

# Formalizing and Securing Relationships on Public Networks by Nick Szabo

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## Abstract

*Smart contracts combine protocols with user interfaces to formalize and secure relationships over computer networks. Objectives and principles for the design of these systems are derived from legal principles, economic theory, and theories of reliable and secure protocols. Similarities and differences between smart contracts and traditional business procedures based on written contracts, controls, and static forms are discussed. By using cryptographic and other security mechanisms, we can secure many algorithmically specifiable relationships from breach by principals, and from eavesdropping or malicious interference by third parties, up to considerations of time, user interface, and completeness of the algorithmic specification. This article discusses protocols with application in important contracting areas, including credit, content rights management, payment systems, and contracts with bearer.*

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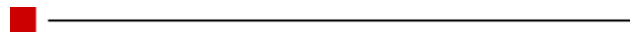
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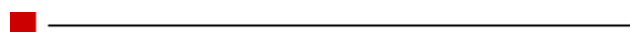
## Introduction

The contract, a set of promises agreed to in a "meeting of the minds", is the traditional way to formalize a relationship. The contract is the basic building block of a market economy. Over many centuries of cultural evolution has emerged both the concept of contract and principles related to it, encoded into common law. Such evolved structures are often prohibitively costly to rederive. If we started from scratch, using reason and experience, it could take many centuries to redevelop sophisticated ideas like contract law and property rights that make the modern market work. But the digital revolution challenges us to develop new institutions in a much shorter period of time. By extracting from our current laws, procedures, and theories those principles which remain applicable in cyberspace, we can retain much of this deep tradition, and greatly shorten the time needed to develop useful digital institutions.

Computers make possible the running of algorithms heretofore prohibitively costly, and networks the quicker transmission of larger and more sophisticated messages. Furthermore, computer scientists and cryptographers have recently discovered many new and quite interesting algorithms. Combining these messages and algorithms makes possible a wide variety of new protocols. These protocols, running on public networks such as the Internet, both challenge and enable us to formalize and secure new kinds of relationships in this new environment, just as contract law, business forms, and accounting controls have long formalized and secured business relationships in the paper-based world.

In electronic commerce so far, the design criteria important for automating contract execution have come from disparate fields like economics and cryptography, with little cross-communication: little awareness of the technology on the one hand, and little awareness of its best business uses other. These efforts are striving after common objectives, and converge on the concept of smart contracts [ [1](#) ].

Smart contracts reduce mental and computational transaction costs imposed by either principals, third parties, or their tools. The contractual phases of search, negotiation, commitment, performance, and adjudication constitute the realm of smart contracts. This article covers all phases, with an emphasis on performance. Smart contracts utilize protocols and user interfaces to facilitate all steps of the contracting process. This gives us new ways to formalize and secure digital relationships which are far more functional than their inanimate paper-based ancestors.



## Contracts Embedded in the World

The basic idea behind smart contracts is that many kinds of contractual clauses (such as collateral, bonding, delineation of property rights, etc.) can be embedded in the hardware and software we deal with, in such a way as to make breach of contract expensive (if desired, sometimes prohibitively so) for the breacher. A canonical real-life example, which we might consider to be the primitive ancestor of smart contracts, is the humble vending machine. Within a limited amount of potential loss (the amount in the till should be less than the cost of breaching the mechanism), the machine takes in coins, and via a simple mechanism, which makes a freshman computer science problem in design with finite automata, dispense change and product according to the displayed price. The vending machine is a contract with bearer: anybody with coins can participate in an exchange with the vendor. The lockbox and other security mechanisms protect the stored coins and contents from attackers, sufficiently to allow profitable deployment of vending machines in a wide variety of areas.

Smart contracts go beyond the vending machine in proposing to embed contracts in all sorts of property that is valuable and controlled by digital means. Smart contracts reference that property in a dynamic, often proactively enforced form, and provide much better observation and verification where proactive measures must fall short.

As another example, consider a hypothetical digital security system for automobiles. The smart contract design strategy suggests that we successively refine security protocols to more fully embed in a property the contractual terms which deal with it. These protocols would give control of the cryptographic keys for operating the property to the person who rightfully owns that property, based on the terms of the contract. In the most straightforward implementation, the car can be rendered inoperable unless the proper challenge-response protocol is completed with its rightful owner, preventing theft. But if the car is being used to secure credit, strong security implemented in this traditional way would create a headache for the creditor - the repo man would no longer be able to confiscate a deadbeat's car. To redress this problem, we can create a smart lien protocol: if the owner fails to make payments, the smart contract invokes the lien protocol, which returns control of the car keys to the bank. This protocol might be much cheaper and more effective than a repo man. A further reification would provably remove the lien when the loan has been paid off, as well as account for hardship and operational exceptions. For example, it would be rude to revoke operation of the car while it's doing 75 down the freeway.

In this process of successive refinement we've gone from a crude security system to a reified contract:

- (1) A lock to selectively let in the owner and  
    exclude third parties;
- (2) A back door to let in the creditor;
- (3a) Creditor back door switched on only upon nonpayment  
    for a certain period of time; and
- (3b) The final electronic payment permanently switches  
    off the back door.

Mature security systems will be undertaking different behavior for different contracts. To continue with our example, if the automobile contract were a lease, the final payment would switch off lessee access; for purchase on credit, it would switch off creditor access. A security system, by successive redesign, increasingly approaches the logic of the contract which governs the rights and obligations covering the object, information, or computation being secured. Qualitatively different contractual terms, as well as technological differences in the property, give rise to the need for different protocols.

# Contemporary Practice

## Accounting Controls

Outside of the financial cryptography community, and long predating it, there is a deep tradition of protocols used in the course of performing contracts. These protocols consist of a flow of forms ("data flow", canonically displayed in data flow diagrams), along with checks and procedures called "controls". Controls serve many of the same functions as cryptographic protocols: integrity, authorization, and so on. This article uses "control protocols" or simply "controls" to refer to this combination of data flow and controls.

**Controls allow a quarrelsome species ill-suited to organizations larger than small tribes to work together on vast projects like manufacturing jumbo jets and running hospitals.**

Control protocols, and the professions of auditing and accounting [ 2 ] based on them, play a critical but ill-analyzed role in our economy. Economists lump them, along with other costs of negotiating and ensuring the performance of contracts, under their catch-all rubric of "transaction costs". But without controls, large corporations and the economies of scale they create would not be possible. Controls allow a quarrelsome species ill-suited to organizations larger than small tribes to work together on vast projects like manufacturing jumbo jets and running hospitals. These control protocols are the result of many centuries of business experience and have a long future ahead of them, but the digital revolution will soon cause these paper-era techniques to be dramatically augmented by, and eventually integrate into, smart contracts.

Controls enable auditing of contract performances, allowing more precise inference of the behavior of an agent. Auditing is costly, so it is undertaken by random sampling. Economists study the substitutability between the probability of verifying a breach and the magnitude of legal fines, where physical enforcement is used. Conceivably, one could substitute increasingly high penalties for increasingly rarer and less expensive auditing. However, this is not robust to real-world conditions of imperfect information.

Since controls primarily address the implicit contracts between employees and employer, there is little mapping from contract to control. A secondary function of controls is to monitor contracts with other organizations. Here there is some mapping, but it is confounded by the integration of the two functions in most controls. Rather than based on contractual terms, controls are typically based on managerial authorization.

Controls are typically based around amounts of money and quantities of goods. A canonical control is double entry bookkeeping, where two books are kept, and there must be arithmetic reconciliation between the books. To conceal an irregularity, necessary to omit from both sides, or to record entries offsetting the irregularity. Notice that there is a problem distinguishing error from fraud. This problem crops up in many areas in both auditing and smart contracts. To illustrate, here are two common control techniques:

*Imprest*: this is a family of controls involving the receipt or disbursement of bearer certificates (usually notes and coins). One example is the protocol used at most movie theaters. Entry is segregated from payment by introducing tickets and establishing two employee roles, the ticket seller in a booth, and the ticket stub salesman at the entrance. Periodically, a bookkeeper reconciles the number of tickets with the total paid. Discrepancy again indicates fraud or error.

*Customer audit:* Techniques to get the customer to generate initial documentation of a transaction. For example, pricing goods at \$.99 forces the employee to open the cash register to make change, generating a receipt.

A complete control protocol typically features the generation of initial documentation, segregation of duties, and arithmetic reconciliation of quantities of goods, standard service events, and money.

