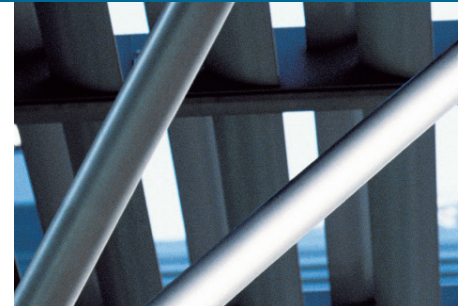# Client**Alert**

## Bank Advisory

July 2014

# New York State Department of Financial Services Proposed Regulatory Framework for Virtual Currency Businesses

On July 23, 2014, the New York State Department of Financial Services (the "NYDFS") proposed a regulatory framework for persons that engage in virtual currency activities involving New York (the "BitLicense Proposal").[1] In doing so, New York has become the first state to propose tailored rules for virtual currency businesses.[2] Comments on the BitLicense Proposal must be submitted to the NYDFS by or on September 6, 2014.

The industry applauds the NYDFS for taking this crucial step in creating a stable environment where legitimate virtual currency businesses can flourish. Without a doubt, regulation is necessary to provide legal certainty to industry participants, for the safeguarding of customer assets and to combat illegal activities.[3] On the other hand, the BitLicense Proposal is viewed by some to be so heavy-handed that it may stifle innovation and force virtual currency businesses to avoid any involvement with the State of New York.[4]

This Client Alert summarizes key elements of the BitLicense Proposal, identifies its notable features and discusses its ambiguities. In addition, the Appendix to this Client Alert describes which common business models in the virtual currency eco-system today would appear to be subject to the licensure requirement under the BitLicense Proposal.[5]

Ernest (Ernie) T. Patrikis
Partner, New York
+ 1 212 819 7903
epatrikis@whitecase.com

Harry Zhou
Associate, New York
+ 1 212 819 7920
hzhou@whitecase.com

---

1   NYDFS, Notice of Proposed Rulemaking on the Regulation of the Conduct of Virtual Currency Businesses, 36 N.Y. Reg. 14 (July 23, 2014), *available at* http://docs.dos.ny.gov/info/register/2014/july23/pdf/rulemaking.pdf (the "Notice"). Full text of the BitLicense Proposal is available from the NYDFS's website at http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf.

2   To date, virtual currency-related guidelines issued by other states primarily affirm that existing regulatory frameworks extend to virtual currency businesses. None of these guidelines proposes a specifically designed set of regulations as the NYDFS did. *See, e.g.*, Supervisory Memorandum 1037 from Texas Dep't of Banking on Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (Apr. 3, 2014), *available at* http://www.dob.texas.gov/public/uploads/files/Laws-Regulations/New-Actions/sm1037.pdf; Guidance Document from Kansas Office of the State Bank Commissioner on Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act (June 6, 2014), *available at* http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf.

3   *See, e.g.*, itBit to Comply with NY DFS BitLicense Regulatory Guidelines, Reuters (July 17, 2014), *available at* http://uk.reuters.com/article/2014/07/17/ny-itbit-bitlicense-idUKnPn46Yb9t+88+PRN20140717.

4   Bitcoin's First Chamber of Digital Commerce Announced in Chicago, CryptoCoins News (July 19, 2014), *available at* http://www.cryptocoinsnews.com/news/bitcoins-first-chamber-digital-commerce-announced-chicago/2014/07/19 ("[The BitLicense Proposal] is like telling a spaceship it has to operate on a train track"). These criticisms are similar to those on New York authorities' attempts to regulate newly emerged businesses, such as Lyft and AirBnB, which arguably do not fit into existing regulatory frameworks. *See* AirBnB's New York Problem, The New Yorker (Oct. 8, 2013), *available at* http://www.newyorker.com/currency-tag/airbnbs-new-york-problem.

5   This Client Alert is prepared for informational purposes only. The BitLicense Proposal, when and if enacted, may differ substantially from its current proposed form. Readers should not rely on this Client Alert as a compliance guide or definitive legal analysis. In addition, this Client Alert does not analyze legal requirements at the federal level, of states other than New York or of New York other than the BitLicense Proposal.

