Barry E. Silbert
Founder & CEO, SecondMarket
Founder, Bitcoin Investment Trust

Barry Silbert is the Founder and CEO of SecondMarket, a platform that enables private companies and investment funds to more efficiently raise capital and provide liquidity to their stakeholders by simplifying complex transaction workflows, streamlining investor onboarding and verifying that investors are accredited.

SecondMarket has received numerous accolades in recent years including being named by the World Economic Forum as a Technology Pioneer and has received honors from Forbes, Fast Company, Deloitte and other organizations. Barry has received several individual honors including being named Entrepreneur of the Year by Ernst & Young and Crain's, and being selected to Fortune's prestigious “40 Under 40” list.

SecondMarket is backed by a premier group of investors, including FirstMark Capital, The Social+Capital Partnership, Li Ka-shing Foundation, Temasek Holdings, NEA and Silicon Valley Bank.

In addition to founding SecondMarket, Barry also created the Bitcoin Investment Trust, a private, open-ended trust that is invested exclusively in bitcoin and derives its value solely from the price of bitcoin. It enables investors to gain exposure to the price movement of bitcoin without the challenges of buying, storing, and safekeeping bitcoins.

Barry is also one of the most prolific angel investors in the bitcoin space via his personal investment vehicle, the Bitcoin Opportunity Fund, with investments in over 20 bitcoin-related companies, including BitPay, Coinbase, Gyft, BitPremier, Coinsetter, itBit, Ripple Labs, Korbit and BitPagos.

Prior to founding SecondMarket in 2004, Barry was an investment banker at Houlihan Lokey and graduated with honors from the Goizueta Business School of Emory University, and holds Series 7, 24 and 63 licenses.

Written Testimony

of

Barry E. Silbert

Founder and CEO, SecondMarket; Founder, Bitcoin Investment Trust

to the

New York State Department of Financial Services

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Introduction

Superintendent Lawsky, my name is Barry Silbert and I am the founder and CEO of SecondMarket, a platform that enables private companies and investment funds to more efficiently raise capital and provide liquidity to their stakeholders.

In addition to founding SecondMarket, I also created the Bitcoin Investment Trust, a private investment vehicle that enables institutional and sophisticated individual investors to invest in bitcoin. I am also an active angel investor in the bitcoin space via my personal investment vehicle, the Bitcoin Opportunity Fund.

Thank you for the opportunity to participate in this important hearing regarding bitcoin, the state of the ecosystem and what regulatory changes might be necessary to adequately protect investors and consumers.

I've structured my written testimony below in two sections. First, I'll provide a detailed overview of SecondMarket's activities in the bitcoin space which, as a regulated broker dealer business (FINRA, SEC, licensed with all 50 state securities regulators), will provide an example of the policies and procedures that a company can take to protect investors and comply with existing rules and regulations.

Second, I'll address the questions put forth by the NYSDFS in the invitation to provide testimony today. It is worth noting, however, that while my activities in the bitcoin space are extensive, my perspective is that of a CEO of a registered broker-dealer, a creator of a bitcoin investment vehicle and an angel investor – but not an operator of a bitcoin business. As such, my level of familiarity with money transmitter rules is limited and my perspective on the concept of BitLicense should be considered in that context.

SecondMarket's Activities in the Bitcoin Space

Role of SecondMarket as Asset Manager

On September 25, 2013, Alternative Currency Asset Management ("ACAM"), a wholly-owned subsidiary of SecondMarket Holdings, Inc., our parent company, launched the first U.S. based investment vehicle for investing in bitcoin, the Bitcoin Investment Trust (the "BIT"), to which ACAM serves as Sponsor.

The BIT is a statutory Delaware grantor trust that passively holds bitcoins – it has no other operations. Investors acquire shares in the BIT via SecondMarket, Inc., our broker dealer subsidiary and the BIT's approved Authorized Participant ("AP"), through a process replicating that of an Exchange Traded Fund ("ETF") invested in a single commodity, currency or similar asset. However, unlike an ETF, the BIT is not currently listed on an exchange or otherwise publicly traded.

