

NEW YORK PROPOSES BITLICENSE REGULATIONS FOR VIRTUAL CURRENCY BUSINESSES

On July 17, 2014, the New York Department of Financial Services (“DFS”) issued proposed regulations for public comment to create a “BitLicense regulatory framework” (the “BitLicense Framework”) for certain virtual currency businesses in New York. Under the proposed BitLicense Framework any person involved in a “Virtual Currency Business Activity” involving New York or a New York resident must obtain a license from DFS. The BitLicense Framework will be open for public comment for 45 days until September 6, 2014, unless extended.¹

The proposed BitLicense Framework defines a “Virtual Currency Business Activity” broadly to include transmitting, storing or holding for others, buying or selling as a customer business, performing retail conversion services, or controlling, administering, or issuing a virtual currency. A “Virtual Currency” is defined to include “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.”

Licensees or BitLicensees must comply with a number of detailed requirements, including meeting specific consumer protection and disclosure standards, safety and soundness requirements, and record-keeping and reporting mandates. These requirements apply to all individuals and entities engaged in a “Virtual Currency Business Activity” irrespective of the size of the business or the volume of transactions.

The BitLicense proposal represents the first comprehensive state regulatory proposal to address Virtual Currency businesses. While there are many issues that will require further clarification, the development of an appropriate regulatory framework is an important step forward for the maturation of the Bitcoin blockchain protocol and other Virtual Currency businesses. While the public comments will, no doubt, illuminate aspects of the proposal that should be adjusted, there is no question that further consumer and commercial development of Bitcoin and other virtual currencies requires appropriate state and federal oversight if it is to achieve the necessary level of business and consumer confidence.

DFS is to be commended for a thoughtful beginning to a dialogue that must address and balance the interests of entrepreneurs, established businesses, and consumers. In this regard,

¹ Press Release, NY DFS Releases Proposed BitLicense Regulatory Framework for Virtual Currency Firms (July 17, 2014), available at: <http://www.dfs.ny.gov/about/press2014/pr1407171.html>.

the apparent openness of Superintendent Benjamin Lawsky and DFS to working with all interested parties to find the right balance is encouraging.²

Background

Virtual currencies, particularly Bitcoin, have been the subject of widespread public commentary and some controversy as well as renewed regulatory scrutiny in recent years. The past two years have seen the closure of the Silk Road marketplace, which offered illegal as well as legal products and services, and the collapse of the Mt. Gox Bitcoin exchange, which suspended trading and reported substantial numbers of missing bitcoins. These events have highlighted the need for a sound regulatory framework for virtual currencies, particularly one like Bitcoin that is designed to operate without any central administrator or trusted third party. In contrast to legal tender or fiat currency, Bitcoin is 'simply' a distributed ledger – through the 'blockchain' - stored on computers that records all transactions involving that particular bitcoin. Significantly, while it can be used to transmit value, it can record virtually any type of information or record. These characteristics present opportunities for development of the protocol beyond the transmission of value. They also pose challenges to design a regulatory framework that focuses on financial interactions that may require regulatory oversight to protect consumers and prevent the abuses seen in Silk Road, while not stifling the potential for innovation through the open source protocol underlying the blockchain. Given past events, balanced regulation is essential for virtual currencies to operate in a sound and trustworthy manner and achieve their potential.

A number of federal and state regulators have been looking at virtual currency developments to determine whether there is a statutory basis for regulation and whether new regulation is warranted. The Federal Trade Commission, Securities and Exchange Commission, Commodity Futures Trading Commission, and the Consumer Financial Protection Bureau ("CFPB") have all begun some review. In fact, on August 11, 2014, the CFPB issued a consumer advisory warning consumers about the potential risks of virtual currencies, such as uncertain costs, volatile exchange rates, risks of hacking and scams, and the potential that some virtual currency companies may not offer help or refunds. At the same time, the CFPB announced that it would begin accepting complaints about virtual currency products and services.³

