"The Effete Rebellion of Bitcoin"

Neil McCauley: We want to hurt no one! We're here for the bank's money, not your money. Your money is insured by the federal government, you're not gonna lose a dime. Think of your families, don't risk your life. Don't try and be a hero!

"Heat" (1995)

"Butch Cassidy and the Sundance Kid" (1969)

Butch Cassidy: What happened to the old bank? It was beautiful.

Guard: People kept robbing it.

Butch Cassidy: Small price to pay for beauty.

John McClane: Why'd you have to nuke the whole building, Hans?

Hans Gruber: Well, when you steal $600, you can just disappear. When you steal $600 million, they will find you, unless they think you're already dead.

"Die Hard" (1988)

"The Town" (2010)

"Point Break" (1991)

"The Dark Knight" (2008)

Cobb: What is the most resilient parasite? Bacteria? A virus? An intestinal worm? An idea. Resilient … highly contagious. Once an idea has taken hold of the brain it's almost impossible to eradicate.

– *"Inception" (2010)*

Jimmy Dell: I think you'll find that if what you've done for them is as valuable as you say it is, if they are indebted to you morally but not legally, my experience is that they will give you nothing, and they will begin to act cruelly toward you.

Joe Ross: Why?

Jimmy Dell: To suppress their guilt.

– *"The Spanish Prisoner" (1997)*

"Is it true that you shouted at Professor Umbridge?"
"Yes."
"You called her a liar?"
"Yes."
"You told her He Who Must Not Be Named is back?"
"Yes."
"Have a biscuit, Potter."

– *J.K. Rowling, "Harry Potter and the Order of the Phoenix" (2003)*

I hold it that a little rebellion now and then is a good thing, and as necessary in the political world as storms in the physical.

– *Thomas Jefferson (1743 – 1826)*

I really can't think about kissing when I've got a rebellion to incite.

– *Suzanne Collins, "Catching Fire" (2009)*

In the day we sweat it out on the streets of a runaway American dream.
At night we ride through the mansions of glory in suicide machines
Sprung from cages out on Highway 9,
Chrome wheeled, fuel injected, and steppin' out over the line.

– *Bruce Springsteen, "Born To Run" (1975)*

So few want to be rebels anymore. And out of those few, most, like myself, scare easily.

– *Ray Bradbury (1920 – 2012)*

Every act of rebellion expresses a nostalgia for innocence and an appeal to the essence of being.

– *Albert Camus, "The Rebel: An Essay on Man in Revolt" (1951)*

I used rebellion as a way to hide out. We use criticism as fake participation.

– *Chuck Palahniuk, "Choke" (2001)*

One of the first Epsilon Theory notes I wrote, and the one that really put this effort on the map, was about the modern meaning of gold. "How Gold Lost Its Luster" argued that gold today is not a currency or some sort of store of value; instead, it is an effective insurance policy against central bank error. That's an Important Thing, just not as important as it used to be or as its more ardent proponents would have you believe. Today's note is about the meaning of Bitcoin. Not its technical construction or its formal market interactions, but the behavioral WHY that gives Bitcoin its ultimate value. I caught a lot of flak for "How Gold Lost Its Luster", and I expect some multiple of that for this note. So be it. The core tenet of Epsilon Theory is to call things by their proper names, even if that's not the best way to make friends here in the Golden Age of the Central Banker.

Like gold, Bitcoin is neither a currency nor a store of value. Bitcoin is the cautious expression of a rebellious identity. **Using Bitcoin is an effete act of rebellion, a weak signifier of resistance like wearing a hoodie or getting a tattoo that's well covered by your work clothes.** Bitcoin is fashion, more than a fad but less than lasting. Now fashion can be lucrative and fashion can be fun. Fashion is one of those intersections of art and commerce that I personally find fascinating (go ahead, quiz me on "Project Runway"). But fashion is not an Important Thing. Sorry, but it's not.

As for the blockchain technology that underpins Bitcoin and is trumpeted as both an Important Thing and the Next Big Thing in every venture capital conference of the past two years, it's a modern twist on the "technology" of the letter of credit. Color me unimpressed.

Strong words. Let's dig in.