We created the BIT to provide investors with a professional solution to gain exposure to bitcoin in a structure that solved for many of the problems of direct bitcoin investment, such as having to wire funds to unregulated exchanges in foreign jurisdictions as well as concerns around bitcoin safekeeping and ownership. In addition, by transacting through SecondMarket, a registered broker dealer, investors gain the protection of regulatory oversight, compliance procedures and a FINRA registered team.

In the four months since launch, the BIT's assets under management have grown to over 70,000 bitcoin (approximately $60 million at today's price) with over 100 investors. The majority of these investors are entities, including family offices and private trusts, and high net worth individuals willing to invest at least $25,000 in the BIT.

It is important to note that the BIT is not registered with the Securities and Exchange Commission and the securities being sold in the BIT are issued pursuant to Rule 506(c), a private placement exemption. As such, the BIT is only open to institutional and suitable, sophisticated individual investors.

Role of SecondMarket as Marketer, Distributor and Authorized Participant for the BIT

In addition to its subsidiary affiliate, ACAM, serving as Sponsor to the BIT, SecondMarket, as Marketer and Distributor, markets and offers shares in the BIT and, as AP, facilitates the investor transactions. As a registered broker dealer, SecondMarket is responsible for verifying the accredited investor status of the investor, carrying out Anti-Money Laundering procedures, and completing FINRA's required "know your customer" procedures, including a stringent suitability review which I will describe in more detail later.

SecondMarket's suitability process mandates that each potential investor complete a detailed questionnaire, specifying the details of their current investment portfolio, past trading experience, risk tolerance and investment intent. We review this information and then reach out to potential investors to verbally confirm their understanding of the risk profile of the investment. Additionally, Rule 506(c) mandates that all investors in the BIT satisfy the SEC's definition of Accredited Investor and that SecondMarket verifies each investor's accreditation status.

Once SecondMarket completes these procedures and determines that an investment in the BIT is suitable for the investor, it will source bitcoin in an amount representing the investment and will deliver the bitcoin to the BIT in exchange for newly issued shares, which are then delivered back to the investor. SecondMarket holds the bitcoin through a highly secure process until delivered to the BIT in exchange for newly issued shares.

At no time do the BIT's investors have their capital exchanged for bitcoin or vice versa. Instead, the investors are indirectly investing in bitcoin through an equity investment in the BIT based on a NAV per share calculated daily based on a 24-hour volume weighted average price based on the major U.S. Dollar-denominated bitcoin exchanges.

SecondMarket is an active buyer in the bitcoin market, sourcing bitcoin from a number of sellers in the market, including merchants that accept bitcoin as payment, merchant processors, early adopters and bitcoin mining companies. In every instance, SecondMarket requires the seller to complete a new account profile that requires full legal name, address, social security number and employment information (for natural persons), or taxpayer ID and formation documents (for entities), along with a copy of a government issued photo ID. Once it obtains that information, SecondMarket carries out standard Anti-Money Laundering procedures on each seller – including background checks through LexisNexis and Google and an OFAC search.

These same procedures also apply to buyers in the market in the event SecondMarket is selling, as when SecondMarket has an excess position in bitcoin. SecondMarket will generally sell the bitcoin through an exchange that has implemented their own Anti-Money Laundering procedures for exchange participants. To the extent that SecondMarket identifies a potential buyer in an off-exchange transaction, we run the buyer through the same process I described for sellers of bitcoin.

SecondMarket's Compliance Practices

As a regulated broker dealer, SecondMarket is subject to FINRA examination on a two year examination cycle. All of SecondMarket's employees transacting in bitcoin are registered representatives holding FINRA licenses. In accordance with FINRA rules, SecondMarket also maintains a system to supervise all of our registered representatives. This system is subject to ongoing testing and review and our Anti-Money Laundering process is audited on an annual basis by an independent firm. I am pleased to note that our most recent audit, completed in December 2013, identified no deficiencies or failures to follow procedures.

In connection with our expansion into trading bitcoin, we also amended our broker dealer Written Supervisory Procedures to encompass our bitcoin trading activities, including procedures for documenting each trade and retaining all related documentation.