Of these, the segregation of duties deserves special comment.

It has long been recognized that an intermediary is more trustworthy when it is distributed. In a large business, transactions are divided up so that no single person can commit fraud. Segregation of duties is an instance of the principle of required conspiracy. For example, the functions of warehouse/delivery, sales, and receipt of payments are each performed by different parties, with a policy that each party reports every transaction to a fourth function, accounting. Any singular reported activity (e.g., delivery without receipt of payment) indicates potential fraud (e.g., a delivery was made to a customer and the payment pocketed instead of being put into the corporate treasury). Segregation of duties is the auditor's favorite tool. Where it is absent the auditor cries "foul", just as a good engineer would react to a single point of failure. Many cryptographic systems have rightfully gone down to commercial failure because they ground down to trust in a single entity rather than segregating functions so as to require conspiracy.

There are at least three significant differences between the scope and emphasis of smart contracts and controls. Controls are paper-era protocols designed around static forms, place little emphasis on confidentiality, and are based on management authorizations rather than one-to-one relationships.

Smart contracts can be based on a wide variety of interactive protocols and user interfaces, and can be involved in a wide variety of kinds of contractual performance. Control protocols, developed in the era of paper, are based on static forms passed as messages and processed in tables and spreadsheets. Controls focus on money and counts of standardized goods and service events, easily recorded by numbers and manipulated by arithmetic, while mostly ignoring other kinds or aspects of contractual performance. Checksums on numbers, the basis of reconciliation, are crude and forgeable compared to cryptographic hashes. Electronic Data Interchange (EDI) keeps these static forms and maintains reliance on controls. It uses cryptographic hashes for nothing more sophisticated than integrity checks on individual messages.

Controls place little emphasis on confidentiality, at least in the modern accounting literature. The emphasis on confidentiality in paper-era protocols is lacking because violation of often implicit confidences, via replication of data, was much more difficult with paper. Furthermore, technologies for protecting confidentiality while auditing were not feasible. Businesses traditionally trusted accounting firms with confidences, a trust that has eroded over the last century, and will erode still further as accounting firms start taking advantage of the vast amounts of inside and marketing information they are collecting from their customers' databases during audits. Using paper-based protocols in a digital world, there are few effective controls against the auditors themselves. Post-unforgeable transaction logs and multiparty secure computation, discussed below, indicate the possibility of cryptographic protocols to implement less relativatory but more effective auditing trails and controls; their use may be able to ameliorate the growing problems with data mining and breach of confidentiality.

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Auditors place quite a bit of trust in management to authorize transactions in a secure and productive manner. Objecting to this dual trust in management and distrust of employees inherent in the accounting tradition, there has been a trend in the last two decades towards a loosening of controls as a part of hierarchy flattening and empowerment of professional employees. Unfortunately, loose controls have led to several recent scandals in the banking and investment trade. The most recent view is that there must be a learned tradeoff between controls and empowerment. The smart contract view is that we need smarter controls, originating at the ownership of the company, and entailing less asymmetry between management and other professional employees. This means converting many implicit employee contracts to more explicit smart contracts based on more direct relationships between owners (or at least their directors) and employees, and symmetric formalizations between employees.

**Smart contracts often involve trusted third parties, exemplified by an intermediary, who is involved in the performance, and an adjudicator, who is invoked to resolve disputes ... .**

Although most of these differences are biased against controls, these traditional protocols have a long future ahead of them, simply because they have a long past. They are highly evolved, hundreds of years old (double-entry bookkeeping, for example, predates the Renaissance). Smart contracts will incorporate many techniques and strategies from control protocols, such as generation of an initial record, segregation of duties, and reconciliation. It will not be long, however, before smart contracts start augmenting and transforming traditional business procedures, making a wide variety of new business structures possible and in the long run replacing traditional controls.

### **Electronic Data Interchange**

Electronic Data Interchange (EDI) is the computer-to-computer communication of standardized business transactions between organizations, in a standard format that permits the receiver to perform the intended transaction. It renders traditional static business forms in cyberspace, and maintains the dependence on traditional controls. Beyond simple encryption and integrity checks, EDI does not take advantage of algorithms and protocols to add security and "smarts" to business relationships. It enables more rapid execution of traditional negotiation and performance monitoring procedures.

EDI loses some security features provided by physical paper (such as difficulty of copying) while not gaining advantages from the wide variety of protocols possible beyond simple message-passing of static forms. This article examples a much richer set of protocols.

EDI contracts tend to be merely reiterations of existing terms and conditions, with only some timing expectations changed for the electronic environment. By redesigning our business relationships to take advantage of a richer set of protocols, smart contracts can take us far beyond the paper-based paradigm of shipping around forms in a secure manner.

The following classification, derived from Sokol [3], illustrates the variety of business forms that have been rendered in electronic form:

#### Administrative

- Product code and price catalogs

- Catalog updates

- Forecasts and plans

- Deals and promotions

- Statements

#### Prepurchasing

- Requests for quote (&response)

- Inventory inquiry/advice

#### Purchasing

- Purchase order & acknowledgment

- Purchase order change & acknowledgment of change

- Material release

- Point of sale/inventory on hand

#### Shipping and Receiving

- Shipment status inquiry & response

- Advance shipment notification

- Bill of Lading

- Freight bill

#### Warehouse

- Inventory inquiry & status

- Shipping notice

- Receipt confirmation

Shipment order

Shipment confirmation

Customs

Declaration

Release

Billing and Paying

Invoice

Payment remittance

Credit and debit memos

Receipts

### **Automata as Authority**

Focal (or Schelling) points are often designed and submitted into negotiations by one side or another, both to bias the negotiations and to reduce their cost. The fixed price at the supermarket (instead of haggling), the prewritten contract the appliance salesman presents you, etc. are examples of hard focal points. They are simply agreed to right away; they serve as the end as well as the beginning of negotiations, because haggling over whether the nearest neighbor focal point is better is too expensive for both parties.

There are many weak enforcement mechanisms which also serve a similar purpose, like the little arms in parking garages that prevent you from leaving without paying, the sawhorses and tape around construction sites, most fences, etc. Civilization is filled with contracts embedded in the world.

More subtle examples include taxi meters, cash register readouts, computer displays, and so on. As with hard focal points, the cost of haggling can often be reduced by invoking technology as authority. "I'm sorry, but that's what the computer says", argue clerks around the world. "I know I estimated \$50 to get to Manhattan, but the meter reads \$75", says the taxi driver.

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## **Dimensions of Contract Design**

Economists stress two properties important to good contract design: *observability* by principals and *verifiability* by third parties such as auditors and adjudicators. From the traditions behind contract law and the objectives of data security, we derive a third objective, *privity*. We flesh out the dimensions of contract design by disentangling mental from computational transaction costs, classifying the kinds of enforceability, characterizing the temporal phases of contracting, and discussing the nature of tradeoffs between the three design objectives.

### **Mental and Computational Transaction Costs**

The costs that smart contracts address are lumped by economists under the catch-all rubric of "transaction costs". We can divide these into mental and computational transaction costs.



One major category of costs include the cost of anticipating, agreeing to, and clearly writing down the various eventualities. These are largely mental transaction costs, although online research tools, for example, may bring more information about eventualities.

Most contractual dispute involves an unforeseen or unspecified eventuality. A common example of an unspecified eventuality is that the parties behind a pseudonym might change: corporate change of officers, sales of brand names, and so on. Dye [ 4 ] suggests that we estimate the cost of writing down a function of the quality of input  $q$  traded a function of price:  $q = f(p)$ . The cost he suggests is the number of different values  $q$  can take on as  $p$  varies: the number of discrete consequences of making the contract at  $p$ . Hart suggests that we should take into account the simplicity of the function. This leads us to the Minimum Description Length of Rissanen and Wallace, an approximation for the [universal description length](#) of a function.

An even more sophisticated model would account for the computational costs of foreseeing these eventualities, some of which may be uncomputable (and therefore of infinite cost). Where eventualities remain unspecified, contracts remain incomplete.

Where counterparties lack focal points, they lack a meeting of minds. Negotiation addresses this gap; the farther apart the focal points (in terms of value), the more expensive the negotiations. There are a variety of institutions of negotiation, which economists study under the rubric of "mechanisms". These range from simple haggling to sophisticated auctions and exchanges.