Among the key federal regulatory responses to Bitcoin was the March 18, 2013 Guidance by the U.S. Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN"), which ruled that "exchangers" and "administrators" of virtual currency were money transmitters and, as a result, money services businesses ("MSBs") and subject to all of FinCEN's registration, reporting, and recordkeeping requirements applicable to MSBs. The Guidance defined "exchangers" as businesses that exchanged virtual currency for legal tender

² See "Proposed Rules Expose Rifts Among Bitcoin Enthusiasts", Sydney Ember, *NY Times*, Dealbook, (July 29, 2014) (quoting Superintendent Benjamin Lawsky).

³ CFPB Warns Consumers About Bitcoin (Aug. 11, 2014), <http://www.consumerfinance.gov/newsroom/cfpb-warns-consumers-about-bitcoin/>.

or other virtual currency. “Administrators” were defined as those who issued or redeemed virtual currency. By contrast, users of virtual currency are not MSBs and not subject to FinCEN’s MSB regulations. This Guidance provided important definitions around who would be required to comply with FinCEN’s regulations, but it left many issues unresolved as well.⁴ The Internal Revenue Service (“IRS”) also has issued its own Guidance ruling that virtual currencies are “property” and subject to the IRS rules governing transactions in property.⁵

In addition to the federal regulations, there has been considerable interest in how state laws and regulations apply to Bitcoin use and businesses. While the treatment under many state laws remains relatively ambiguous, a number of states do require state licensing for certain Bitcoin operations under state money transmitter regulations. The continuing interest is demonstrated by the April 2014 adoption by the Conference of State Bank Supervisors (“CSBS”), through its Emerging Payments Task Force, and the North American Securities Administrators Association (“NASAA”) of model consumer guidance to assist regulatory agencies in defining appropriate consumer information and relevant factors for consumers to consider when using virtual currencies. However, until the proposal of the BitLicense framework, no state had proposed or adopted comprehensive regulations to address virtual currencies.

DFS’s BitLicense proposal is the product of a year-long inquiry by DFS, which included extensive public hearings and public comments. DFS Superintendent Benjamin Lawsky has been actively reviewing the consumer and other issues involved in a wide variety of virtual currency operations. For example, on March 11, 2014, Superintendent Lawsky separately issued an order inviting applications and proposals for the establishment of virtual currency exchanges in New York. While the BitLicense proposal is designed specifically to address virtual currency businesses broadly, DFS explicitly noted in the proposal that it would not apply to those businesses chartered to conduct exchange services.

This memorandum provides a brief overview of the BitLicense Framework, discusses the licensing application process, highlights key provisions regulating license holders, and compares BitLicense requirements to federal requirements established by FinCEN for money transmitters.

⁴ FinCEN, Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies (March 18, 2013), http://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html; see also FinCEN subsequently published rulings addressing some of those unresolved issues, including ruling that virtual currency “mining” “solely for the user’s own purposes” such as purchasing goods or services did not make the person a money transmitter. FinCEN, FinCEN Publishes Two Rulings on Virtual Currency Miners and Investors (Jan. 30, 2014), http://www.fincen.gov/news_room/nr/pdf/20140130.pdf.

⁵ Internal Revenue Service, IRS Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply, <http://www.irs.gov/pub/irs-drop/n-14-21.pdf> (March 25, 2014).

Overview, Scope and Application of the BitLicense Framework

Along with other states, New York regulates money transmitter businesses broadly consistent with the multi-state Uniform Money Services Act. Under New York law, anyone selling or issuing checks, or engaging in the business of receiving money for transmission or transmitting money must obtain a license from DFS. DFS regulates such money transmitters and requires them to post surety bonds, undergo periodic safety and soundness examinations, comply with applicable anti-money laundering laws, and maintain certain books and records.⁶ A number of states have already required money transmitter licenses for firms engaged in Virtual Currency transactions on behalf of institutions and/or individual consumers.