Bitcoin's greatest attribute – its independence from every manner of organized social control – is also its fatal flaw. **Bitcoin is a bearer bond**. We all know what a bearer bond is, because we've all watched heist movies like "Heat" and "Die Hard". Bearer bonds are the MacGuffin of choice for so many screenwriters because they side step all of those annoying plot questions when it comes to the logistics of stealing cash ($600 million in $100 dollar bills weighs more than 6 tons) or fencing stolen goods. By definition, there's no registered owner of a bearer bond. If you possess it, you can trade it for value without your trading partner worrying about whether or not you are the "rightful" owner.

Bearer bonds have a very similar legal foundation to a bank letter of credit, where the bank will release the contracted funds to anyone who presents the documents required by the letter of credit, regardless of whether or not there was fraud or theft associated with the underlying real-world transaction or sales contract. **This so-called "abstraction principle", where the bank is only responsible for validating the documents defined in the letter itself and has no responsibility for validating the**

underlying transaction, is what makes a letter of credit work. The abstraction principle limits the liability of the letter issuer when faced with an unscrupulous beneficiary (the person receiving cash from the issuer) and places that liability squarely on the applicant (the person giving cash to the issuer in exchange for the letter). For those who are interested in such things, the abstraction principle is a fundamental concept in German common law and has lots of interesting twists and implications. I can just imagine some clever merchant guild master of the Hanseatic League coming up with this idea in the 13th century and transforming international commerce for the next 1,000 years.

The abstraction principle is Bitcoin's fatal flaw. If I possess the private key associated with a Bitcoin address, then I can trade that Bitcoin with any counterparty for value without the counterparty worrying about whether or not I am the "rightful" owner of the Bitcoin. **The private key is the only "document" required to satisfy the abstraction principle at the legal heart of Bitcoin, and so long as that document is not forged (which is what blockchain is very good at preventing) then the Bitcoin issuer has absolutely zero liability to any party in a Bitcoin transaction, including the "rightful" owner of the Bitcoin.** ALL of the liability associated with unscrupulous presentation of the documents associated with a beneficiary claim on a Bitcoin credit rests with me, the rightful owner of that Bitcoin. I have absolutely zero recourse if my private key is lost or stolen. I am, to use the technical texting acronym, SOL.

As you might imagine, banks don't go out of their way to inform you of the liability assignments associated with the abstraction principle, and neither do Bitcoin service providers. It's not that they hide any of this, but they also know full well that the legal principles surrounding letters of credit and Bitcoin are entirely foreign to our common experience. They know full well that our behavioral expectations in this regard are almost entirely determined by our experience with credit cards and cash accounts – two bank-issued products underpinned by radically different legal principles.

Credit card issuers have made a simple deal with the US government. Bank issuers can charge outrageous fees and rates of interest on their revolving loans, but they do NOT enjoy the protection of the abstraction principle on the underlying transactions made with these loans. If someone steals my credit card, then my maximum liability is $50. Period. The bank will undoubtedly try to shift a portion of the liability onto the merchant accepting the stolen "document", particularly with a card-not-present transaction, but it is illegal for the bank to push more than $50 of the liability onto me, no matter how careless or stupid I was in losing the keys to my revolving credit account. This is why credit card issuers are so quick to freeze your account when you go on vacation and start charging in person (card present) in a new locale. They couldn't care less about "looking out for you". It's entirely an effort to limit their liability at the expense of your convenience.

It's a little more complicated when it comes to your cash accounts, because any nation's currency is, in effect, a form of bearer bond. Neither the cash in my wallet nor the cash in my checking account is registered to me, and whoever possesses those physical cash bills can trade them for value without the transaction counterparty worrying about whether or not the possessor was the rightful owner of those bills. That's not to say there are no limitations or liabilities associated with cash acceptance by a transaction counterparty – this is the entire purpose of anti-money laundering (AML) regulations and other capital controls – but on a fundamental level the abstraction principle is in effect here, as the currency issuer bears zero liability if my "documents" (the cash bills) are lost or stolen.