Additionally, in connection with the commencement of our bitcoin activities, we voluntarily instituted a company-wide insider trading policy with respect to bitcoin. Under this policy, at any time that SecondMarket has an open order to buy or sell bitcoin, our employees are not able to buy or sell more than 25 bitcoin for their own account without obtaining prior written permission from our General Counsel or Chief Compliance Officer. Use of information regarding open customer orders to buy or sell bitcoin for personal gain or the gain of third parties regardless of the amount of bitcoin is strictly prohibited.

Responses to DFS Questions

1. The feasibility of the Department issuing a BitLicense specific to virtual currency transactions.

I applaud the NYDFS for taking a proactive role with respect to virtual currencies and determining what changes, if any, are necessary with respect to the current regulatory scheme. As there remains a high level of uncertainty at the state level regarding the status of virtual currencies from a regulatory perspective, I believe there is a tremendous opportunity for the NYSDFS to take an approach that can be replicated nationwide. Further, by ensuring such an approach provides clarity without being overly burdensome, NYSDFS can also promote the state economy by attracting the growing business segment, while also ensuring for adequate consumer protections.

Given that New York already requires that money transmitters be registered with the state, a sensible approach might be to amend this requirement to explicitly cover virtual currencies too, along the lines of the California state regulation, as opposed to imposing a separate licensing requirement on a broader group of bitcoin market participants, particularly those already subject to the same regulation a BitLicense may impose, such as banks, investment companies, registered broker dealers or persons registered with the CFTC. For example, to the extent that a New York business accepts bitcoin as payment for goods or services, I don't see the regulatory benefit of requiring such businesses to get a license.

However, if a BitLicense is not an expansion on the money transmitter scheme but instead a "light touch" construct that could be used to encourage bitcoin businesses to operate in New York, the opportunity to secure such a license could be beneficial to New York as it will likely attract more companies and jobs to the state.

2. What types of virtual currency transactions and activities should require regulation?

It may be appropriate to regulate any transaction that involves an unregulated intermediary converting bitcoin to dollars on behalf of a third party, commonly referred to as exchanges. This is the approach that FinCEN takes with respect to decentralized currencies where intermediaries that are not registered broker dealers or registered with the CFTC must be registered as money service businesses, subject to regulation around their activities and anti-money laundering obligations. I do not believe regulated bitcoin market participants, like SecondMarket, already subject to regulatory requirements that sufficiently address the NYDFS' bitcoin-related money laundering, safety and soundness, transparency and accountability concerns, should be covered by duplicative regulation.

Additionally, I do not think that retail transactions where goods and services are paid for with bitcoin should be subject to regulation. If New York merchants who agreed to accept bitcoin as payment were required to obtain documents to verify the identity of every potential purchaser of goods, the current trend towards acceptance of bitcoin as payment in New York would grind to a halt.

3. *Should entities that are regulated be required to follow specifically tailored anti-money laundering guidelines?*

Yes, which again supports the concept of amending the current money transmitter registration requirement to specifically include virtual currencies and entities acting in that capacity that are not otherwise regulated as a bank, broker dealer or by the CFTC.

As previously mentioned, banks and broker-dealers are already fully regulated and subject to AML requirements. I see no need to expand the requirement to include merchants or consumers.

4. *Should entities that are regulated be required to follow specifically tailored consumer protection guidelines?*

Merchant and consumer transactions are already subject to the provisions of the state and federal consumer protection requirements. In addition, banks and broker-dealers are already subject to fair dealing/fiduciary guidelines. Accordingly, it may be the case that these broader classes of guidelines are sufficient and there is no need for additional, more specific rule making which could limit innovation and development within the segment.

5. *Should entities that are regulated be required to follow specifically tailored regulatory examination requirements?*

Banks and broker-dealers facilitating conversion of bitcoin into dollars are already subject to regulatory examinations. Expanding New York's money transmitter registration to cover virtual currency would subject unregulated entities in the business of receiving virtual currency for transmission to examination. If the suggestion is to impose an examination scheme on a broader class of entities, for example, retail entities that accept bitcoin for payment, such a requirement would be exceptionally burdensome and likely make accepting bitcoin cost prohibitive which would have a significant chilling effect on the current trend and would likely drive these transactions out of New York. To the extent that current regulation applies only to fiat currencies, it would be sensible to expand those rules to include virtual currencies.

