Cryptocurrency Exchanges Emerge as Regulators Try to Keep Up

Trust issues plague bitcoin and other digital currencies. Licensed exchanges could change that.

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Digital cryptocurrencies—including bitcoin and litecoin, along with dozens of others—have struggled to win mainstream acceptance in the U.S. Interest in this so-called “Internet money” is not going away, however, which is why regulators are developing rules that they hope can avert a repeat of last year’s Mt. Gox meltdown, when the world’s largest bitcoin exchange unexpectedly shut down after losing hundreds of thousands of bitcoins in a cyber attack.

The U.S. government has largely sat on the sidelines, leaving states to regulate digital cryptocurrency exchanges. The exchanges, with names such as BitPay and Coinbase, are Web sites for buying, selling and exchanging digital currency. Bitcoin and its ilk are referred to as cryptocurrencies for their use of cryptography to secure transactions and mint new virtual coins.

More than a dozen states and Puerto Rico already issue licenses for bitcoin exchanges, which represent the lion’s share of the world’s cryptocurrency transactions. California is working out the details of its own licensing guidelines while New York State’s Department of Financial Services plans to finalize its BitLicense regulatory framework in the coming weeks. Other countries are likewise grappling with the legal status of such currencies. The U.K., for example, recently announced it would police digital currencies by applying anti-money laundering rules to these exchanges.

Regulations are good for cryptocurrency exchanges, says Campbell Harvey, a Duke University professor of finance. The rules will lend them a sense of legitimacy that should help reduce the volatility that has kept merchants and investors out of the action. The volatility comes from people seeing virtual currency as operating just outside the law, Harvey adds.

Coinbase is licensed in 16 states and claims that eight other states—including California and New York—allow access to the exchange without the need for a license. Part of Coinbase’s success comes from allowing investors to change U.S. dollars into bitcoins and vice versa, an important feature because of bitcoins’ fluctuating value. A single bitcoin is currently worth about $250; a couple of years ago they were trading at more than $1,100 apiece.

Cameron and Tyler Winklevoss, venture capitalist siblings best known for their legal battle with Mark Zuckerberg over the origin of
Facebook, are awaiting New York’s licensing regulations to their Gemini Bitcoin exchange in the state. Gemini will be a place to buy and sell bitcoins, akin to the way NASDAQ lets investors trade stocks, the Winklevosses said at last month’s South by Southwest Interactive conference in Austin, Texas. Bitcoin is a harbinger of the “cashless society” that will be here by 2025, they said, adding that they believe in the cryptocurrency so much that they currently own 1 percent of the world’s more than 14 million bitcoins.

Bitcoin operates on a peer-to-peer network that consists of computers run by people known as “miners.” Their computers are set up specifically to verify the validity of a transaction and record it in a digital public ledger system called a “blockchain.” The first computer to solve a cryptographic puzzle accompanying each transaction wins bitcoins for its miner. Other computers in the network check the solution, creating a redundancy designed to guard against transaction fraud. Once a transaction is entered into the blockchain ledger, it cannot be deleted or changed. The idea behind the blockchain is to prevent fraudulent transactions. And the peer-to-peer nature of the Bitcoin network means there is no bank or clearinghouse to charge a large fee per transaction.

Although Apple Pay, Paypal and other digital payment services are improvements over credit cards and other online options, they are not a “breakaway” technology on par with the Bitcoin Network, Cameron Winklevoss said at SXSW.

Regardless of such endorsements, Bitcoin exchanges continue to be a risky proposition. Start-up exchange Buttercoin will shut down on April 10 after failing to raise sufficient funding. Even high-profile financial backing from the likes of investors Y Combinator, Google Ventures and Reddit co-founder Alexis Ohanian was not enough to keep the lights on. Part of the problem is the nascent technology’s history as a volatile investment as well as an enabler of anonymous cyber criminal activity, including the infamous Silk Road online market for illegal drugs.

The U.S. has a lot of ground to make up if banks and businesses here want to cash in on cryptocurrency—80 percent of all Bitcoin volume is exchanged into and out of Chinese yuan, according to a March 10 Goldman Sachs report. The report estimates that more than 100,000 merchants worldwide—including Overstock.com, TigerDirect.com and Expedia—accept bitcoins as payment.

A sign that these companies do not completely trust their finances to cryptocurrencies, however: many convert these payments into more stable currencies rather than hold them as bitcoins.

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