Securing the contractual phases, especially performance, against third parties can be costly; this is one of the major transaction costs which smart contracts address. This is discussed under "[Attacks Against Smart Contracts](#)" below.

One example where we must untangle mental from computational transaction costs is in examining the idea that lower computational costs make micropayments possible.

The function of prices, from the point of view of a shopper, is to let the shopper map his personal resources (budget) to his personal values (unique and not directly observable). This mental process requires comparison of the purchase price of a good to its personal value. This entails a significant mental cost, which sets the most basic lower bounds on transaction costs. For example, comparing the personal value of a large, diverse set of low-priced goods might require a mental expenditure greater than the prices of those goods (where mental expenditure may be measurable as the opportunity costs of not engaging in mental labor for wages, or of not shopping for a fewer number of more comparable goods with lower mental accounting costs). In this case it makes sense to put the goods together into bundles with a higher price and an intuitive synergy, until the mental accounting costs of shoppers are sufficiently low.

These mental accounting costs, not the physical or computational or amortized R&D costs of payment or billing method, set the main lower bound on price granularity. Judging from pricing granularity trends such as the trend towards flat rates in online services, online pricing granularity is far above suggested micropayment levels of a few cents or even fractions of a cent. The mental accounting costs for a typical on-line consumer seem to be somewhat higher than those in more familiar areas of commerce. These mental costs often dwarf the computational costs; reductions in the per transaction computational costs of smart contracts may often be economically insignificant. Other transaction costs, such as fraud, theft, and unforeseeability, are usually more important objectives for cost reduction by smart contracts.

### **Contracting Phases**

For the temporal phases of contracting we use the following schema, classified according to the two-phase model used in economics:

Ex-Ante

Search

Negotiation

Commitment

Ex-Post

Performance

Adjudication

Smart contracts often involve trusted third parties, exemplified by an intermediary, who is involved in the performance, and an adjudicator, who is invoked to resolve disputes arising out of performance (or lack thereof). Intermediaries can operate during search, negotiation, commitment, and/or performance. Hidden knowledge, or adverse selection, occurs ex-ante; hidden actions (moral hazards) occur ex-post.

Here are some examples of contemporary electronic commerce activities and the phases of contracting they deal with:

EDI	commitment, performance
Contract drafting	negotiations
Web surfing	search
Payment	performance
Online exchange	search, negotiation, commitment
"I agree" button	commitment

This article covers all phases, with a particular emphasis on performance.

### **Observability, Hidden Knowledge, and Hidden Actions**

The first objective of smart contract design is *observability*, the ability of the principals to observe each others' performance of the contract, or to prove their performance to other principals. The field of accounting is, roughly speaking, primarily concerned with making contracts an organization is involved in more observable.

Economists discuss "hidden knowledge", also known as "adverse selection", which can occur due to lack of ability to observe potential counterparties during the search and negotiation phases. Another major problem is "hidden actions", also known as "moral hazard", which can occur due to the lack of observability and ability to drop out of contract during the performance phase of a contract.

One important task of smart contracts, that has been largely overlooked by traditional EDI, is critical to "the meeting of the minds" that is at the heart of a contract: communicating the semantics of the protocols to the parties involved. There is ample opportunity in smart contracts for "smart fine print": actions taken by the software hidden from a party to the transaction. For example, grocery store POS machines don't tell customers whether or not their names are being linked to their purchases in a database. The clerks don't even know, and they've processed thousands of such transactions under their noses. Thus, via hidden action of the software, the customer is giving away information they might consider valuable or confidential, but the contract has been drafted, and transaction has been designed, in such a way as to hide those important parts of that transaction from the customer.



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Without user interfaces smart contracts are largely invisible, like the electronics in newer car engines. This is both a blessing - counterparties don't have to feel like they're dealing with user-hostile computers - and a curse - the "smart fine print" problem of hidden actions.

Here's a little example of smart fine print:

```
if (x == true) {  
  
    printf("x is false");  
  
}
```

To properly communicate transaction semantics, we need good visual metaphors for the elements of the contract. These would hide the details of the protocol without surrendering control over the knowledge and execution of contract terms. A primitive but good example was provided by the SecureMosaic Web browser from CommerceNet. Encryption was shown by putting the document in an envelope, and a digital signature by affixing a seal onto the document or envelope. On the other hand, most Web servers log connections, and sometimes even transactions, without warning users - classic hidden actions.

### **Online Enforceability**

Amid all the hype about "information warfare", lost in the noise is the fact that it is impossible to commit an act of physical violence over the Net. That includes not only all physical crimes of coercion, but also arrest, incarceration, and other traditional methods of law enforcement. Because of this fact, and the jurisdictional swamp that is the Internet, this article concentrates on means of protecting against breach and third parties that do not rely on law enforcement.

We can categorize the security measures against breach, eavesdropping, and interference in the following manner:

#### Proactive

- breaching actions rendered impossible
- either side can drop out with minimal loss upon counterparty

breach

#### Reactive

Deterrence

- reputation

- physical enforcement

third parties: tort law

Damage Recovery

- secured transaction

- reputation

- physical enforcement

principals: contract law

third parties: tort law

Currently, the most prevalent forms of security software are not proactive cryptography, but reactive and panoptic methods like virus scanning software, filtering firewalls, traceroutes of attackers, etc. Once modern cryptographic protocols are more widely deployed, the balance may shift towards preventative security.

### **Verifiability by Adjudicators**

Reactive measures rely upon two areas: verifiability and penalties. As discussed in the section on accounting controls, under ideal economic conditions, the statistical distribution of verification failures is known, so that verification costs and penalties are can be traded off neatly. But with imperfect information, the jurisdictional swamp, and lack of collateral or other security, collection of damage awards is even more severely limited than in contracts confined to traditional geographic jurisdictions. Reputation costs may be the only practical source of penalties in many cases. For reactive measures to work, high verifiability is critical.

So our second objective is *verifiability*, the ability of a principal to prove to an adjudicator that a contract has been performed or breached, or the ability of the adjudicator to find this out by other means. The disciplines of auditing and investigation roughly correspond with verification of contract performance.

### **Privity: Protection from Third Parties**

Our third objective of smart contract design is *privity*, the principle that knowledge and control over the contents and performance of a contract should be distributed among parties only as much as is necessary for the performance of that contract. This is a generalization of the common law principle of contract privity, which states that third parties, other than the designated adjudicators and intermediaries, should have no say in the enforcement of a contract. Generalized privity goes beyond this to formalize the common claim, "it's none of your business". Attacks against privity are epitomized by third parties Eve the eavesdropper, a passive observer of contents or performance, and malicious Mallet, who actively interferes with performance or steals service. Under this model privacy and confidentiality, or protecting the value of information about a contract, its parties, and its performance from Eve, is subsumed under privity, as are property rights. The field of security (especially, for smart contracts, computer and network security), roughly corresponds to the goal of privity.

Our generalization derives, not only from analyzing the objectives of computer security, but also from examining the ancient usage of "privity". To recover privity, we use hermeneutical techniques. A sliver of the original idea of privity has remained in English contract law. Here is a typical definition:

PRIVITY OF CONTRACT. The relation which subsists between two contracting parties [ 5 ].

Here being "in privity" to a contract is simply defined as being a party to the contract. We can get more insight by looking into the requirements for becoming such a party, by forming such a contract. The chief requirement is a "meeting of the minds": a state of mutual agreement.


We have to go back more than a century to find significant usage of the word beyond its parched modern usage in English law. In English literature prior to the 20th century, "privity" appears in contexts which indicate two connotations. The first, most linguistically obvious connotation, is that one has "privity" to an event if one has knowledge of it that is shared by few others. In this interpretation it means being privy to an event. The second connotation is that one assents to that event, or to its consequences. The event might have been called to the attention of others; it or its consequences might have been prevented or avoided. "Privity" thus often carries the connotation of moral or legal responsibility. The event is usually, furthermore, some human action; what contract law refers to as "performance" when such action has been promised. Much of this knowledge is what Michael Polanyi describes as "tacit knowledge" [ 6 ], knowledge which cannot be articulated but must remain subjective. Furthermore, even explicit knowledge of special circumstances is widely dispersed [ 7 ]. The basis of privity is the distribution of knowledge, both articulable and implicit.

The modern legal principle of "privity" [ 8 ] has been modified in many jurisdictions by the doctrine foreseeability. The fixed, clear boundary of foreseeability around a contract provided by privity is erased, in an attempt to define the scope of responsibility as "foreseeability" in particular cases. Now the courts have to draw new clarified boundaries, lest the law remain a muddle.