6. *The benefits and drawbacks of using virtual currency from a retail prospective.*

Many have been attracted to bitcoin due to its potential benefits from a retail perspective, including:

- Potential for lower transactions costs compared to current credit card and payment service fees (and this remains unaffected by bitcoin's price volatility through the concurrent exchange of bitcoin to dollar by merchant processors).
- Reduced cost and risk of fraud and theft as bitcoin transactions do not generate the same personal identifier information that creates issues for credit card holders.
- No charge back risk to vendors.
- Enabling micro-transactions in a variety of industries including, for example, facilitating paywalls in the publishing industry.

However, as a relatively new and emerging system, bitcoin currently does have some drawbacks from a merchant perspective, including:

- Inconvenience due to lack of ability to establish recurring payments or automatic payments – transactions are "push" versus "pull".
- Potential for longer transaction confirmation time as compared to credit card transactions.
- Inability for very large merchants to realize the necessary liquidity to implement at scale – currently the market is just not big enough for large merchants to do significant transactions in bitcoin.
- Potential for confusion when bitcoin is used as a unit of account, such as when prices are quoted in bitcoin (though such confusion exists in the context of purchases of goods quoted in foreign currencies).

7. Pricing, volatility and security of the virtual currency market from an investor perspective.

Though progress toward market maturity is being made at an increasingly rapid rate, virtual currencies such as bitcoin carry risks and other challenges, including pricing, volatility and security, among others. Such risks and challenges are faced by the system as a whole as well as by its respective market participants, including investors. The SecondMarket activities I have described are designed to, first and foremost, address the immediate risks faced by the latter, namely investors in the BIT.

In following the same order of priority, my response will first discuss the risks and challenges to investors as market participants. However, our activities are also designed to bring more structure and stability to the entire system, thereby further mitigating investor risk in a sort of virtuous circle of market development. As such, my response will conclude with a broader view of our approach in addressing the immediate risks to the market participants balanced with activities fostering a more stable system.

As a threshold matter and as a private issuer of unregistered securities, the BIT is only open to institutional and suitable, sophisticated high net worth investors, not to retail customers. There is also a minimum investment of $25,000, though the average investment size is nearly $200,000.

Those looking to invest into bitcoin directly will often encounter a fast-moving, disjointed market of unknown counterparties and attendant risks. There are scores of online bitcoin exchanges scattered across the globe, with new marketplaces opening regularly. Exchanges are generally international, unregulated and have limited operating history, resources and capital reserves. Even well-run exchanges still face the challenge of uncertain banking relationships and the prospect of frozen funds. To be sure, there are exchanges with reasonably run businesses and service without issue, but it can be challenging for investors to identify these exchanges without prior experience. Off-exchange bitcoin sources such as miners, merchant processors and early investors can be difficult to locate without devoting substantial resources or having a previous relationship. Sale and settlement processes are not standardized and usually involve the potential buyer bearing a substantial portion of the transactional risk.

Within this disjointed bitcoin market, pricing can differ greatly across the various bitcoin exchanges and other sources, at times even by as much as 15%. The volatility is well-known with significant and fast-moving price swings in both directions. The challenges in finding an appropriate source and price for bitcoin are magnified for those attempting to transact at scale, with any single venue often unlikely to accommodate larger orders at all and certainly not without an effect on the market price.

In addition to the transactional challenges, there can be issues in merely holding bitcoin. Securing bitcoin can be technically and operationally challenging and most investors are simply not equipped to do so. On the other hand, keeping bitcoin at an exchange or wallet provider requires further and continuous counterparty assessment and trust. Security issues aside, investors often discover legal and administrative challenges to ownership. As an untitled, bearer instrument, proving ownership can be challenging, whether for the purpose of auditing, accounting or legal transfers, especially to beneficiaries and decedents under estate law. This can be compounded by the digital nature of bitcoin and the lack of familiarity with it by most legal, tax and financial professionals.

In contrast to transacting directly in the bitcoin market, shares in the BIT are offered through a single regulated channel via SecondMarket as a registered broker-dealer with all the incumbent oversight, operations and compliance protocol.