White & Case LLP
1155 Avenue of the Americas
New York, NY 10036
United States
+ 1 212 819 8200

## 1. Introduction to Virtual Currencies

A virtual currency is a digital medium of exchange, a unit of account or a store of value that has no legal tender[6] status.[7] Virtual currencies are typically decentralized in that they have no central issuers or administrators; rules governing the creation, transfer and ownership of a virtual currency are collectively agreed upon and transparently enforced by its users.[8]

Virtual currencies may be revolutionary in that transferring them is a bilateral,[9] near instant and usually free process. But their exchange rates to fiat money have historically been extremely volatile, as their value is decided purely by users' willingness to accept them. In addition, the pseudo-anonymous nature of virtual currencies has made them the preferred instruments for illicit trade and financial crimes.[10]

## 2. Statutory Authority

The BitLicense Proposal draws statutory authority from the New York Financial Services Law (the "FSL") and is to be codified as Part 200 under Title 23 of the New York Code, Rules and Regulations (the "N.Y.C.R.R."). The FSL authorizes the NYDFS to take necessary actions to, among other things, (i) ensure the continued solvency, safety, soundness and prudent conduct of the providers of financial products and services; (ii) eliminate financial fraud, other criminal abuse and unethical conduct in the industry; and (iii) educate and protect users of financial products and services and ensure that users are provided with timely and understandable information to make responsible decisions about financial products and services.[11] The BitLicense Proposal as drafted is consistent with these goals.

## 3. Key Elements of the BitLicense Proposal

### Scope

Under the BitLicense Proposal, persons that engage in one or more of the following activities involving the State of New York or a New York State resident must be licensed:[12]

- Receiving virtual currencies for transmission

- Securing, storing, or maintaining custody or control of virtual currencies on behalf of others

- Buying and selling virtual currencies as a customer business

- Performing retail conversion services between fiat currencies and virtual currencies or between virtual currencies and

- Controlling, administering or issuing a virtual currency

Merchants and consumers that use virtual currencies solely for the purchase or sale of goods or services are exempted.[13] There is no exemption based on the jurisdiction of formation or the physical location of a virtual currency business.

### Application

Application for a BitLicense must contain, among other things, (i) the applicant's identifying and organizational information; (ii) detailed personal information for the applicant's principal officers, stockholders and beneficiaries, including independent background reports, fingerprints and financial statements for each such key person; (iii) a description of the applicant's proposed, current and historical business; (iv) details of all banking arrangements; (v) all written policies and procedures; and (vi) the methodology the applicant would use to calculate the value of virtual currencies in fiat currencies.[14]

---

6   In general, a currency has legal tender status in a jurisdiction if sellers and creditors in that jurisdiction are required to accept the currency in exchange for goods sold and for the satisfaction of debts. *See*, *e.g.*, 31 U.S.C. § 5103 (Federal Reserve notes, commonly known as US dollars, are legal tender in the United States). But private parties are probably free to issue and voluntarily accept a currency that has no legal tender status as long as such activities do not violate the counterfeiting criminal statutes. *See* US Const. Art. I, § 10 (while the US Constitution prohibits states to emit their own currencies, that prohibition does not extend to private parties); *see, also*, Cong. Research Serv., Bitcoin: Questions, Answers, and Analysis of Legal Issues, (July 15, 2014), *available at* http://fas.org/sgp/crs/misc/R43339.pdf; *see, e.g.*, US to Auction Bitcoins on June 27, The Wall St. J. (June 13, 2014), *available at* http://online.wsj.com/articles/fbi-readies-144-341-bitcoins-for-sale-1402606244.

7   *See, generally*, FinCEN, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (Mar. 18, 2013), *available at* http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf; Financial Action Task Force, Virtual Currencies—Key Definitions and Potential AML/CFT Risks, (June 2014), *available at* http://www.fatf-gafi.org/topics/methodsandtrends/documents/virtual-currency-definitions-aml-cft-risk.html. Virtual currencies may be treated as commodities under the Commodities Exchange Act of 1936 and as goods under each state's commercial codes.

8   The BitLicense Proposal broadly defines virtual currency as "any type of digital unit that is used as a medium of exchange or a form of digitally stored value or that is incorporated into payment system technology," subject to exclusions for digital units in gaming platforms or customer loyalty programs that are inconvertible into fiat currency. BitLicense Proposal § 200.2(m).