The BitLicense Framework applies many of these requirements to Virtual Currency Business Activities with adaptations and expansions of some of the requirements. As Superintendent Lawsky noted in introducing the BitLicense Framework, “[w]e have sought to strike an appropriate balance that helps protect consumers and root out illegal activity – without stifling beneficial innovation. Setting up common sense rules of the road is vital to the long-term future of the virtual currency industry, as well as the safety and soundness of customer assets.”

To address these issues, DFS proposes to require individuals and firms to obtain a license before engaging in Virtual Currency Business Activities. As noted above, the BitLicense Framework broadly defines “Virtual Currency Business Activity” as:

[T]he conduct of any one of the following types of activities involving New York or a New York Resident:

- (1) receiving Virtual Currency for transmission or transmitting the same;
- (2) securing, storing, or maintaining custody or control of Virtual Currency on behalf of others;
- (3) buying and selling Virtual Currency as a customer business;
- (4) performing retail conversion services, including the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency; or
- (5) controlling, administering, or issuing a Virtual Currency.

The proposed BitLicense Framework specifically exempts from the licensing requirement (1) merchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services; and (2) persons that are chartered under New York Banking Law to conduct exchange services and are approved by the Superintendent to engage in Virtual Currency Business Activity.

The definition of Virtual Currency Business Activity likely includes most customer-facing activities involving Virtual Currencies, including exchanges (unless exempted by complying with

⁶ NYBL Sections 640 to 652-b.

the other requirements applicable under the New York Banking Law), e-wallets, merchant payments processors, Virtual Currency dealers, administrators of Virtual Currencies (though it is unclear how that might apply to activities in a decentralized Virtual Currency such as Bitcoin), and likely Virtual Currency automated teller operations. It is less clear whether it encompasses other businesses that may hold or transmit Virtual Currencies, such as investment managers, traders, and miners that may engage in transmission or other customer-facing activities as part of their mining operations.

The press release introducing the BitLicense Framework provided some additional insight into how DFS may interpret the scope of these Virtual Currency Business Activity categories. First, the press release described categories (1) and (2) above as applying only to such activities done on behalf of customers. Presumably, this is meant to clarify that such elements are not intended to cover proprietary activities. Additionally, with respect to category (5) above, DFS noted that the activities of Virtual Currency miners are not covered. These issues are examples of issues that may benefit from clarification in the final rules.

Also, as referenced earlier in the discussion, DFS has broadly construed “Virtual Currency” to include “digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort.” However, DFS has excluded digital units “used solely within online gaming platforms with no market or application outside of those gaming platforms” or “used exclusively as part of a customer affinity or rewards program, and can be applied as solely as payment.” Similarly, these exclusions offer examples where further clarification in the final rules may be necessary to fully encompass the types of activities that DFS may not intend to be covered as Virtual Currency.

The definitions governing the scope of the BitLicense Framework raise a number of questions that may be important to achieving the announced goals of the BitLicense requirements, while encouraging innovation. Some clarification of the intended scope of the BitLicense Framework may be appropriate given the apparent breadth of the definitions. For example, the Bitcoin blockchain has many uses that focus on its qualities as a public ledger rather than the transmission of value. It may be appropriate to regulate those ledger functions in some way, but it may not be optimal to regulate them as purely financial transactions. In addition, some functions such as those provided through open-source wallets, where there is no currency exchange or custodial holding of customer assets, may not pose the kind of risks that DFS is seeking to address with the BitLicense Framework and whose activities should (as with Bitcoin miners) be excluded from the definition of Virtual Currency Business Activity. Similarly, while DFS has indicated that Bitcoin mining is not included as a Virtual Currency Business Activity, without further clarification, there may be uncertainty about whether that definition includes transfers to merchants to pay for commercial goods through intermediaries or to indirectly pay contractors with Bitcoin. Other commentators have noted that the breadth of the formulation applying the licensing requirements to anyone engaging in “activities involving New York or a New York Resident” may be overbroad given the flow of Bitcoin around the globe and through the internet. These and a number of other questions likely will be developed through the public comments.