One has "privacy" with respect to some information against those with whom one is not in privity, in the early "privity to" sense. In contract law, "privity" refers only implicitly to some relative lack of third party knowledge, but refers directly to third party \_control\_ at law. In reconstructing privity for our own uses, we can generalize the concept to refer to lack of both third party knowledge \_and\_ control.

This brings us to an important and fascinating parallel which shows the utility of this revitalized concept of privity in the information age. Our definition of privity now corresponds to the passive and active attacks against a data security system. Passive attacks against privacy are epitomized by Eve, the eavesdropper. Active attacks against performance are epitomized by Mallet, a malicious interferer [ 9 ].

Since "meeting of the minds", one connotation of "privity", comes under the rubric of observability, we will use "privity" to refer to protection from third parties. Thus privity is the protection of the contents and activities of a relationship - or, specifically, the terms, performance, and adjudication of a contract - from third parties.



**To maintain knowledge and control, performance must be encapsulated: protected from outside influences, especially sophisticated attacks. This is the idea behind both the legal doctrine of privity ... and the idea of property rights.**

To maintain knowledge and control, performance must be encapsulated: protected from outside influences, especially sophisticated attacks. This is the idea behind both the legal doctrine of privity, which restricts redress to the parties to a contract, and the idea of property rights.

Our generalized privity thus encompasses property rights as stable objects linked to particular contracts (and thereby the parties in privity to such contracts, the "owners"). Privity creates a clear boundary within which operate a coherent set of rights, responsibilities, and the knowledge with which to carry out those responsibilities and protect those rights. Clarified boundaries also allow accountability. Protection from

extraneous interference allows us to focus responsibility for the consequences of contract-related activity onto the parties to the contract.

## Trading Off Contract Design Objectives

Privity says that we want to minimize vulnerability to third parties. Verifiability and observability often require that we invoke them. An intermediary must be trusted with some of the contents and/or performance of the contract. An adjudicator must be trusted with some of the contents, and some of the history of performance, and to resolve disputes and invoke penalties fairly. In smart contract design we want to get the most out of intermediaries and adjudicator, while minimizing exposure to them. One common outcome is that confidentiality is violated only in case of dispute.

Many kinds of specific performance are often entrusted to intermediaries. We must be able to trust the intermediary (credit agency, anti-virus software vendor, certificate intermediary, digital cash mint, etc.) with their particular claims (about creditworthiness, dangerous byte patterns, identity, conservation of the money supply, etc.) As Ronald Reagan remarked in a slightly different context, "trust but verify". To deserve our trust, intermediaries must convince us that their claims are true. We need to be able to "ping" their veracity, verifying that certain claimed transactions in fact occurred. An entire profession exists in market economies to perform this function: auditing.

Ideally, observability and verifiability can also include the ability to differentiate between intentional violations of the contract and good faith errors, but this is difficult in practice, since the difference is often largely one of subjective, unrevealed intent.



## Building Blocks of Smart Contract Protocols

### Protocols

A *protocol* [ 9 ] in computer science is a sequence of messages between at least two computers. At a higher level of abstraction, a protocol consists of algorithms communicating via messages. These programs act as proxies, or agents, for human users, who communicate their preferences via users interfaces. We distinguish protocol endpoints by names such as "Alice" and "Bob", but it should be kept in mind that the end points are really computer processing units, which may or may not be under the control of, or taking actions contrary to the intent of, the human user. Human users typically do not have full knowledge of the protocol in question, but rather a metaphorical understanding obtained via user interface, manuals, and so on. Unlike most real-world contracts, protocols must be unambiguous and complete.

Protocols come in three basic types. I have modified the terminology of Schneier [ 5 ] to match more closely to the corresponding business terminology:

self-enforcing: Alice <--> Bob,

mediated: Alice <--> intermediary <--> Bob

adjudicated: (Alice <--> Bob) --> [evidence] --> adjudicator

The corresponding smart contracts elaborate on "Alice" to distinguish between the software (in two components, the endpoint of protocol and the user interface), and Alice herself. Cryptographic and other computer security mechanisms give us a kit of tools and parts from which we can build protocols, which form the basis of smart contracts.

## Cryptographic Protocols

A family of protocols, called *cryptographic protocols* because their first application was computerized "secret writing", provide many of the basic building blocks that implement the improved tradeoffs between observability, verifiability, privacy, and enforceability in smart contracts. Contrary to the common wisdom, obscurity is often critical to security. Cryptographic protocols are built around foci of obscurity called *keys*. A key's immense unknown randomness allows the rest of the system to be simple and public. The obscurity of a large random number, so vast that a lucky guess is astronomically unlikely, is the foundation upon which cryptographic protocols, and smart contracts based on them, are built.

- **Contrary to common wisdom,**
- **obscurity is often critical**
- **to security.**

Two significant cautions are in order when thinking about how cryptographic protocols can be used in online relationships. The first is that protocols usually provide security "up to" some assumption. This assumption is a remaining weak point which a complete working system must address in some reasonable manner. One common endpoint is assumptions about trusted third parties. Often the degree or function of the trust is not well specified, and it is up to the real-world systems analyst to characterize and ameliorate these exposures. The best mediated protocols only trust the intermediary or counterparty with a well limited function.

Even without trusted third parties, cryptographic protocols often ground out in trust of the counterparty. For example, encryption of a message provides confidentiality up to the actions of parties with decrypting keys. Encryption does not stop key holders from posting plain text to Usenet. We cannot just say that encryption provides "confidentiality" and leave our concern for confidentiality at that.

The second caution is that much of the terminology used in the cryptographic literature to name protocols ("signatures", "cash", etc.) is misleading. Sometimes the terminology falls short on substantial matters: a "digital signature", for example, is not biometric and is based on a key that can easily be copied if not protecting by another mechanism. Often cryptographic protocols can be generalized to much wider purposes than implied by the label. For example, "digital cash" is a very general protocol which can implement a wide variety of bearer certificates and conservation wrappers for distributed objects.

### Attacks against Smart Contracts

Protocols for smart contracts should be structured in such a way as to make their contracts

(a) robust against naive vandalism, and

(b) robust against sophisticated, incentive compatible (rational) breach

A vandal can be a strategy or sub-strategy of a game whose utility is at least partially a function of one's own negative utility; or it can be a mistake by a contracting party to the same effect. "Naive" simply refers to both lack of forethought as to the consequences of a breach, as well as the relatively low amount of resources expended to enable that breach. Naive vandalism is common enough that it must be taken into consideration. A third category, (c) sophisticated vandalism (where the vandals can and are willing to sacrifice substantial resources), for example a military attack by third parties, is of a special and difficult kind that doesn't often arise in typical contracting, so that we can place it in a separate category and ignore it here. The distinction between naive and sophisticated strategies has been computationally formalized in [algorithmic information theory](#)

The expected loss due to third party attack is called the exposure. The cost of third parties to breach the security mechanism is the breach cost. If the breach cost is greater than the expected benefit, we can expect an incentive compatible attacker to breach the security.

## Public and Secret Key Cryptography

A wide variety of new cryptographic protocols have emerged in recent years. The most traditional kind of cryptography is *secret key* cryptography, in which Alice and Bob (our exemplar parties to a smart contract) use a single shared, prearranged key to encrypt messages between them. A fundamental problem we will see throughout these protocols is the need to keep keys secret, and *public key* cryptography helps solve this. In this technique, Alice generates two keys, called the private and public keys. She keeps the private key secret and well protected, and publishes the public key. When Bob wishes to send a message to Alice, he encrypts a message with her public key, sends the encrypted message, and she decrypts the message with her private key. The private key provides a "trapdoor" that allows Alice to compute an easy inverse of the encryption function that used the public key. The public key provides no clue as to what the private key is, even though they are mathematically related. The [RSA](#) algorithm is the most widely used method of public key cryptography.

## Public Authentication

Public key cryptography also makes possible a wide variety of *digital signatures*. These prove that a piece of data (hereafter referred to as just an "object") was in active contact with the private key corresponding to the signature: the object was actively "signed" with that key. There are two steps to an authentication protocol: signing and verification. These may occur synchronously, or, in many public protocols, a signature may be verified at some distant time in the future.