9   Transfers of virtual currencies require no intermediary. In comparison, transfers of depositary account balances require the involvement of one or more banks to clear.

10  Prepared Testimony of Deputy US Attorney Richard B. Zabel, NYDFS Public Hearing on Law Enforcement and Virtual Currencies (Jan. 29, 2014), *available at* http://www.justice.gov/usao/nys/pressspeeches/2014/DFSLawEnforcementandVirtualCurrenciesHearing2014.php.

11  FSL § 201. The NYDFS provides no elaboration on why virtual currency meets the definition of "financial product or service."

12  BitLicense Proposal §§ 200.2(n) and 200.3(a).

13  BitLicense Proposal § 200.3(c)(2).

14  BitLicense Proposal § 200.4.

## Capital Requirements

Each licensee is subject to capital requirements. In setting a licensee's capital requirement, the NYDFS will consider, among other things, a licensee's financial soundness, transaction volume, and the amount of the trust account or bond required to be posted by the licensee for customer protection purposes.[15]

## Permitted Investments

A licensee may only invest its retained earnings in short-term high-quality investments such as (i) certificates of deposit issued by a bank regulated by a US bank supervisor; (ii) money market funds; and (iii) US government, agency and state government securities. A virtual currency is not a permitted investment.[16]

## Customer Asset Protection

Each licensee must maintain a bond or trust account denominated in US dollars in a form and amount acceptable to the NYDFS for the protection of customers.[17] In addition, each licensee must hold virtual currencies of the same type and amount as owed to its customers, and is prohibited from selling, transferring, lending, pledging or otherwise encumbering customer assets, including customers' virtual currencies.[18] This is similar to a law or a regulation that would prohibit a securities broker/dealer from lending customers' securities.

## Books and Records

Each licensee must keep detailed information for each transaction (including the identities and physical addresses of all parties involved), bank statements, customer account statements, board minutes, evidence demonstrating compliance with legal requirements, incident reports and other books and records in original and accessible form for at least ten years from the creation date.[19]

## Examinations

The NYDFS will examine each licensee at least once every two years to assess the licensee's financial soundness and compliance. Each licensee must permit the NYDFS to examine its books, records, and other information and also those of its affiliates.[20] Some licensees may consider the access to their respective affiliates' books and records to be overly intrusive.

## Reports and Financial Disclosures

Each licensee must submit (i) quarterly financial statements, and (ii) audited annual financial statements prepared in accordance with generally applicable accounting principles, to the NYDFS.[21]

## Anti-Money Laundering Program

Each licensee must maintain an anti-money laundering ("AML") program to ensure ongoing compliance with all applicable AML legal requirements. Some aspects of this AML program requirement appear to go beyond similar requirements by the Financial Crimes Enforcement Network of the US Treasury Department ("FinCEN").

The development of an AML program must begin with an AML risk assessment, the results of which should inform the program's design. The AML program must, among other things, provide for the following:

- **Customer Identification Program**
  Each licensee must, among other things, (i) verify the identity of a customer, including the customer's name, physical address and other identifying information and check the identity against the Specially Designated Nationals list maintained by the Office of Foreign Asset Control of the US Treasury Department upon account opening, and (ii) re-verify the identity of an accountholder prior to the initiation of each transaction having a value greater than US$3,000.[22] This re-verification requirement might greatly slow down any large-value transactions.

---

15  BitLicense Proposal § 200.8.

16  BitLicense Proposal § 200.8(b).

17  BitLicense Proposal § 200.9(a). The NYDFS does not require the bond or trust account balance to be no less than a specified minimum amount. This differs from a similar requirement applicable to NYDFS-licensed money transmitters. N.Y. Banking Law § 643(1) (a surety bond posted by a money transmitter shall be no less than US$500,000 in amount); 3 N.Y.C.R.R. § 406.13(b).

18  BitLicense Proposal §§ 200.9(b) and (c). This requirement raises the question whether a licensee that holds customer virtual currencies would be deemed a warehouseman under Article 7 of the New York U.C.C.