Key Requirements of the Proposed BitLicense Framework

Under the proposal, each licensee would be required to comply with specified requirements and establish, maintain, and enforce policies and procedures reasonably designed to comply with the BitLicense Framework and all applicable federal and state laws. One feature of the BitLicense Framework that is likely to garner considerable comment is that the requirements apply to all licensees regardless of the type of Virtual Currency Business Activity they engage in or the transaction volume, number or type of customers, or the size of the licensee. While the proposed BitLicense Framework would provide the Superintendent with considerable discretion to tailor some of the requirements, it may be appropriate to provide further guidance or clarification about the applicability of some requirements to different types and sizes of Virtual Currency Business Activity businesses.

The principal requirements and policies are described below.

(1) Capital Requirements

Pursuant to Section 200.8 of the BitLicense Framework, each licensee would be required to keep “at all times such capital as the Superintendent determines is sufficient to ensure the financial integrity of the Licensee and its ongoing operations.” The minimum amount of capital each Licensee must maintain would be determined by the Superintendent based on consideration of a variety of factors, including total assets, total liabilities, actual and expected volume of Virtual Currency Business Activities, existing licenses, the degree of leverage, liquidity, and protection for customers.

In addition, each licensee would be required to invest its retained earnings and profits only in high-quality, investment-grade permissible investments with maturities of up to one year and denominated in US dollars. Such investments include certificates of deposit issued by federal or state regulated financial institutions; money market funds; state or municipal bonds; US securities or US agency securities. This may be another area where consideration should be given in the final BitLicense Framework to investment guidelines that may be more appropriate to different types of Virtual Currency businesses.

(2) Examinations, Recordkeeping, and Reporting

In connection with engaging in Virtual Currency Business Activity, each licensee must allow and assist the Superintendent to examine the licensee’s financial condition, safety and soundness⁷, management policies, and compliance with applicable laws, rules and regulations. The Superintendent may examine other matters such as any of the licensee’s activities outside of New York that may affect the licensee’s business involving New York or New York residents. The examination may occur when the Superintendent determines an examination is necessary or advisable, but no less than once every two years. At any time or in the event of a special

⁷ The licensee must permit and assist the Superintendent examine an affiliate of the licensee if the Superintendent determines it is necessary or advisable in determining the licensee’s financial condition or the safety and soundness of the licensee’s business practices.

investigation, each licensee must permit and assist the Superintendent to examine the licensee's facilities, books, records, accounts, documents, and other information. In some cases, the licensee may be required to take actions under foreign law (such as by obtaining consents or waivers) in order to facilitate DFS examinations while remaining in compliance with non-U.S. data protection, privacy or financial institution statutory and regulatory requirements.

Further, each licensee must make and maintain books and records that adequately demonstrate that the licensee is complying with all applicable federal and state laws. These books and records must include transaction information (including the amount, date, and precise time of the transaction, payment instructions, amount of fees and charges, and the names, account numbers and physical addresses of all parties), records or minutes of the board of directors, bank statements, and documents related to customer identification, compliance breaches, and investigations of customer complaints. Each licensee must preserve these books and records for a minimum of ten years⁸, and upon request, must provide DFS immediate access.

Also, each licensee has an obligation to submit quarterly financial statements to DFS within 45 days after the close of the licensee's fiscal quarter. These quarterly financial statements must include a statement of the licensee's financial condition, financial projections, and a statement showing compliance with all financial requirements outlined in BitLicense. Along with the financial statements, the licensee must submit audited financial statements with an opinion and evaluation by an independent certified public accountant of the licensee's accounting procedures and internal controls. Given the highly confidential nature of these materials to licensees, the final BitLicense Framework should provide that these materials are exempt from disclosure pursuant to certain exemptions to the New York Freedom of Information Law (N.Y. Pub. Off. Law §§ 84-90).

