Regulation and the Future of Money: Mobile Payments and Virtual Currencies

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Key Questions:

- What drives mobile payments innovation and consumer acceptance of these products?
- What problems can virtual currencies solve in the payments space?
- What role can and should federal regulators play (and who’s going to tell them)?

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Mobile Payments Products Abound

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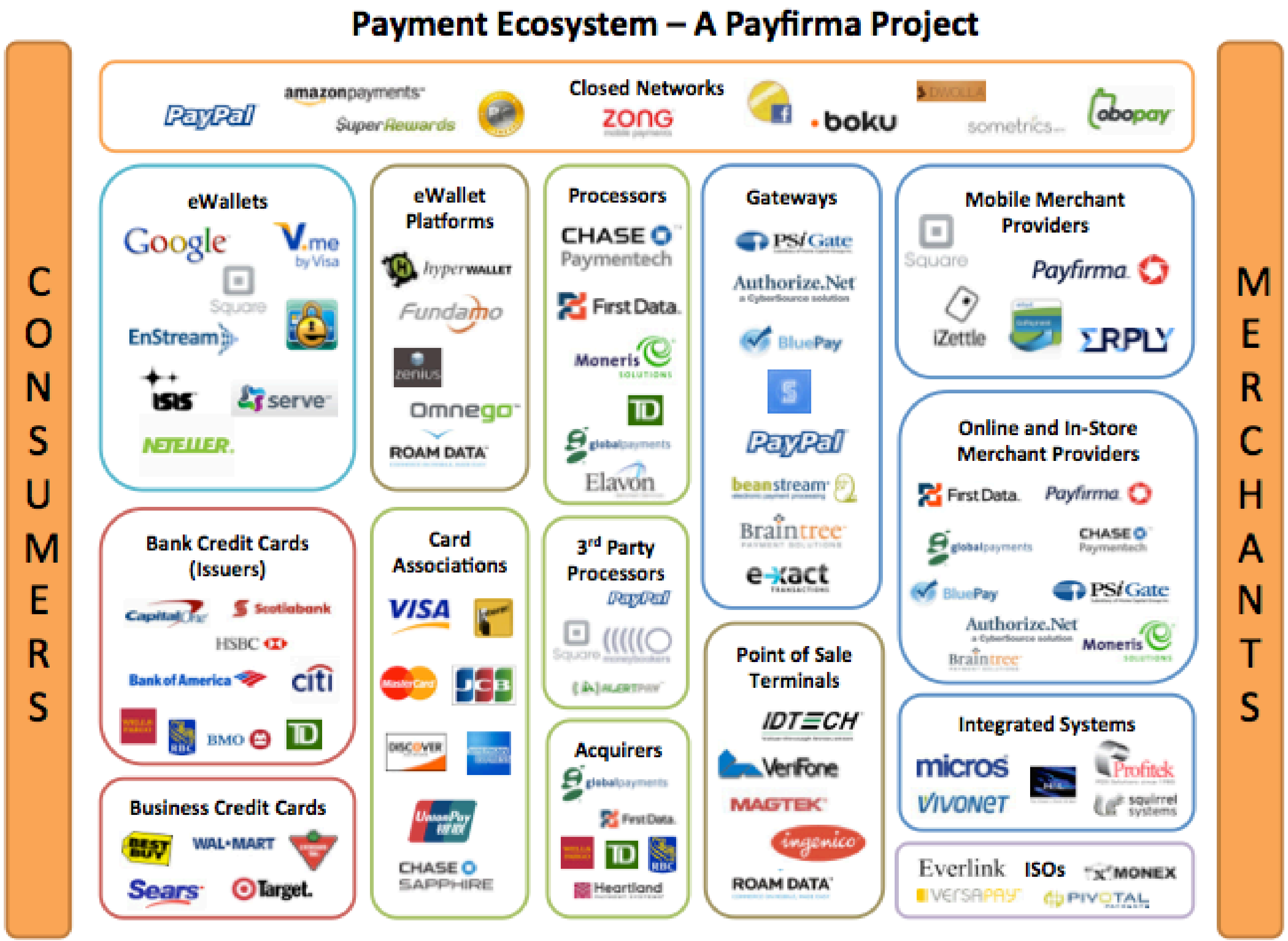

Kalle Radage, Payments Ecosystem: Online, In-Store, and Mobile Payments Market (Nov. 24, 2011), http://www.payfirma.com/blog/payments-ecosystem-online-in-store-mobile-payments-market/.

What’s Holding Back Mobile Wallets?

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~30 million American consumers now hold mobile wallets, but mobile wallets only make up 1.2% of total credit card purchases, why?

Because mobile devices don’t yet *fit* at the point of sale or improve upon existing and widely-accepted payment instruments.

What Could Address This Problem?