## The digital signature ... is not biometric like an autograph ... .

The digital signature probably should have been called a "digital stamp" or "digital seal" since its function resembles more those methods than an autograph. In particular, it is not biometric like an autograph, although incorporation of a typed-in password as part of the private key used to sign can sometimes substitute for an autograph. In many Asian countries, a hand-carved wooden block, called a "chop", is often used instead of autographs. Every chop is unique, and because of the unique carving and wood grain cannot be copied. A digital signature is similar to the chop, since every newly generated key is unique, but it is trivial to copy the key if obtained from the holder. A digital signature relies on the assumption that the holder will keep the private key secret.

A *blind signature* publically authenticates privy information (but can we use non-privy signatures blindly as well?) This is a digital signature and secret-key encryption protocol that together have the mathematical property of commutativity, so that they can be stripped in reverse of the order they were applied. It's like stamping an unknown document through carbon paper (without having to worry about smudging). The effect is that Bob "signs" an object, for which he can verify its general form, but cannot see its specific content. Typically the key of the signature defines the meaning of the signed object, rather than the contents of the object signed, so that Bob doesn't sign a blank check. Blind signatures used in digital bearer certificates, where Bob is the clearing agent, and in [Chaumian credentials](#), where Bob is the credential issuer.

## Privy Authentication

The blind signature is one example of the many "magic ink signatures" cryptographers have invented. Another class of these protocols are used to limit the parties allowed to either verify the signature or to learn the identity



of the signer. The most privy are the zero-knowledge proofs, where only the counterparty can authenticate the prover. Designated confirmer signatures allow the signer to designate particular counterparties as verifiers. For example, a business could give particular auditors, investigators, or adjudicators the authority to verify signed objects, while other third parties, such as competitors, can learn nothing from the signature. Group signatures allow members to sign as an authentic member of a group, without revealing which member made the signature.

## **Protection of Keys**

So far, we've assumed parties like Alice and Bob are monolithic. But in the world of smart contracts, they will use computer-based software agents and smart cards to do their electronic bidding. Keys are not necessarily tied to identities, and the task of doing such binding turns out to be more difficult than at first glance. Once keys are bound, they need to be well protected, but wide area network connections are notoriously vulnerable to hacking.

If we assume that the attacker has the ability to intercept and redirect any messages in the network protocol, as is the case on wide area networks such as the Internet, then we must also assume, for practical all commercial operating systems, that they would also be able to invade client if not merchant computers and find any keys lying on the disk.

There's no completely satisfactory solution to end point operations security from network-based attacks, but here's a strategy for practically defanging this problem for public-key based systems:

All public key operation can be performed inside an unreadable hardware board or smart card on a machine with a very narrow serial-line connection (ie, it carries only a simple single-use protocol with well-verified security) to a dedicated firewall. This is economical for high traffic servers, but may be less practical for individual users. Besides better security, it has the added advantage that hardware speeds up the public key computations.

If Mallet's capability is to physically seize the machine, a weaker form of key protection will suffice. The trick is to hold the keys in volatile memory. This makes the PC proof from physical attacks - all that needed to destroy the keys is to turn off the PC. If the key backups can be hidden in a different, secure physical location, this allows the user of this PC to encrypt large amounts of data both on the PC itself and on public computer networks, without fear that physical attack against the PC will compromise that data. The data is still vulnerable to a "rubber hose attack" where the owner is coerced into revealing the hidden keys.

## **Capabilities**

Object-oriented, or capability, security is a deep and promising area, but beyond the scope of this article. Capabilities can potentially simplify the design of many distributed security protocols. Instead of developing a new or modified cryptographic protocol for each contracting problem, capabilities may allow us to design a rich variety of distributed security protocols over a common cryptographic framework.

For more information see [Introduction to Capability Based Security](#)

## **Mixes**

Mixing is a general technique of confidentiality used in many protocols. Three examples of mixing discussed in this paper are anonymous remailers, bearer certificates, and the Dai/Finney anonymous loan protocol. In this section we discuss remailers.



**.. a digital mix can allow parties to communicate across a network without revealing their partners to network partners or the outside world.**

Information about who is talking to whom, such as can be found on telephone bills, can be quite valuable even without records of the actual content. Confidential messaging is necessary for some of the privacy features of [Chaumian credentials](#) and bearer certificates to be strongly implemented on an actual network. To provide this traffic confidentiality, a *digital mix* can allow parties to communicate across a network without revealing their partners to network providers or the outside world. In a mix, traffic analysis by Eve is prevented by the Russian-doll encryption of the message by the sender with the public keys of each mix operator in the chain, and the mixing of messages by each operator, so that panoptic wiretapper Eve loses track of the messages. For the sender/recipient pair to remain confidential, only 1 out of N of the operators needs to be trusted with their local traffic information, although Eve can sometimes gather statistics over large numbers of messages between the same partners to eventually guess who is talking to whom. The communicating parties can also be mutually anonymous, and with normal encryption need trust no other parties with the content of messages. The "Mixmaster" remailer implements most of the features of a digital mix [ [10](#) ].

## Quora

Quorum distribution of performance or control over resources can be based on the [secret sharing](#) of keys needed to perform or control a resource. These are also known as threshold techniques. These are methods of splitting a key (and thus control over any object encrypted with that key) into N parts, of which only M are needed to recreate the key, but less than M of the parts provide no information about the key. Secret sharing is a potent tool for distributing control over objects between principals.

[Markus Jacobsson](#) has designed a quorum of mints for signing digital coins, for example. Quorum establishes a "required conspiracy" of M out of N to perform a function, providing an option for stronger protection than the typical 2 out of N used in segregation of duties, and greater confidence in the security underlying the segregation.

## Post-Unforgeable Transaction Logs


Traditionally, auditors have contacted counterparties in order to verify that a transaction actually took place (The "principle of required conspiracy" at work again). With post-unforgeable logs, via [a hierarchical system of one-way hash functions](#), a party can publically commit to transactions as they are completed by publishing signed cumulative hashes of the transaction stream. The confidentiality of the transaction is fully maintained until an auditor "pings" the transaction to determine its actual nature. The counterparty identity can remain confidential, because it is not required to establish the other facts of the transaction. The only attack is to forge transactions in real time, as the transaction itself takes place, which in most practical cases will be unfeasible. Most accounting fraud involves analyzing sets of completed transactions and then forging them to make them compute to a desired counterfactual result.

## Mutually Confidential Computation

Cryptographers have developed protocols which create virtual machines between two or more parties. [Multiparty secure computation](#) allows any number of parties to share a computation, each learning only what can be inferred from their own inputs and the output of the computation. These virtual machines have the exciting property that each party's input is strongly confidential from the other parties. The program and the output are shared by the parties. So, for example, we could run a spreadsheet across the Internet on this

virtual computer. We would agree on a set of formulas, set up the virtual computer with these formulas, and each input our own private data. We could only learn only as much about the other participants' inputs as we could infer from our own inputs and the output.

There are two major complications. The first is that this virtual computer is very slow: one machine instruction per network message. The second is that some parties learn the results before others. Several [papers](#) have discussed the fraction of parties one must trust in order to be assured of learning the correct output. The mechanism must be constructed so that a sufficient number of parties have an incentive to pass on the correct result, or reputation, side contracts, etc. used to the same effect.



**... any algorithmic intermediary can, in principle, be replaced by a trustworthy virtual computer.**

With these caveats, any algorithmic intermediary can, in principle, be replaced by a trustworthy virtual computer. In practice, because of the two complications, we usually construct more limited protocols out of more efficient elements.

Multiparty secure computer theory, by making possible privy virtual intermediation, has major implications for all phases of contracting. This can be seen most clearly in the area of negotiations. A "mechanism" in economics is an abstract model of an institution which communicates with its participants via messages, and whose rules can be specified algorithmically. These institutions can be auctions, exchanges, voting, and so on. They typically implement some kind of negotiation or decision making process.

Economists assume a trusted intermediary operates the mechanism. Here's a simple example of using this virtual computer for a mechanism. Alice can submit a bid price, and Bob an ask price, to their shared virtual computer which has one instruction, "A greater than B?". The computer then returns "true" if Alice's bid is greater than Bob's offer. A slightly more sophisticated computer may then decide the settlement price according to a number of different algorithms (Alice's bid, Bob's ask, split the difference, etc.) This implements the mechanism "blind bargaining" with no trusted intermediary.

