TESTIMONY OF

JEREMY LIEW

Before the New York State Department of Financial Services

Hearing on

Virtual Currencies

January 28, 2014
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Introduction

Mr. Superintendent and members of the Department of Financial Services, thank you for inviting me to appear before the Department today to offer my perspective on virtual currencies and to address the topic of appropriate regulation in this area.

I have worked in the consumer Internet industry for nearly twenty years. Presently, I am a Partner at Lightspeed Venture Partners. Lightspeed has invested over $2 billion, primarily in technology-based consumer-facing companies, including virtual currency-related companies. I have written and spoken frequently on the topic of virtual currencies.

Today, I will address some of the advantages and opportunities that I believe virtual currencies present. I also will address some of the concerns that critics have raised about virtual currencies and ways in which I think appropriately tailored regulation could advance positive developments in this area.

Discussion

Benefits of Virtual Currencies

I would like to begin by addressing some of the benefits of virtual currencies from a retail perspective. Specifically, virtual currencies can serve to (1) lower transaction costs; (2) allow for microtransactions; (3) facilitate "smart contracts"; and (4) solve the "double spending" problem. I will discuss each of these benefits in turn.

First, virtual currencies such as Bitcoin allow the transfer of value without the use of a third-party intermediary, thereby decreasing transaction costs. Lower transaction costs benefit consumers and businesses and may place competitive pressure on traditional third-party intermediaries, such as credit cards companies, traditional money transmitters, and PayPal, to lower their transaction costs.

Second, virtual currencies allow for online microtransactions, payments typically less than a dollar, and potentially into single-digit cents or even below. The current credit card infrastructure effectively prohibits microtransactions because each transaction incurs a minimum fee of thirty cents. This makes it diseconomic for a publisher to charge a consumer one cent to read a newspaper article or a game publisher to charge a consumer one cent to buy a virtual good in a game. Instead, online business models are pushed towards either a subscription model or a much larger purchase of credits, which distorts the true demand for these online products through an artificially high minimum price.

Third, virtual currencies allow for the possibility of "smart contracts," computer protocols built on top of the virtual currency protocol that can be used to facilitate, verify, execute, and enforce the performance of a contract. Smart contracts can be used to embed contractual terms into digital property. For example, smart contracts can build automatic payment into transactions.[1]

Fourth, virtual currencies that have a public ledger and verification system, such as Bitcoin, address the problem of possible "double spending"—that is, the practice of using forgery or counterfeiting to spend money that the user does not own. The public ledger system ensures that an owner of a single bitcoin (or fraction of a bitcoin) cannot transmit that bitcoin more than once, which obviates the need for a third party (such as a credit card company or bank) to verify the electronic transactions.[2]

Beyond these benefits, additional advantages of using virtual currencies may be realized as the technology evolves and matures beyond the infrastructure setup phase. A rapidly expanding number of businesses and digital wallet companies now accept virtual currencies. The growing retail and investor interest in virtual currencies as an asset class will increase the mainstream use of virtual currencies, furthering their transactional benefits.

<u>Concerns About Virtual Currencies</u>

I am aware that a number of concerns have been raised with regard to virtual currencies. While I understand these concerns, I believe that much of the anxiety about virtual currencies is misplaced. Although much media attention has focused on outlaw companies such as Liberty Reserve and Silk Road, these underground companies are far outnumbered by legitimate companies and investors operating in the virtual currency ecosystem. Many of the concerns about virtual currencies, including volatility and security, could be addressed through appropriate regulation.

Some have expressed concerns about price volatility and potential exposure to currency risk. While we have seen significant volatility in the price of bitcoin, this volatility would not impact a merchant's ability to use bitcoin for payments, as long as there is a liquid market that would allow the merchant to exchange bitcoin into fiat immediately upon receipt. Moreover, increased investor and regulatory interest in virtual currencies should bolster their legitimacy, provided that virtual currencies are regulated in an appropriately tailored fashion. Increased legitimacy will, in

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[1] *See, e.g.*, Nick Szabo, *Smart Contracts: Building Blocks for Digital Markets* (1996), http://szabo.best.vwh.net/smart_contracts_2.html.

[2] *See, e.g.*, Craig K. Elwell, M. Maureen Murphy & Michael V. Seitzinger, Cong. Research Serv., R43339, *Bitcoin: Questions, Answers, and Analysis of Legal Issues* 2 (2013).

turn, lead more people and businesses to use virtual currencies, dampening price volatility and creating a more liquid market. In addition, innovations such as a U.S.-based wallet for virtual currencies that is licensed and regulated would act as an intermediary in virtual currency transactions, thus shifting the currency risk to the wallet.

