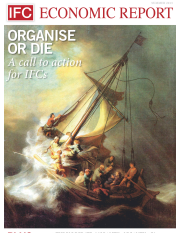




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Due Diligence: Digital Currency

By L Burke Files, CDDP, President, Financial Examinations & Evaluations, Inc (01/04/2014)

Linden Dollars, Liberty Dollars, e-Gold, Bitcoins are all Fiat Currencies issued by entities with some form of limiting mechanism so that they just don't keep issuing bazillions of digital dollars - like some governments do with paper dollars. Zimbabwe was, at one time, issuing so much currency they ran short of paper to print it on.

The discussion of digital currency reminds of an encounter I had many years ago.

I had strolled into a bar to have a glass of wine, as I do from time to time. While sipping - I listened with interest to a bookie and a broker arguing over what was the nature of money. The bookie stuck his meaty paw into a generous pocket and pulled out a roll of bills that could have choked a horse. He said to the bar tender and the broker, "Dis here is money, moola, lolly, cash money and anybody out there would be glad to get a chunk of dis here roll." The broker eyed the meaty fist wrapped tightly around the roll of bills. He took a sip of his Manhattan and looked at the ceiling, and exasperatedly said "What is this wad, - your flash roll - tis nothing but a few thousand dollars. Only today I wired 200 million dollars to a widow, it was nothing but electronic bits sent through the ether." I was outraged at their lack of understanding, such ignorance and overt crude behavior, I had to do something. I walked right up to them and castigated them for such base actions. "My God men, a woman has lost her husband how can you speak of such base items." I took the only proper action one could take in these circumstances. I asked the broker for her name and address so I would able to offer her some comfort after such a horrible loss.

Money is a store of our labours, mental or physical, that can be saved and used at a later date. The value of that money is in the eye of the recipient. Martin Mayer, a financial writer of significant insight, noted that a given currency only has value if the recipient of the; puka shell, tea wheel, or paper currency, believes it has value. Once that belief has been violated, the currency, for all intents and purposes is worthless.

In the days of brick and mortar banking, back when you got a toaster or a blender if you opened a new account, - paper currency was it, it was deposited and accrued in accounts

and when we wanted it out, it came out as cash. Sometimes we used markers for cash on deposit (checks and drafts) - but it was cash. With the advent of credit cards and electronic access we, as a fiscal population, became more comfortable with bits of data representing cash. Now even the paper money is disappearing it seems in the modern world it is all just bits of data.

Most of the recent digital currency 'innovations' were in fact, not really that innovative. To acquire those currencies you usually had to buy them with government issued currencies. If you wanted Liberty Reserve Dollars you had to buy them before you could use them. Also the Liberty Reserve Dollars system allowed you to 'cash them in' - meaning that many took Liberty Reserve Dollars so you could swap the digital Liberty Reserve Dollars for recognised government issued digital credits representing US dollars, for example. The limit on digital currencies to date has been how much of other currencies people were willing to exchange for them. The exchange rates were usually pegged to one or another currency and that was that.

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Bitcoin really looks to be the first true digital currency, not just an electronic marker for another currency. Its issuance and exchange rate are not linked to another currency. It really is most interesting.

Bitcoin was created by Satoshi Nakamoto, of California on January 3rd 2009. Satoshi Nakamoto was a model train enthusiasts and he wanted a simpler way and less expensive way to pay for the hobby items he was purchasing from around the world. For large transactions, the cost of a wire is demimus, but for transactions involving a few hundred dollars or less, wire fees and credit card fee add a substantial cost. So as any mathematician does when they encounter a problem, they work on a solution. For Satoshi Nakamoto - his solution, Bitcoin, was to find a simple, easy and inexpensive way to buy his model trains. Bitcoins can be purchased at an exchange or they can be mined. There is no fixed rate of exchange, and as we have seen, the value can fluctuate wildly. In 2013 Bitcoins went from but a few dollars each to over US\$1,200 each and as of the time of scribbling this article are around US\$600 each. The mining, or issuance of more Bitcoins requires the solving of ever more complex algorithms. As the difficulty to solve the algorithms gets harder and harder over time it becomes harder and harder to issue Bitcoins. Thus, effectively limits the growth of the currency to the community's ability to solve math puzzles. To use Bitcoins is very simple, Bitcoins can be transferred between online wallets or through an exchange. The transfer is accomplished by a digital signature and connected to a public encryption key of the next owner. Bitcoin records all of the necessary data to make the transaction valid in the block chain.

So what is the appeal of Bitcoins? It is about as anonymous as cash and the transfer of cash can be. The transactions occur without heavy fees and are instant. Was the purpose of this design to be the currency for all sorts of shady business? Well it certainly could look that way. But, to me, it looks like the work of a mathematician who devolved the twin processes of the creation and use of currency to its basic elements. No friction from non-core functions. Just valued currency created that was storable and transferable with verification. That is it.

What has the appeal of Bitcoin been? Simplicity and ease of use. Transactions are simple, near instant and as frictionless as possible. So who wanted something like this? Well, we all do in a way, however, the first early adapters were criminals and speculators. The criminals - well heck they just enjoyed the simplicity and anonymity and the speculators were buying and mining Bitcoins.

The enterprise once known as the Silkroad run by Dread Pirate Roberts (the now indicted Ross William Ulbricht) needed just such a currency to operate. Bitcoin came around at the right time and the dark web had a currency they could use. Bitcoin was at the heart of the success of the Silkroad and its online criminal bazaar imitators. This is where Bitcoin first came to notoriety and the public eye. But, it was not until the US government seized Bitcoins in a criminal matter that a court ruled that, yes in fact Bitcoins were a currency and thus could be frozen and forfeited.

The speculators were more interesting. I cannot say this for sure, as I have not spoken to Satoshi Nakamoto but part of the puzzle of Bitcoins was solving more and more complex algorithms. To me it strikes me a bit like an ongoing X-Prize for advancing the mathematics and computing required to mine Bitcoins. The very fact that one needs ever increasing levels of problem solving and raw computing power to mine Bitcoins is clearly a way to foster development in the field Satoshi Nakamoto was most fond of. A gift of enterprise and diligence that becomes as self-rewarding and I might say a virtuous cycle. The currency is issued as math and computing science advance. Again this is my speculation, so I'll stick with it.

Bitcoins are neither good nor evil, they just are. And now they are a recognised form of currency created and accepted by many.

Future of digital currency is bright, if it is not mis-managed. In 2013, JP Morgan wanted to patent a digital currency payment system, Apple filed a patent for a digital currency wallet, IBM filed a patent to track the value of digital currency than finally JP Morgan filed a patent for a digital currency with many similarities to Bitcoin, but it appears to be more of an update from a filing in 1999. What does this mean, serious money is looking at digital currency. I also have zero faith in the ability of any of those firms to manage a currency. Think managed economy - and well, the rest of my reasoning about their, or any other organization's inability, becomes clear.

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Digital currency is on the upswing of popularity. It is easy to use, simple to transfer and does not come with a pesky compliance department. As it continues to rise, it will be a second blow to the banks and governments. It is another process that will disintermediate the banks as a service provider for a payment gate and deposit function. It will also disintermediate government issuance of fiat currency, as Bitcoin and other digital currencies will also challenge governments issuance of currency, as well as a governments controls on its currency, such as exchange limits or rates.

So it may be Bitcoin or it may be Digital Thalers - but digital currency is not going to go away.

Under the principle of comity if government can issue, use, and misuse currency, why can't you?

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