Bitcoin could be regulated as a commodity if market volatility continues, academics and financial industry players warned at a Senate hearing today.

Speaking at a subcommittee hearing organized by the Senate Committee on Banking, Housing, and Urban Affairs, a representative from a financial industry technology round table also called for more regulation for virtual currencies.

Sarah Jane Hughes, university scholar and fellow in commercial law at Indiana University Maurer School of Law, argued that bitcoin may need to be regulated as a commodity or security, based on its market behaviour.

“Bitcoin prices seemingly move separately from the values of the world’s major currencies,” she said. “If other virtual currencies demonstrate this market freedom from legal tender currencies, this may be the signal that a reconsideration of type of regulation to be applied from regulation as payment systems to regulation as commodities or securities.”

Hughes wasn’t the only one talking up potential commodities regulation for virtual currencies. Mercedes Kelley Tunstall, partner and practice leader for the Privacy and Data Security Group at Ballard Spahr LLP, argued that virtual currencies “either need to comply with or protect against commoditization”.

“Unless the next generation of virtual currencies can resolve the question as to whether virtual currency should be considered a commodity, the industry will remain characterized by volatility,” she said, adding that this would hinder mainstream adoption.

Paul Smocer, the President of BITS, the technology policy division of the Financial Services Roundtable, also highlighted market volatility risk for bitcoin, and was particularly vocal in calling for more regulation. Other than the FinCEN guidance in March, virtual currency firms have virtually no existing regulatory oversight, said Smocer, whose organization was founded by large financial services firms.

“Without regulations, these digital currencies are not providing appropriate consumer protections to ensure individuals understand the risks much less are protected in ways we now take for granted.

While the digital currency market seems ripe for further oversight and regulation, the act of regulating it, in and of itself, adds legitimacy to the market.”

Hughes steadfastly opposed any special treatment of virtual currency companies by creating regulations specifically for them.

“The ‘don’t regulate us or you will stifle innovation’ arguments did not persuade many as digital money, prepaid cards, payroll cards and other new products appeared in markets and they offer no reason to abandon existing prudential regulation now,” she warned.

She also warned against creating a single licensing scheme covering both state and federal licensing. “It is not clear to me that early applicants will enjoy the relief from 50-state regulation that they seem to expect,” she warned.

*“If the United States doesn’t allow our businesses to accept bitcoin and create more jobs and exports, then countries like Germany and China certainly will.”*

David Cotney, Commissioner of Banks for the Commonwealth of Massachusetts, also worried about the risks of virtual currencies, pointing particularly to real time losses and “other destabilizing effects”.

Cotney spoke on behalf of the Conference of State Bank Supervisors (CSBS), where he is vice-chair. The CSBS unites all 50 state banking regulators in the US. However, it is still trying to characterize virtual currency, he said.

“State agencies would be negligent in their responsibilities if they simply allowed the push of technological innovation to preempt the need to apply the law in a thorough and deliberate manner,” he warned, pointing to New York as an example of a state that was taking steps to try and regulate the currency. Hughes also said that she was “delighted” by the discussion over BitLicenses in New York State.

Hughes, who also called for an in-depth Federal Reserve study into virtual currencies, also warned about the anonymity of virtual currencies. Instead of “condoning” virtual currency systems that market the anonymity of their users, they should be handled under existing financial privacy guidelines – specifically, the Right to Financial Privacy Act of 1978, which governs access to account and transaction information of individuals and businesses by the federal government.

They could also fall under Title V (Privacy) of the Gramm-Leach-Bliley Financial Services Act of 1999, which governs how providers of consumer financial products and services may use and share the non-public, personally identifiable information they hold, she asserted.

However, Hughes admitted that these regulations have their privacy limits, particularly in the area of border seizures, and Title 18 forfeiture.

Although FinCEN updated its guidance on virtual currencies in March, Hughes said that banks still needed more clarity if they are to be persuaded to deal with virtual currency companies.

The agency must clarify how anti-money-laundering (AML) and know-your-customer (KYC) policies apply to virtual currencies, as "this is one of the few ways in which we can stop the recent spate of terminations of banking relationships with providers of virtual currencies". Virtual currency firms should be made to follow the same AML and KYC rules that traditional financial institutions do, she said.

For all the regulatory grandstanding, there were at least some conciliatory overtones. Hughes, unlike Smocer, advised lawmakers not to step up regulatory efforts – at least for now. She said:

"My answer is not yet, and not until such time as stronger evidence suggests problems exist with these currencies that contribute to financial instabilities, or otherwise enable issuers or intermediaries to commit fraud on users or complicate monetary or other important public policies."

Hughes also called for payment issuers in the virtual currency space to make up their own rules, in an attempt to preclude regulatory interference.

"I encourage virtual currency issuers to create payment systems rules for their own systems and harbor some hope that issuers will compete to offer system rules that match the needs of the individuals and businesses who participate," she said.

One such payment systems company is BitPay. CEO Tony Gallippi also presented, and argued against regulation. He recommended that Congress take the same approach to bitcoin as they did to the commercial Internet in the early nineties: wait and see.

“If America is the leader in Bitcoin technology, America will create more jobs and more exports,” he said. “If the United States doesn’t allow our businesses to accept bitcoin and create more jobs and exports, then countries like Germany and China certainly will.”

He understood why banks might be nervous about virtual currencies, though, as it is a disruptive technology, which threatens to undermine their business models. “With bitcoin, users can handle many of their daily payments needs themselves and avoid the bank fees, so banks relying on fee revenue could be impacted the most by virtual currencies,” said Gallippi.

Gallippi also talked up bitcoin’s potential as a mechanism for trading smart property. “By reporting deeds and titles on the block chain, the information would be public record forever, for pennies, and eliminate the need for title insurance,” he said.