In principle, since any computable problem can be solved on this virtual computer (they are "Turing complete"), any computable economic mechanism can be implemented without a trusted intermediary. In practice, these secure virtual computers run very slowly (one virtual machine instruction per network message), and the order in which participants learn results often matters. But the existence proof, that any economic mechanism can be run without a trusted intermediary, up to temporal issues, is very exciting. This means that, in principle, any contract which can be negotiated through a trusted third party (such as an auction or exchange) can be negotiated directly. So, in some abstract sense, the only remaining "hard" problems in smart contract negotiations are (a) problems considered hard even with a trusted intermediary (for the standard economic reasons), (b) nonsimultaneity problems in learning the decision, and (c) the task of algorithmically specifying the negotiating rules and output contract terms (This includes cases where an intermediary adds knowledge unavailable to the participants, such as a lawyer giving advice on how to draft a contract).

Applying this kind of analysis to the performance phase of contracts is less straightforward. For starters, economic theories of the performance phase are not as well developed or simple as the mechanism theory of negotiations. Indeed, most economic theory simply assumes that all contracts can be perfectly and costlessly enforced. Some of the "transaction cost" literature has started to move beyond this assumption, but there are few compelling results or consensus theories in the area of techniques and costs of contract enforcement.

Performance phase analysis with multiparty secure computer theory would seem to apply only to those contracts which can be performed inside the virtual computer. But the use of post-unforgeable auditing logs, combined with running auditing protocols inside the shared virtual computer, allows a wide variety of performances outside the virtual computer to at least be observed and verified by selected arbitrators, albeit not proactively self-enforced.

The participants in this mutually confidential auditing protocol can verify that the books match the details of transactions stored in a previously committed transaction log, and that the numbers add up correctly. The participants can compute summary statistics on their confidentially shared transaction logs, including cross-checking of the logs against counterparties to a transaction, without revealing those logs. They only learn what can be inferred from the statistics, can't see the details of the transactions. Another intriguing possibility is that the virtual computer can keep state over long periods of time, allowing sophisticated forms of privity and self-enforcing secured credit.

With mutually confidential auditing we will be able to gain high confidence in the factuality of counterparties' claims and reports without revealing identifying and other detailed information from the transactions underlying those reports. These provide the basis for solid reputation systems, and other trusted third party systems, that maintain integrity across time, communications, and summarization, and preserve confidentiality for transaction participants. Knowing that mutually confidential auditing can be accomplished in principle may lead us to practical solutions. Eric Hughes' ["encrypted open books"](#) was one attempt.

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## Contracts with Bearer

### Bearer Certificates

Bearer certificates implement transferable rights on standardized contracts. Each kind of contract (for example, each denomination of "coin" in digital cash) corresponds to a digital signature, just as each issue of Federal Reserve Notes or stock certificates corresponds to a particular plate.

In the most straightforward bearer certificate protocol, the issuer and transfer agent (the same entity, for our purposes, though they can easily be unbundled) create a serial number (really a large unguessable random number, rather than a sequence), and add it to a list of issued certificates. The transfer agent clears a transfer by checking the signature to identify and nature of the bearer contract and verify that it was made, then looking on that contract's issued list to make sure the serial number is there, then removing the serial number. Alternatively, the issuer can let the issuee make up the serial number, then, when cleared, check the signature and put the number on the list of cleared certificates. The signature provides the assurance that the certificate is indeed the the particular kind of contract with bearer, while the serial number assures that the same instance of that contract is not cleared or redeemed more than once. In these simple versions, the transfer agent can link the transferee to the transferor for all transfers. To implement the privacy characteristics of coins and physical bearer certificates, we need to add unlinkability features.

### Unlinkable Transfers

Unlinkability can be provided by combining the second variation above, a list of cleared certificates, with blind signatures and a mixing effect. Enough instances of a standardized contract are issued over a period of time to create a mix. Between the issuing and clearing of a certificate, many other certificates with the same signature will be cleared, making it highly improbable that a particular clearing can be linked to a particular issue via the signature. There is a tradeoff between the mixing effect and the exposure to the theft of a "plate" for a particular issue: the smaller the issue, the smaller the exposure but the greater the linkability; a larger issue has both greater exposure and greater confidentiality.

Blind signatures can be used to make certificate transfers unlinkable via serial number. Privacy from the transfer agent can take the form of transferee-unlinkability, transferor-unlinkability, or "double blinded" where


both transferor and transferee are unlinkable by the transfer agent or a collusion of a transfer agent and counterparty.

Bearer certificates come in an "online" variety, cleared during every transfer, and thus both verifiable and observable, and an "offline" variety, which can be transferred without being cleared, but is only verifiable when finally cleared, by revealing any the clearing name of any intermediate holder who transferred the object multiple times (a breach of contract).

This unlinkability is often called "anonymity", but the issue of whether accounts are issued to real names or pseudonyms, and whether transferor and transferee identify themselves to each other, is orthogonal to unlinkability by the transfer agent in the online model. In the off-line model, account identification (or at least a highly reputable and/or secured pseudonym) is required: passing an offline certificate a second time reveals this identity. Furthermore, communications channels can allow Eve to link transferor and transferee, unless they take the precaution of using an anonymous remailer. Online clearing does make lack of identification a reasonable option for many kinds of transactions, although common credit and warrantee situations often benefit from or even require identification.

When confronting an attempted clearing of a cleared serial number, we face an error-or-fraud dilemma similar to the one we encountered above in double entry bookkeeping. The ecash(tm) protocol from DigiCash actually takes advantage of this ambiguity, second-transferring certificates on purpose to recover from a network failure. When certificates are lost over the net it is not clear to the transferor whether they have been received and cleared by the transferee or not. Second-transferring directly with the transfer agent resolves the ambiguity. This only works with the online protocol. The issue of distinguishing error from fraud is urgent in the offline protocol, but there is as yet no highly satisfactory solution. This problem is often intractable due to the subjectivity of intent.

## Conserved Objects



**Conserved objects provide the basis for a software economics that more closely resembles economics of scarce physical objects.**

Issuance and cleared transfer of references to a distributed object conserves the usage of that object. This object becomes "scarce" in economic terms, just as use of physical objects is finite. Conserved objects provide the basis for a software economics that more closely resembles economics of scarce physical objects. Conserved objects can be used to selectively exclude not only scarce physical resources (such as CPU time, network bandwidth and response time, etc.), but also fruits of intellectual labor - as long as one is willing to pay the price to interact with that information over the network rather than locally (cf. content rights management). Conservation immunizes objects and the resources they encapsulate to denial of service attacks. Bearer certificate protocols can be used to transfer references to a particular instance or set of instances of an object, just as they can be used to transfer other kinds of standardized rights.

## Digital Cash

[Digital cash](#) is the premier example of a digital bearer certificate. The issue and transfer agent is called a "mint". Bearer certificate protocols enable online payment while honoring the characteristics desired of bearer notes, especially unforgeability (via the clearing mechanism) and transfer confidentiality (via mixing and blinding).

To implement a full transaction of payment for services, we often need need more than just the digital cash protocol; we need a protocol that guarantees that service will be rendered if payment is made, and vice versa. Current commercial systems use a wide variety of techniques to accomplish this, such as certified mail, face to face exchange, reliance on credit history and collection agencies to extend credit, etc. Potential smart contract protocols in this area are discussed under Credit.

## Credentials

A *credential* is a claim made by one party about another. A *positive credential* is one the second party would prefer to reveal, such as a degree from a prestigious school, while that party would prefer not to reveal a *negative credential* such as a bad credit rating.

A [Chaumian credential](#) is a cryptographic protocol for proving that one's pseudonym (for example, the identification number one uses in a health care system) possesses credentials issued to one's other pseudonyms, without revealing linkages between these pseudonyms or between pseudonym and true name. It's based around the *is-a-person credential* the true name credential, used to prove, without revealing, the linkage between pseudonyms, and to prevent the transfer of pseudonyms between parties.

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## Content Rights Management

Content protection contracts are valuable in that they incentive publishers to allow users to view content directly, rather than indirectly and partially via queries to remote servers. Content protection of software distributed online would allow it to be run locally rather than remotely, while enforcing the contract rights and copyrights of the publisher against the user. This local usage billing of software often goes under the rubric of "superdistribution" [ [11](#) ].

## Watermarks

Watermark schemes work by altering less significant bits of content - usually a picture; sound works less well and text is difficult. These altered bits typically contain the identities of the publisher and viewer, and perhaps other information related to the contract. The idea is that, when investigators scan released content, the watermark will finger the breacher of the contract (or violator of copyright law).