I also am aware of concerns about possible security breaches on virtual currency networks, and the need to safeguard against theft and fraud. Security—specifically the security of companies that Lightspeed Venture Partners invests in—is a key diligence area for us. In the financial services realm, customers need and want to trust their counterparties, and any security breach would damage that trust.

Relatedly, some have voiced concerns about potential efforts to undermine or destroy virtual currency systems. For example, a majority of bitcoin owners could force a change in the cap on bitcoin supply. However, a large and expensive investment scheme would be required to manipulate the market. Such attempts likely would backfire and scare away investors. Moreover, the transparency of virtual currencies that have a public ledger, such as Bitcoin, mitigates against the risk of abuse, since any misuse could be detected.

Finally, some have expressed concern that the irrevocable nature of virtual currency transactions can facilitate fraud (e.g., if a consumer does not receive the good for which he or she paid). Others have pointed to the benefits of irrevocability, such as preventing chargeback fraud (e.g., if a consumer falsely claims that he or she did not receive purchased goods or services).[3] As I see it, irrevocability is neither a benefit nor a drawback, but simply a difference between traditional currency and virtual currency transactions.

Principles for Appropriate Regulation of Virtual Currencies

Turning to the subject of appropriate regulation for virtual currencies, I want to emphasize at the outset that I appreciate that there are various perspectives on how best to regulate virtual currencies. I know firsthand the challenges that Internet and financial services companies face in maintaining compliance with evolving regulatory regimes. At the same, I recognize that regulation has the potential to serve business and consumer interests and facilitate positive developments in the virtual currency ecosystem. I think that the overarching principles guiding regulatory efforts in this area should include enforcing the rule of law and collaborating with industry to develop regulatory guidelines that are clear and not overly burdensome. I am heartened by the Department's decision to meet with the many players in the virtual currency world, as I think it will help the Department to design carefully tailored regulations that will not run the risk of driving virtual currency activity underground.

An appropriately tailored regulatory framework will be crucial in helping to foster legitimate virtual currency operations, while at the same time helping to police against rogue operators and operators with weak controls that enable criminals and terrorist organizations to launder money. The mere presence of illegal operations in the virtual currency marketplace negatively affects the

[3] *See id*. at 5.

perceived legitimacy of all virtual currencies. Deterring illegal activity will help bolster the legitimacy of law-abiding virtual currency companies, which will in turn promote the use of—and investment in—virtual currencies.

Regulatory Questions Raised by the Department

The Department has raised several questions regarding specific aspects of virtual currency regulation. While I am not a lawyer, my present feeling is that regulators should treat virtual currencies in much the way they treat other types of currency in considering regulation. To the extent that the Department is inclined to create new regulatory guidelines, such regulations should be narrowly tailored to avoid tamping down the benefits of virtual currencies.

I understand that the Department currently is considering the feasibility of issuing a "BitLicense" specific to virtual currency transactions, which would include anti-money laundering and consumer protection requirements for licensed entities. I would be open to the possibility of a BitLicense framework, provided that it is tailored appropriately. My sense, however, is that it would be easier to use the existing regulatory frameworks to prohibit bad behavior (such as money laundering), rather than developing new regulatory frameworks specifically geared to virtual currencies. Regarding consumer protection guidelines, my feeling is that existing regulatory frameworks are adequate for addressing fraud, but potentially could be strengthened in the area of safeguarding privacy. I think that virtual currency entities should not be required to follow specific regulatory examination requirements, as existing regulatory frameworks are adequate.

To the extent that new regulations are created, the regulatory guidelines should be clear as to what activities are covered and to whom the regulations apply (e.g., users, administrators, exchangers, or others). In terms of the types of virtual currency transactions and activities that should require regulation, I think that the focus should be on potential money laundering and terrorist financing transactions, as is the case with current regulations governing money services businesses.

Conclusion

Virtual currencies represent an innovative alternative to traditional money systems, with significant potential benefits for consumers and businesses. I am cognizant of the concerns that have been raised regarding virtual currencies and the challenges that regulators face in deciding how best to regulate in this rapidly evolving space. However, I think that an appropriate balance can be struck between enforcing the rule of law and promoting innovation and legitimate commercial uses of virtual currencies.

Thank you again for inviting me to appear today. I would be happy to answer any questions.