Or at least that's the way it was back when Butch Cassidy and the Sundance Kid were out robbing banks. Whether Butch and Sundance stole cash or gold nuggets from the vault made absolutely no difference to the owners of that cash or gold. Whatever you had on deposit with the local bank was almost always uninsured, recoverable only if you put together a posse and got your money back from Butch and Sundance directly. Some banks maintained "blanket bonds" that would insure accounts from fraud and theft, but far more often these provisions were honored only in the breach.

That all changed with the Banking Act of 1933 (establishment of the FDIC and deposit insurance), the Banking Act of 1935 (essentially all banks under FDIC jurisdiction), and the Federal Deposit Insurance Act of 1950 (codification of our current system). Now obviously these laws and the entire notion of deposit insurance came out of the massive spate of bank failures associated with the Great Depression, not because we were overrun with bank robbers, and even today the FDIC does not directly insure deposits against theft and fraud. But with the FDI Act of 1950, the FDIC was empowered to require regulated banks (which means essentially all US banks) to maintain sufficient blanket bond coverage to make cash account holders whole (up to FDIC limits) for almost any source of loss. More importantly, for the past 60+ years the FDIC and every other organ of government has promoted the idea that, without exception, no one can lose a dime in an FDIC-insured account. **Our government has well and truly become an insurance company with an army attached, to use the phrase popularized by Paul Krugman, and nowhere is this set of behavioral expectations more solidly ensconced than in the cash deposits of US banks.** It's no wonder we all have a soft spot in our hearts for the plucky thieves in bank heist movies. Whatever they're stealing, it's no skin off our collective noses.

There's one more piece of legislation relevant to our story, and that's the Tax Equity and Fiscal Responsibility Act of 1982. This was the final nail in the coffin for the issuance of corporate and municipal bearer bonds in the US, as it eliminated the corporate issuer's tax deduction for interest payments and the muni purchaser's federal tax exemption for interest received. Both tax advantages were preserved for registered bonds, of course. I say of course because the US government, regardless of political party (the 1982 Act was in Reagan's first term), has been trying to eliminate bearer bonds for a looooong time. Why? **Because the US government believes that bearer bonds are at best a gift for criminal enterprises and at worst actively subversive.** Whether this belief is right or wrong (and I think it's mostly right), the notion that the US government will do anything to help a modern twist on the bearer bond under ANY circumstances is absolutely ludicrous.

So where does that leave us? It leaves us with an extremely elegant credit instrument that is almost immune to forgery or government registration, but because of this immunity it is permanently trapped by the abstraction principle within the world of bearer bonds and letters of credit. As such, **Bitcoin is the apple of every criminal's eye**. Every modern day Butch and Sundance, every Neil McCauley, every Hans Gruber is trying to steal your private key. Some will succeed through violence and intimidation. More will succeed with words rather than guns, using what cybersecurity experts call social engineering. If you've never seen David Mamet's "The Spanish Prisoner", now would be a good time.

And because Bitcoin is hated by governments, it's all on you to maintain the security of your private key. There is no insurance here, either directly through deposit insurance or indirectly through a blanket bond required of federally regulated banks. There is no "forgot your password?" button to push here, no regulatory or enforcement agency that will vouchsafe a service provider.

For some, the constant liability risk generated by the abstraction principle is – as Butch Cassidy said – a small price to pay for beauty. **But for anyone with a serious amount of money who's not in a criminal enterprise, this is an intolerably risky legal no-man's land**. Look … there are good reasons why bearer bonds have gone the way of the dodo. Are they illegal? No. Do they have an insanely poor risk/reward profile as a central part of any investment portfolio? Yes.

So why is Bitcoin popular, at least on its appropriately small scale? Because it IS beautiful in its technological conception and execution. Because it IS independent from and mildly threatening to the Powers That Be. Because it IS associated (albeit indirectly and at a safe distance) with criminal venues like Silk Road. Bitcoin projects an identity of technological sophistication, bad boy savvy, and a healthy suspicion of Big Government in a safe, palatable manner. That's an identity that many people (including me) find attractive and would like to take on. It's an identity that mainstream corporations that sell to those people, like Dell and Microsoft, would like to take on. **Bitcoin is a fashion statement**. I don't say that to be pejorative. I say that as high praise. It's a brilliant marriage of art and commerce, and that's a lot. Unfortunately that's not enough for some.

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