Watermark investigation can be assisted by a quite inexpensive technique, Web spiders. These spiders look for redistributed watermarked material on the Web. The customer originating the copy can then be fingered.

One attack against watermarks is to overwrite likely watermark bits with other patterns legitimate to viewing software. The entanglement of watermark bits with bits important to the picture can be made rather obscure, but not strongly so by the standards of cryptography. Another attack is to steal content from a customer and distribute it as is. The watermark will finger the victim, rather than the thief.

All watermark schemes can be defeated with sufficient effort. These schemes can then be distributed as software worldwide. Once the initial effort is put into breaking a scheme, the marginal cost of breaking it is minimal. Furthermore, once the watermark is removed, the content can be distributed and even published [ [12](#) ] with secure anonymity.

In sum, watermark schemes can add significant risk to the copying of of low value or ephemeral information. This will be sufficient for many kinds of content, such as news or product updates. It won't stop, for long, the redistribution of high-value content. Since watermarks require traceable identification, they reduce customer privacy and require the inconvenience of registration and authentication, adding to the transaction costs of content purchase.

## Controlled CPUs

Contrary to the hype, there is no strong content protection software. Watermarks are as close as we've come, and they fall far short of the standards of computer security. Large sums have gone into attempts to develop such technology, resulting in hundreds of patents but no substantial results.

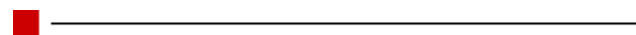
As a result, some publishers have begun putting their research dollars into a radical alternative, innocuously dubbed the "secure CPU" (SPU) [ 13 ]. This is a CPU that is "secure" against the owner of the computer! To enforce copyright or content contracts, the SPU monitors all content-related activity. Some marketing literature even lists, alongside the traditional copyright, a new "right" of publishers to monitor the usage of their content. Remarkably enough, these panoptic non-personal computers are the focus of major R&D efforts.



**The radical SPU projects demonstrate both the high value of content contracts to publishers and the high price we have to pay to maintain the paper-era intellectual property model online.**

The radical SPU projects demonstrate both the high value of content contracts to publishers and the high price we have to pay to maintain the paper-era intellectual property model online. Strong content protection would be valuable in going beyond indirect and partial viewing of content on servers, to viewing content directly and locally. The price is the loss of control over our own computers, and loss of privacy over our activities on those computers.

The online content market is squeezed from above and below. From above, by the ease of redistributing high-value content. From below, by the mental transaction costs of charging for low value content - costs to which the requirements of registration and traceable identification add substantially. The size of the market in between is an open question. "Information wants to be free", but authors and publishers want to be paid for it. The current content market for more difficult to copy media, such as books, films, CD-ROM, and so forth is large, in the hundreds of billions of dollars per year. But on the Internet, free content dominates. Distributing ephemeral content in the form of service subscriptions is in most cases a more viable way to go. It remains to be seen how large the Internet content market will become, and to what extent customers will tolerate impositions on privacy and control of their computers in order to obtain legal content.



## Reputation Systems

Reputation relies on intermediaries to convey information. For example, credit rating agencies are used to minimize adverse selection (hidden knowledge) problems in credit.

Reputation can be viewed as the amount of trust an agent has created for himself [ 14 ]. Reputation systems ultimately need to be based on fact rather than mere opinion or faith to be effective. For example, if we are to have a good credit rating system, we need to be confident that the credit record assembled by the agency is sufficiently accurate. Reputation information is typically gathered and distributed by intermediaries trusted to perform this task.

An important and general problem seems to be that of tagging a negative behavior source for future recognition. The tag might be used for negative information shared publically (e.g., credit ratings) or kept private (e.g., kill files). The behavior source might be non-human (e.g., recognizing virus patterns for the purposes of virus scanning). Where the behavior source is adaptable and self-interested, it has an incentive to spoof the tagging: a debtor to change names to avoid paying his debt, a virus to scramble its pattern to avoid

scanning, and so on. If the tag carries a greater positive reputation (where zero is the reputation of a newcomer) this incentive is lost and the negative side of the reputation must be borne.

Can digital credentialing systems facilitate such negative reputation handling?

Service-specific, or local, name reputation may not be able to accomplish such tracking of negative reputation. If a local name accumulates more negative than positive credentials, it can simply be replaced by a newcomer local name for this service, without harming the positive reputation capital of the other behavior source local names. Hostile sources can continuously spoof innocent newcomers. Counterparties lose the ability to determine a history of previous hostile behavior - kill files, virus scanning, credit ratings, and so on fail.

[Chaumian credentials](#) also give the credential holder control over the transfer of credentials between his local names, creating an incentive to show positive credentials and hide negative ones. To remedy this, counterparties can demand "non-negative credentials" (in a form such as, "Alice in many transactions recorded by me in area X has never done bad things x,y,z"), Non-negative credentials are limited to areas that can be well-tracked. One such may be credit ratings, as long as one is doing the bulk of one's credit transactions through is-a-person linked local names.

Where Chaumian credentials are inapplicable, we might raise the cost of entry to be greater than that of a newcomer. This gives us two clearly defined reputation points to compare on an otherwise rather subjective scale: participation threshold and newcomer reputation. Both are subjective in the eye of the party choosing whether or not to participate in an activity with the name.

A participation threshold greater than newcomer reputation clashes with the desirable goal, that one be able to make a fresh start. For that matter, unless previous names and their positive reputations are linked to their new names, the pioneers cannot make a start, so that the institution itself cannot be started. Ditto for for institutional growth.

Tags that bundle the results of a wide variety of transactions - global names, or universal IDs, or "True Names" - seem to provide the most incentive for parties to carry their negative credentials. Most people have accumulated enough positive reputation in some areas that it is well-nigh impossible for them to start over their entire lives as newcomers.

A big problem arises with negative credentials when they are used, not merely to avoid engaging in a particular activity with a party, but for retribution against that party. Retribution may take some nonviolent online form, such as slander, denial of service attack, and so on, but the most worrisome form of retribution is a violent physical attack. Could we have digital tags that, while tracking negative behavior sources through the digital world, remain strictly unlinked to any kind of physical location data? Alas, we have several important systems, such as cellular phones, shipping addresses, etc. that provide such linkage.

- **What is perfectly**
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- **may bring a**
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Another problem for negative reputations is that "negative" is subjective. What is perfectly reasonable in one culture may bring a death sentence in another. However, there are some important, well-defined transactions where there is a widely agreed use of historical information. For example, for those who extend credit (and keep in mind, credit is implicit in most contracts), borrowers who have not paid their bills in the past are universally a negative. Being on the receiving end of a computer virus is practically always a negative.

The question may become one of deciding what of these three dimensions are most important, and how they can be traded off:



- The gains to be had from tracking and thereby avoiding negative behavior sources
- The gains to be had from a nonviolent digital world (i.e., a virtual realm within which any digital action can have no physically violent consequences).
- The inconvenience (and perhaps impracticality) of partitioning the physical and digital worlds into different ID systems (more realistically, some "pure" subset of the digital world completely partitioned from location devices, physical shipping information, etc.)

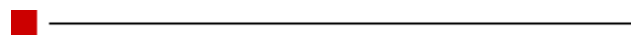
Keep in mind too, that in practice these are evaluated primarily by a market evolving from its current state, rather than by abstract ethical philosophies.

Robin Hanson [ [15](#) ] has observed that in a world of global names, the use of a local name may signal the hiding of negative credentials, so that the use of global names is in equilibrium. A further problem with local names is that our relationships are often not neatly compartmentalizable into standard service types, and even where they are we might like to expand them into new areas. I suggest that, at minimum, we will want to reveal progressively more local names to our counterparties as our relationships with them become closer and more co-exposed.

While the global name equilibrium may hold for many of our relationships, there may be plenty of areas where the privacy benefits of localizing names outweigh the costs of being less or unable to differentiate newcomers from hostiles. (By "privacy" I refer the entire general task of protecting relationships from hostile third parties; confidentiality and protection of property from theft are two examples of privacy). For example, the preference-tracking service at [www.firefly.com](http://www.firefly.com) increases participation via the use of pseudonyms, and suffers little exposure from hostiles. On the other hand, credit transactions typically demand identifying information, because the contractual exposure typically outweighs benefits of privacy.