Investors purchase at a price according to the NAV/share struck daily according to a 24-hour volume weighted average price across the major exchanges. In order to facilitate this, SecondMarket as the AP has done the work to identify, vet and aggregate all the sources within the market, thereby delivering more consolidated market access in a single source. This market aggregation and price weighting has the effect of smoothing out inter-market and short-term pricing discrepancies and, when combined with the fact that investment in the BIT is intended and understood by investors to have a long-term investment horizon, also alleviates some of the volatility experienced by bitcoin. The market aggregation also enables investors to transact at a greater scale and with greater liquidity, which are also promoted by the fact that BIT shares can be sold on the secondary market, thereby providing investor liquidity without dipping into the underlying bitcoin market.

Finally, investors in the BIT don’t need to store bitcoin. SecondMarket maintains and ensures the safekeeping of the underlying bitcoin with best practices that are state of the art. The BIT was structured with counsel from a top law firm and will be audited, along with its assets, annually by a big four accounting firm. Investor ownership is evidenced with traditional unregistered, restricted securities issued in the investor’s name, enabling and simplifying processes for their legal, tax and financial advisors. As an additional benefit, BIT shares are eligible to be held in certain self-directed and tax-advantaged accounts, including some IRAs and 401Ks.

As I mentioned earlier, the way in which we have structured the BIT and SecondMarket’s activities were meant to address many of the risks and challenges facing investors, but were also intended to strengthen and develop the system. While facilitating investment through the BIT brings scale, our back-end sourcing and transactional activities bring structure. The former grows bitcoin's monetary base and provides investor liquidity separate from the underlying bitcoin market. The latter helps to standardize sale and settlement procedures based on accepted financial industry practice, develops an active community of trusted counterparties and consolidates pricing and depth in the market.

If there is a third concept to consider, it's consumer and merchant activities, though I will reiterate my earlier caveat of not being a bitcoin business operator and therefore not an expert on such matters. However, it is my understanding that many of the systemic risks in that arena are also hinged on those in the bitcoin trading and exchange space, such as the need for a larger monetary base, greater liquidity, a more consolidated and uniform market, and increased transaction velocity. And it is certainly my understanding that the bitcoin trading and exchange space will benefit from the growth of consumer and merchant activities and the volume of its market activities. Due to this interrelationship, each segment needs the growth of the other and all actions within one segment should be taken in consideration of the effects within the other.

8. The future expectations and anticipated developments of the virtual currency market from an investor and retail perspective

Reflecting on the past five years since the Bitcoin paper was first published, I tend to think about the evolution of bitcoin in five stages. The first stage, or Experimental Phase, which began when the open sourced Bitcoin code was first released in 2009, was a period of early experimentation and technology hacking. During this period, there was very little economic value associated with each bitcoin and the enthusiasts tended to be developers, cryptographers and libertarians.

The second stage, or Early Adopter Phase, began in 2011 when the concept of bitcoin having fiat equivalent value became more widespread – which culminated with a rapid price increase in that immediately followed by a price crash that summer – could best be described as period when a group of early innovators, entrepreneurs and investors began dedicating time, resources and money to bitcoin and bitcoin-related business.

The next stage, or Venture Capital Phase, kicked off in early 2013 with a small, but increasing number of venture investors deploying capital in the bitcoin space. These well known, successful investors – such as Union Square Ventures, Andreesen Horowitz, Lightspeed Ventures, Accel Partners, General Catalyst and Google Ventures – all have a successful track record of identifying trends early and backing fantastic entrepreneurs with big ideas.

Beginning in 2014, I believe we will see the beginning of the fourth stage, or Wall Street Phase, where we will see a large amount of institutional investor capital invested in bitcoin and bitcoin-related businesses, as well as the general acceptance by the financial services industry of the disruptive, transformative nature of the Bitcoin protocol. During this stage, I expect banks, broker-dealers, money transmitters and other types of regulated financial companies to incorporate bitcoin into their operations.

Finally, likely in 2015 or beyond, I believe we will enter the final stage – the Mass Consumer Adoption Phase. This period will be characterized by a dramatic increase in the number of bitcoin users, merchants accepting bitcoin and a proliferation of products and services utilizing the Bitcoin protocol. This phase will be rapid and global given the network effects.