- Emergence of improved security measures and solutions to increase consumer confidence and acceptance, e.g.:
  - – Apple fingerprint biometric;
  - – Clef identity verification via key issuance;
- Optimization of POS experience, such as:
  - – PayPal mobile wallet to allow POS sales while phone remains in your pocket
  - – Total System Services (TSYS) authorization controls allow on/off functionality for stored cards
  - – Major disruption of traditional POS experience to displace preference for payment cards/traditional instruments

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Virtual Currencies

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- Virtual currency: "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency," and lacks status as legal tender in some jurisdiction (FIN-2013-G001)
- Financial Crimes Enforcement Network ("FinCEN") guidance states "exchangers" and "administrators" of virtual currency are money services businesses (excludes mere "users")
  - Applies to centralized and decentralized convertible virtual currencies
  - Does not apply to non-convertible virtual currencies (*e.g.* in-game currencies not exchangeable for value outside of game)

Regulation Afoot for Virtual Exchange: New York BitLicense

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- As of March 11, 2014, New York Superintendent of Financial Services Benjamin Lawsky issued a public order allowing the NY Department of Financial Services to consider formal proposals for establishing regulated virtual currency exchanges under BitLicenses
- Goal to propose regulatory framework by end of second quarter 2014
- At least one exchange, Coinsetter, has signaled its intent to apply for a BitLicense

Bitcoin Isn't "Currency"…

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- Bitcoin aims to address a problem associated with instability in fiat currencies, but in the U.S. it's not treated as currency at all
- The IRS has concluded bitcoin and other virtual currencies are "property" for federal tax purposes.[1] Tax implications include:
  - Wages and payments in virtual currency are taxable to employees/independent contractors and must be reported in W-2 or Form 1099;
  - Virtual currency received as payment must be valued in U.S. dollars according to fair market value on date of receipt (users who mine virtual currency must also report FMV as of date of receipt for income reporting);
  - For sales and exchanges of virtual currency, the character of the taxpayer's gain or loss depends on whether the currency is a capital asset or inventory or other type of asset held primarily for commercial sale;
  - payments made in virtual currency are subject to information reporting requirements for payments made in property

1. Internal Revenue Service, Notice 2014-21 (Mar. 25, 2014).

…But Isn't Quite "Property" Either

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- The IRS has concluded bitcoin and other virtual currencies are "property" for federal tax purposes.[1] Tax implications include:
  - Wages and payments in virtual currency are taxable to employees/independent contractors and must be reported in W-2 or Form 1099;
  - Virtual currency mined into existence is treated as income and must be reported;
  - Virtual currency received as payment must be valued in U.S. dollars according to fair market value on date of receipt (users who mine virtual currency must also report FMV as of date of receipt for income reporting);
  - For sales and exchanges of virtual currency, the character of the taxpayer's gain or loss depends on whether the currency is a capital asset or inventory or other type of asset held primarily for commercial sale;
- What is the IRS missing? If bitcoin is property you can grow, why does it tax mined bitcoin like income?
- Will virtual currency be treated like true property, or some hybrid? Time will tell…

(Even this Santoshi Nakamoto is confused)

Post-Bubble Virtual Currency: What Problems Can it Solve?

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- If Bitcoin's goal is to provide asset stability where fiat currencies are instable and/or subject to appropriation by a sovereign, what else could virtual currencies do?
- Ripple aims to address money movement, especially cross-border transactions such as remittances, at substantially greater speeds and lower costs than existing methods
- CrossCoin Ventures launches Ripple Labs Accelerator, with access to CrossCoin partners as well as Ripple Labs resources, to launch businesses using Ripple protocol as payment system

CrossCoin Ventures

ripple

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What Does The Federal Reserve Regulate?

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"The Federal Reserve simply does not have authority to supervise or regulate bitcoin in any way. . . . This is a payment innovation that is taking place entirely outside the ***banking industry****[.]" –Janet Yellen*[1]

1. *Federal Reserve Semiannual Monetary Policy Report: Hearing Before the Senate Banking, Housing & Urban Affairs Committee*, 113th Cong. (2014) (statement of U.S Federal Reserve Board Chair Janet Yellen) (emphasis added).

Federal Reserve Regulates Banking Industry …And Payments?