Global name public keys, which have many drawbacks in terms of privacy, may be the best way to track negative reputation, but they are no panacea. There is an important conundrum in an ID-based key system: the conflict between the ability to get a new key when the old one is or could be abused by another (key revocation), and the ability of another to be sure they are dealing with the same person again. This may also provide an opportunity for parties to selectively reveal positive credentials and hide negative ones. For example, a person with a bad credit rating could revoke the key under which that rating is distributed and create a new one, while selectively updating their positive credentials to the new key (e.g., have their alma mater create a new diploma). Key revocation authorities might combine forces with credit rating agencies to avoid such erasure of negative history, but this gives them even more centralized control - not merely over IDs but over important elements of reputation associated with those IDs. This further violates the principles of separation of powers and segregation of duties, providing added opportunity for fraudulent issue or revocation of IDs along with fraudulent communication of reputation information.

The current universal (non-cryptographic) key in the U.S., the social security number (SSN), is very difficult to revoke; it's much easier to change your name. This policy is probably no accident, since the biggest economic win of global name identification is the tracking of negative reputations, which revocation can defeat. As long as the SSN is a shared database key, not used for the purpose of securely identifying a faceless transaction, there is little need for revocation beyond the undesired erasure of negative history. Combining a secret authentication key, which must be revocable, with a public universal ID is quite problematic.



## Credit

One of the basic outstanding problems in smart contracts is the ensurement of credit. This comes up not only in loans, but in any other contract which involves a temporal lag between performance and reciprocal performance of the contractual terms.

In current practice, there are several partially effective processes for ensuring future performance:

\* Reputation (especially credit reports): often effective, but only to a point, as it is often hard for the debtor to accurately judge the future reputational effects of an action (e.g., failure to pay a bill, taking out too large a loan, etc.) that has clear, local, beneficial effects today. There is more imbalance in knowledge between current and distant consequences among individual consumers, but even among large organizations with high credit ratings it is not an irrelevant factor.

\* Secured transactions: liens, escrow, etc.

\* Garnishment of future income

\* Law enforcement, especially to enforce transfer of control over liened assets, garnishment, etc.

These processes have a fundamental property in common - they violate the privity of credit transactions - in other words, they bring in third parties to track reputations or enforce repayment. Do credit transactions entail a fundamental imbalance in incentives that can only be redressed by bringing in third parties, or can the security protocols be discovered which allow credit with minimal or no third party involvement?

### **Pseudonymous Credit Ratings**

Wei Dai [ [16](#) ] proposes three important variables for reputation economics:

*operating value*: expected future profits, given the reputation

*throw-away value*: profit from cheating, which ruins reputation

*replacement cost*: cost of recreating reputation

In turn, Peter Swire [ [17](#) ] describes two problems facing inadequately secured or unsecured loans to "credit names":

*Adverse selection*: Prior deadbeats can start fresh by signing up for the new service. Going in, it will be biased in favor of deadbeats. This problem may be addressed by using Chaumian credentials. These allow the established positive reputations of previous names to be carried over to the credit name, without allowing anyone to link the two names. Entrants without positive reputations can be rejected.

*The endgame problem*: A credit name can establish a good credit rating over time. When the limit is high enough, the borrower can quickly spend it all. A malicious borrower, with a good rating established under a previous name, can systematically profit at the expense of the lender, if the throw-away value is greater than the replacement cost. To address this problem, creditors will have to charge higher rates to new credit names and raise credit limits more slowly than for traceable names. Honest borrowers will subsidize the dishonest, to an even greater extent than they do in the current credit card system.

### **Secured Credit**

Secured credit need not violate privity if the physical control over the securing property can be shared. So that, for example, automobile credit can be secured as long as repossession is possible, as described in the example above.

A standard mechanism of secured credit applicable online is the escrow. An escrow is an intermediary trusted to hold messages until messages from both sides are received, and, optionally, their contents verified - to extent the content is verifiable, and at the expense of some privity. The escrow then sends the messages off to their recipients, along with receipts. Messages can contain any sort of data: content, a bearer certificate, etc.

### **Ripped Instruments**

Alice wants a New York City cab ride for which she's willing to pay \$100, but she doesn't trust Bob the taxi driver to get her there on time if she pays up front. Bob in turn doesn't trust Alice to pay at the end of the trip. Commerce can be consummated by Alice tearing a \$100 bill and giving half to Bob. After the trip she gives the other half to Bob, which he can then reassemble into a negotiable \$100 bill. Alice loses her incentive to not pay. Bob gains incentive to get her there on time as promised. Both have made what economists call a "credible commitment" to perform their respective parts of the contract. [Markus Jacobsson](#) has digitized this idea, coming up with a protocol for ripped digital cash. As with many other aspects of digital cash, the idea can be generalized to rip bearer certificates of any kind. If the transfer is double-blinded the transfer agent has no knowledge of the participants and therefore no bias to favor one over the other. The transfer agent must, however, be able to assess proof of performance, and the protocol is only workable where such proof (in the form of proof of receipt of a message, for example) is available.

The ripped bill is similar to using the transfer agent as an escrow agent. An advantage over using an escrow agent is that the need for extra anonymous channels between the parties and the escrow is avoided. A disadvantage is that the transfer agent now has taken on the major additional job of acting as an adjudicator, assessing proofs of performance (or at the very least, must be responsible for subcontracting out this job and implementing the adjudicator's judgement).

### **Credit Cards**

Credit cards provide relatively little protection from third parties, especially in the area of privacy, but they do have an interesting contractual feature worth noting, the chargeback. With chargebacks customers can get refunds on allegedly unwanted merchandise. The issuer tracks the number of chargebacks both for customers and merchants; too many chargebacks can get you booted out of the system. This provides an efficient mechanism for refunds without resorting to expensive tort proceedings. Many customers who read the fine print or otherwise learn about chargeback limits often do chargebacks despite receiving and enjoying the merchandise; there is no practical way for the issuer to detect such fraud, and so it can only be pruned by limiting the number of chargebacks per customer. Some merchants complain vociferously about such customer "theft", and it seems to make possible coordinated attacks to put merchants out of business, but nevertheless merchants sign up for credit cards, because that's what their customers have signed up for. The chargeback feature makes customers more comfortable purchasing goods of unknown quality, especially mail-order and over the Internet. Chargeback provides a crude but effective partial solution to the information asymmetry problem between retailers and consumers.

### **Interval Instruments**

Tim May [ [18](#) ] has proposed a "time release" form of money that becomes good only after a certain date. "Interval money"; that would expire after a certain date has also been proposed. These can be implemented by a digital mint expiring or activating special issues of digital cash, or by a third party issuing escrowed keys at specific times. Since these keys are encrypted against the escrow agent, and that agent doesn't know what they will be used for, the escrow agent has no incentive to cheat. A generalization of this is that transfer and redeemability are each associated with interval sets, or validity periods when each can and cannot be performed. This is analogous to clipping coupons on bonds.

### **Known Borrowers of Unknown Amounts**

Wei Dai and Hal Finney [ [19](#) ] have proposed a loan mix, to unlink borrowers from amount borrowed. The identity of the potential borrowers is still public, as well as the system for enforcing payment, but the actual amount loaned or borrowed remains unknown. The system starts with participants putting unknown amounts into a pot and getting receipts (bearer bonds) for these amount. All participants then borrow a standard amount. Whether a participant is a net borrower or a net creditor, and of what amount, remains private. When the loan is due all participants repay the standard amount, and the creditors reclaim the amounts on their bearer bonds. The amount actually borrowed (or, if negative, loaned) is the public amount borrowed minus the amount put into the pot. One consequence is that while negative reputations can still be accumulated when participants fail to pay back the standard amount, positive reputations are minimal, since participants who

borrow and loan are indistinguishable. If future creditors put stock in positive participation, one could gain a credit rating by perpetually participating as a net borrower of zero, by loaning and borrowing the same amounts.

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## Conclusion

Smart contracts combine protocols, users interfaces, and promises expressed via those interfaces, to formalize and secure relationships over public networks. This gives us new ways to formalize the digital relationships which are far more functional than their inanimate paper-based ancestors. Smart contracts reduce mental and computational transaction costs, imposed by either principals, third parties, or their tools.



Mark Miller [ [20](#) ] foresees that the law of the Internet, and the devices attached to it, will be provided by a grand merger of law and computer security. If so, smart contracts will be a major force behind this merger.

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## Notes

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  16. Wei Dai, personal communication.
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