution and birth of bitcoin seems more than coincidental.

In April 2007 the owners of e-gold were indicted. In July 2007 they pleaded guilty to charges of money laundering, conspiracy, and operating an unlicensed money transmitting business. Just three weeks later the domain name bitcoin.org was registered. On 31 October the white paper was issued and on 3 January 2009 the bitcoin network started processing. Things become even more suspicious if the design of the new payment network is looked at in more detail.

What had fundamentally allowed enforcement action against e-gold was that there were identifiable parties managing the opening of accounts, running the network, keeping account balances, processing transactions, and converting money to and from e-gold. E-gold had come to be interpreted as a form of currency falling within payment regulations. Bitcoin was designed to make its founder(s) seemingly invulnerable to regulation or law enforcement. Anyone could open the equivalent of an account with no background checks and there was no way to hold the founders of the network (who remained unknown) accountable for who used it. The bitcoin network used a completely unrecognised form of money (also called bitcoin), and the processing of transactions could be done by anyone, anywhere in the world (and anonymously if they chose). There is simply no one to hold accountable because of the combination of anonymity with the dispersal of responsibility. There were, however, mechanisms for the founders to make a considerable fortune by creating over a million bitcoins before the system started getting any adoption.

There was only one problem: there was simply no reason to believe the new "bitcoins" had any value. At the time of the birth of bitcoin, another alternative to e-gold was emerging, called the Liberty Reserve dollar. Like e-gold, Liberty Reserve had a stable value because it was backed by dollars in various offshore bank accounts, and it was even easier for criminals to set up untraceable accounts. The criminal world far preferred Liberty Reserve to bitcoin and it was only when the management of Liberty Reserve were arrested and the network shut down that bitcoin finally got its place in the sun as the preferred currency of those who preferred not to have to obey any rules.

The design features of bitcoin have ultimately served it well and the cryptocurrency industry has grown huge. The founder's million bitcoins are now worth $45,000,000,000. However, with each major development in the industry, the model for avoiding accountability more commonly known as "de-centralisation" has been used over and over again to avoid regulation. Sadly, for Satoshi or his heirs, the lack of central control means there is no one to go to if the cryptographic "keys" required to access bitcoin balances are lost. Satoshi's coins have not moved for nine years, suggesting one of the greatest fortunes in the world is lost forever.

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Notes:

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