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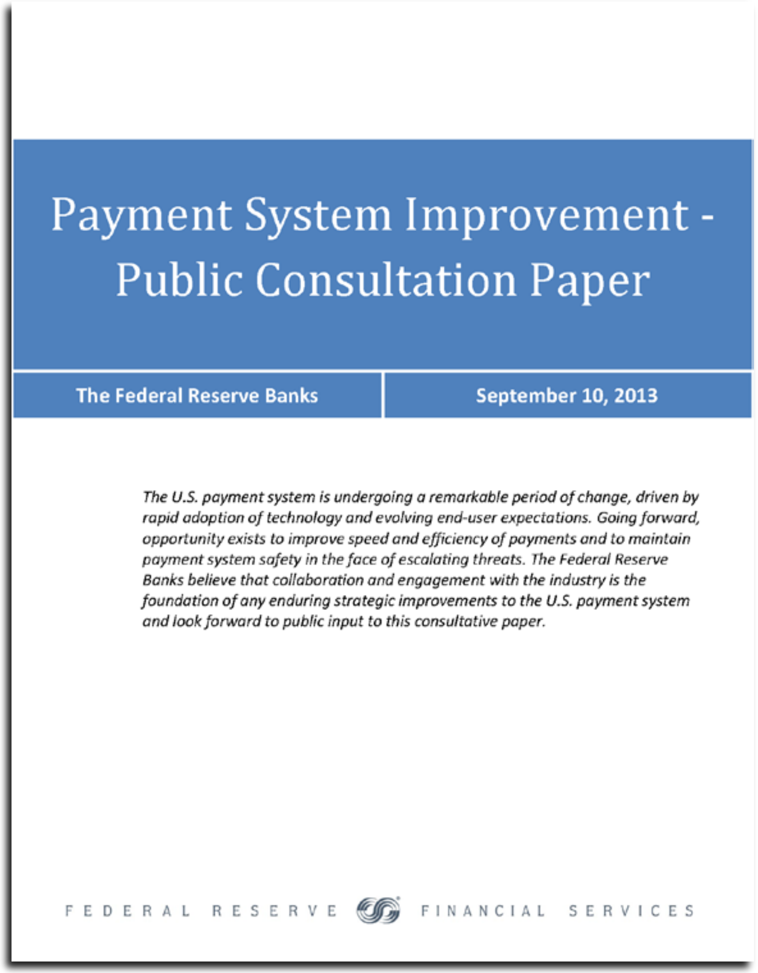
"The challenge for the industry is to provide a payment system for the future that combines the valued attributes of legacy payment methods – convenience, safety, and universal reach at low cost to the end user – with new technology that enables faster processing, enhanced convenience, and the extraction and use of valuable information that accompanies payments."[1]



Payment System Improvement - Public Consultation Paper

The Federal Reserve Banks | September 10, 2013

The U.S. payment system is undergoing a remarkable period of change, driven by rapid adoption of technology and evolving end-user expectations. Going forward, opportunity exists to improve speed and efficiency of payments and to maintain payment system safety in the face of escalating threats. The Federal Reserve Banks believe that collaboration and engagement with the industry is the foundation of any enduring strategic improvements to the U.S. payment system and look forward to public input to this consultative paper.

FEDERAL RESERVE FINANCIAL SERVICES

1. Federal Reserve Bank, Payment System Improvement: Public Consultation Paper (Sept. 10, 2013), *available at* http://fedpaymentsimprovement.org/wp-content/uploads/2013/09/Payment_System_Improvement-Public_Consultation_Paper.pdf, at 4.

Business Arm of the Fed Identifies Gaps in Payment Environment

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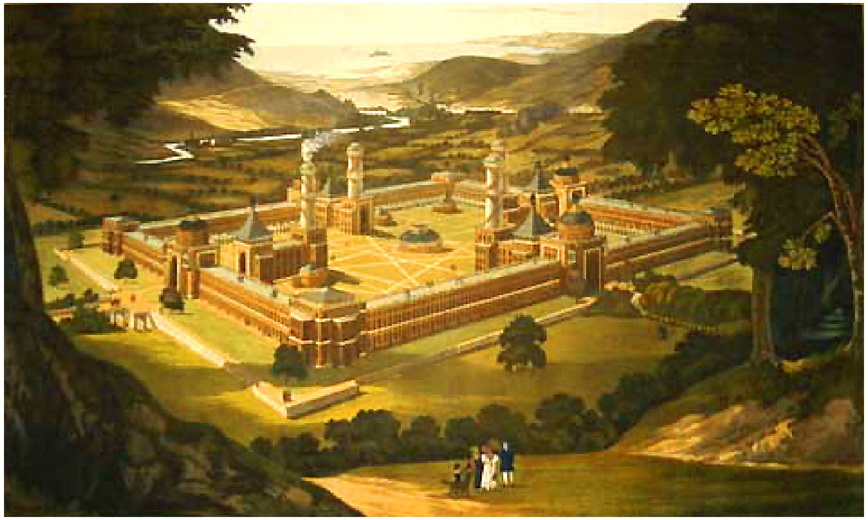
- Fed Identified Gaps and Opportunities in Current Payment Environment:
  – Persistence of checking writing and lack of viable electronic substitutes;
  – Desire for faster, near-real-time retail payment systems;
  – Market penetration issues and limitations on member-based services;
  – Security, authentication, and consumer protection concerns persist in both legacy payment systems and mobile commerce products;
  – Cross-border payments lack speed and transparency;
  – Mobile device potential for merchants and consumers;
  – Conversion issues for large businesses whose existing payments structures are tied to legacy models

Fed's Dream of a Utopian Payments Future

Fed's Desired Outcomes:

- Collective identification and acceptance of improvements by payment participants;
- Ubiquitous and non-member-based electronic retail payment system (where sender not required to know recipient bank account information);
- Increased "electronification" of payments and reduced costs for electronic payments;
- Improved choices for cross-border payments; and
- Collaboration between Fed and industry to improve security and increase consumer confidence



Is this a dream, or the future of the Fed's scope of authority? If so, someone has to tell Janet Yellen that it isn't just the "banking industry" anymore…