19  BitLicense Proposal § 200.12. 200.15(d) and (1).

20  BitLicense Proposal §§ 200.13(a) and (d).

21  BitLicense Proposal § 200.14.

22  BitLicense Proposal § 200.15(g)(4).

- **Recordkeeping**
  Each licensee must keep records of certain information for each virtual currency transaction, including the identities and physical addresses of the parties involved, the value of the transaction, the type of virtual currencies involved, the method of payment, the dates on which the transaction was initiated and completed, and a description of the transaction.[23]

- **Transaction Monitoring and Reporting**
  Each licensee must monitor transactions and report to the NYDFS (i) a transaction or a series of transactions in an aggregate value exceeding US$10,000 in one day by a single person and (ii) any transactions that signify illegal or criminal activities.[24]

## Cyber Security

Each licensee must maintain a cyber security program to ensure the reliability and security of the licensee's systems. The cyber security program must include, among other things, (i) annual penetration testing, (ii) an audit trail system that allows for the reconstruction of all financial transactions and accounting, (iii) third-party reviews of the source code of internally developed software, and (iv) evaluation of technical personnel competency.[25]

## Other

Other requirements of the BitLicense Proposal include the maintenance of a business continuity and disaster recovery plan, rules on advertising and marketing, and consumer protection requirements such as risk disclosure and the establishment of procedures to handle customer complaints.[26]

## 4. Notable Features

### Broad Definition of "Virtual Currency Business Activity"

The broad scope of activities the BitLicense Proposal captures is notable. For example, the definition of "virtual currency business activity" could subject payment processors, namely businesses that enable merchants to accept payments in virtual currencies, to licensure. Payment processors are, however, expressly excluded as money service businesses under FinCEN regulations.[27]

Furthermore, "virtual currency business activity" also covers "maintaining custody or control of Virtual Currency on behalf of others." It provides no exception for a licensee's transient custody of virtual currencies as an incidental result of its business model. Broadly applied, this provision could subject mining pool operators to licensure. Mining pool operators enable individual miners to aggregate mining powers and share the mined virtual currencies in proportion to mining powers contributed. It is typical for a mining pool to withhold the earned rewards for a miner until a cash-out threshold set by the miner has been reached. As such, a mining pool operator will almost always "maintain custody or control of" virtual currencies for miners, albeit only temporarily.

Finally, individual dealers on decentralized or peer-to-peer ("P2P") exchanges that buy and sell virtual currencies as a customer business must be licensed to do so;[28] the BitLicense Proposal provides no de minimis exception to the definition of "virtual currency business activity."

### Cash-Like Treatment of Virtual Currencies

In one instance, the NYDFS is proposing to regulate virtual currencies as if they were fiat currencies. The BitLicense Proposal would require a licensee to report any virtual currency transmission in an equivalent amount exceeding US$10,000, mirroring a financial institution's obligation to file a currency transaction report with FinCEN for a currency transaction exceeding US$10,000 in amount. This requirement represents a divergence from FinCEN's position, which reserves cash-like regulation of virtual currencies for a time when "daily financial life can be conducted for long stretches completely within a virtual currency environment."[29]

---

23  BitLicense Proposal § 200.15(d)(1).

24  BitLicense Proposal §§ 200.15(d)(2) and (3).

25  BitLicense Proposal § 200.16.

26  BitLicense Proposal §§ 200.17 – 20.

27  31 C.F.R. § 1010.100(ff)(5)(ii)(B) (a person acting as a payment processor to facilitate the purchase of, or payment of a bill for, a good or service is excluded from the definition of a money transmitter).

28  BitLicense Proposal § 200.2(n)(3).

29  (Under Sec'y of Terrorism & Fin. Intelligence David S. Cohen, Prepared Remarks on Addressing the Illicit Fin. Risks of Virtual Currency (Mar. 18, 2014) "[v]endors processing cash transactions are required to report transactions involving more than US$10,000 in cash to FinCEN, while those processing virtual currency transactions are not", *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl236.aspx), cited by FinCEN Director Jennifer Shaskey Calvery, Prepared Remarks at the ACAMS 19th Annual Int'l AML & Fin. Crime Conference (Mar. 18, 2014), *available at* http://www.fincen.gov/news_room/speech/pdf/20140318.pdf.

## Full Reserve

The BitLicense Proposal requires a licensee to hold customer assets, including virtual currencies, in the same type and amount as owed to its customers. No selling, lending, pledging or encumbering of customer assets is permissible.[30] This requirement might prohibit virtual currency exchanges from lending fiat or virtual currencies of some customers to other customers (i.e., margin trading).

## Enhanced Due Diligence and Foreign Licensees

Enhanced AML due diligence is required when a virtual currency business maintains a relationship with a customer or counterparty that is a non-US person.[31] No standards for enhanced due diligence are specified. For a non-US business that targets a foreign market, however, the majority of its customers and counterparties would be non-US persons. This requirement might, as a practicable matter, compel most non-US licensees to implement enhanced due diligence as the norm, which may prove to be overly burdensome and uneconomic.

## Third-Party Review of Proprietary Source Code

The BitLicense Proposal mandates an audit of the *source code* a licensee's internally developed software by an independent third-party at least annually.[32] This requirement is more stringent than audit standards that federal and state regulators impose on commercial banks with regard to their information technology.[33]

## 5. Ambiguities

The BitLicense Proposal as drafted contains considerable uncertainties. To begin with, the broad definition of virtual currency as "any type of digital unit that is used as a medium of exchange or a form of digitally stored value or that is incorporated into payment system technology"[34] appears to cover digital representation of fiat currency such as bank account balances recorded on a bank's computers. If so, banks worldwide would have to apply for BitLicenses, which is unlikely to be the NYDFS's intention.

It is also unclear what types of virtual currency activities would require licensing:

- The BitLicense Proposal does not specify what constitutes "control" of virtual currencies for the definition of "virtual currency business activity."[35] When a wallet provider holds the private key on behalf of a customer and the private key is the only one required to transfer the customer's virtual currencies, the wallet provider could be deemed to be in control of the customer's virtual currencies and, therefore, must be licensed.[36] But it is quite unclear whether a wallet provider that (i) has no ability to initiate transactions and (ii) enables customers to transfer stored virtual currencies even if the provider has been compromised or no longer exists is in "control" of the virtual currency maintained in the wallet.[37]

- While some businesses do not directly sell virtual currencies, they sell mining contracts that eventually pay out in virtual currencies. It is unclear whether sellers of mining contracts need to be licensed under the BitLicense Proposal.

---

30 BitLicense Proposal §§ 200.9(b) and (c).

31 BitLicense Proposal § 200.15(g)(2).

32 BitLicense Proposal § 200.16(e)(3).

33 *See*, *e.g.*, FFIEC, IT Examination Handbook—Audit, (Apr. 2012), *available at* http://ithandbook.ffiec.gov/ITBooklets/FFIEC_ITBooklet_Audit.pdf (IT auditors' use of computer-assisted audit techniques to conduct "black box" style testing of information systems is acceptable; no review of source code is required). Moreover, because virtual currency software is highly specialized, a virtual currency business may face difficulty in finding a qualified auditor.

34 BitLicense Proposal § 200.2(m).

35 BitLicense Proposal § 200.2(n)(2).

36 Conversely, producers and distributers of hardware or software wallet solutions are most likely not in control of customers' virtual currencies, even if the purpose of the hardware or software solutions is to facilitate virtual currency storage. *See*, *e.g.*, FinCEN, Application of FinCEN's Regs. to Virtual Currency Software Dev. and Certain Inv. Activity, FIN- 2014-R0002, (Jan. 30, 2014), *available at* http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R002.pdf.

37 Examples of such wallet providers include those that provide "Pay To Script Hash" ("P2SH") technology. Virtual currencies protected by P2SH or "multi-sig" technology can only be transferred when more than one private key cosigns the transaction. Leveraging the P2SH technology, a wallet provider may implement a key ownership scheme between itself and each of its customers such that the provider has no possible way to transfer the customers' virtual currencies even if the provider's systems have been compromised by malicious third parties, and the customers have the absolute power to transfer stored virtual currencies without any need for the wallet provider to cooperate or participate.

■ "Issuers" of virtual currencies must obtain a BitLicense.[38] It is unclear whether miners and developers of virtual currencies, especially developers who "issue" pre-mined virtual currencies by organizing sales or auctions, constitute "issuers," an undefined term.[39] While the NYDFS press release accompanying the BitLicense Proposal clarifies that miners are not issuers, this is unclear from the text of the BitLicense Proposal itself.

How licensees will have to comply with the requirements on suspicious activities reporting and the avoidance of identity obfuscation is also unclear:

■ The BitLicense Proposal appears to require a licensee that has filed a Suspicious Activity Report ("SAR") in accordance with FinCEN regulations to also file a separate report with the NYDFS.[40] The necessity of this requirement is unclear because a state regulatory authority, such as the NYDFS, may require a licensee to make available to it all SAR reports filed with FinCEN by the licensee, and the licensee is authorized by FinCEN to do so.[41]

■ No licensee may facilitate or knowingly allow the transfer of virtual currencies that has the effect of obfuscating the identity of the parties involved. While this suggests that a licensee may not engage in the tumbling or mixing[42] of virtual currencies to sever the chain of ownership, it is unclear whether the same requirement would prohibit a licensee from transferring a virtual currency that has mixing functionality built into its protocol.

Last but not least, it is unclear whether the BitLicense Proposal is the exclusive regulatory framework that virtual currency businesses need to comply with in New York. As discussed above, the BitLicense Proposal draws statutory authority from the FSL. No language in the BitLicense Proposal suggests, however, that Article XIII-B of the New York Banking Law and Part 406 under Title 3 of the New York Codes, Rules and Regulations, both relating to money transmitters, would not also apply. It would certainly be surprising if the BitLicense Proposal is an addition to, and not a replacement of, the New York regulatory framework on money transmitters.[43]

## Appendix[44]

| Sector | Business Model | BitLicense Required? |
|--------|----------------|----------------------|
| Exchange | Conventional exchanges | Yes. |
| | Virtual currency only exchanges | Yes. |
| | P2P exchanges with no embedded wallet | Exchange itself: No. Users of Exchange: Unclear. |
| | P2P exchange with embedded wallets | Exchange itself: Yes. Users of Exchange: Unclear. |
| Payment processor | Payment processors | Yes. |
| Dealer | Buying or selling virtual currencies as a customer business | Yes. |
| Wallet | Online wallet providers without P2SH support and store customers' private keys | Yes. |
| | Online wallet providers with P2SH support or do not have unfretted access to customers' private keys | Unclear. |
| | Mobile, browser extension, desktop, paper and hardware wallet providers | No. |
| Remittance | International remittance | Yes. |
| Mining | Mining pool operators | Yes. |
| | Mining contract dealers | Unclear. |
| | Mining hardware manufacturers | No. |
| Developer | Developers of virtual currencies | Unclear. |
| Mixer | Services designed to facilitate the obfuscation of the identity of customers or counterparties | Prohibited. |

---

38 BitLicense Proposal § 200.2(n)(5).

39 Miners engage in mining, the process through which miners use their computing power to verify and record payments into a virtual currency's public ledger in exchange for transaction fees or newly created virtual currencies.

40 BitLicense Proposal § 200.15(d)(3).

41 31 C.F.R. §§ 1022.320(a), (c) and (d)(1)(ii)(A)(2).

42 Transactions of a virtual currency are usually traceable in a public ledger known as the block chain. *See* Nakamoto, Satoshi, Bitcoin: A Peer-to-Peer Electronic Cash System (Oct. 13, 2008), *available at* https://bitcoin.org/bitcoin.pdf. Traceability of virtual currencies may be impaired, however, if transactions are intentionally channeled through a complex series of bundling and de-bundling that are designed to obscure the destinations of transfers. This process is known as "tumbling" or "mixing." *See* Financial Action Task Force, Virtual Currencies—Key Definitions and Potential AML/CFT Risks (June 2014), *available at* http://www.fatf-gafi.org/topics/methodsandtrends/documents/virtual-currency-definitions-aml-cft-risk.html.

43 The NYDFS states in its Notice that "[e]xisting laws and regulations do not cover proposed or current virtual currency business activity," suggesting that the NYDFS is probably of the opinion that New York laws and regulations for money transmitters may not apply to virtual currency businesses. *See* Notice, 36 N.Y. Reg. 15, *available at* http://docs.dos.ny.gov/info/register/2014/july23/pdf/rulemaking.pdf.

44 The analysis in this Appendix assumes that each business model described has a New York connection and the BitLicense Proposal is enacted as proposed.

whitecase.com