(3) Consumer Protection

Under the BitLicense Framework, each licensee must afford consumers with protections that safeguard their assets. First, each licensee must possess the same type and amount of Virtual Currency that it owes to a third party. Likewise, for its customers' benefit, the licensee must maintain a trust account or bond in US dollars in an amount determined by DFS. Each licensee may not impede access to the assets stored on behalf of a customer, including Virtual Currency, by selling, transferring, assigning, lending, pledging the assets to another.

Moreover, each licensee has an obligation to clearly and concisely disclose all material risks related to the licensee's products and services. These disclosures focus on the differences and risks that may arise in Virtual Currency transactions compared to fiat money transactions. For instance, each licensee, prior to the initial transaction, must inform the customer that Virtual Currency is not backed by the government or subject to Federal Deposit Insurance Corporation protections; the price of Virtual Currency is subject to volatile change that

⁸ For virtual currency deemed abandoned property, the BitLicense Framework would provide for a 5 year recordkeeping requirement.

may result in loss or tax liability; and Virtual Currency transactions are generally non-reversible, and, as such, losses from accidental or dishonest transactions are most likely non-recoverable.

Once the transaction is complete, each licensee must provide each customer with a receipt of the transaction and clear and conspicuous notice that the customer can bring any complaint to DFS's attention for additional review. The receipt must indicate the licensee's contact information, the transaction details, the charged fee, the exchange rate, a statement of the licensee's liability in the instance of failed or delayed delivery, and a statement of the licensee's refund policy.

(4) Anti-money Laundering Compliance

Each licensee must also implement and maintain an anti-money laundering ("AML") compliance program that offers internal controls, written policies, and procedures that will address the licensee's potential risk and ensure compliance with applicable AML laws. As part of its AML compliance program, the licensee must keep records of each Virtual Currency transaction, report transactions above \$10,000 in US dollars in one day, and report suspicious activity that indicate illegal or criminal activity. In addition, the licensee's AML compliance program should incorporate functions that reasonably and practicably verify each customer's identity. These functions should cross-reference the Specially Designated Nationals list kept by the Office of Foreign Assets Control of the U.S. Department of Treasury and preserve records verifying the customer's identity for potential examination. Enhanced due diligence will be required by licensees holding accounts with foreign individuals.⁹

Similarly, the licensee must designate qualified individual(s) that will be responsible for coordinating and monitoring daily compliance with the AML program. The designated personnel must receive ongoing training to assist in identifying suspicious transactions and maintaining records. While the BitLicense Framework mirrors the current FinCEN requirements in significant part, there are some variations in language that will require clarification to ensure full compliance under the parallel requirements.

(5) Cyber Security

Furthermore, each licensee must implement a written cyber security policy and maintain a cyber security program that will protect the licensee's electronic systems and any sensitive data stored on those systems from any unauthorized use or malicious acts. The licensee must designate a chief information security officer, who will be charged with overseeing and enforcing the licensee's cyber security program. At a minimum, the cyber security program should identify internal and external cyber risks, detect system intrusions and data breaches, and respond to and recover from identified breaches. Additionally, the cyber security program must incorporate audit functions that include penetration testing and vulnerability assessments of its electronic systems. The auditing functions should track and maintain data that creates an audit trail which

⁹ Enhanced due diligence may be required where there is a high-risk customer, a high-volume account, or an account where a suspicious activity report has been filed.

the license must protect and maintain for ten years. Annual reports assessing the licensee's cyber security must be submitted to DFS and presented to the licensee's board of directors.

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As the first comprehensive state regulatory proposal to address Virtual Currency businesses, the proposed BitLicense Framework will an important step towards further development of virtual currencies if the final rules provide clarity and confidence in the reliability of virtual currency businesses. While much innovation has been achieved in the absence of such regulation, certainly some of the difficulties experienced over the past two years are the result of inadequate attention by some participants to consumer protections and safe business practices. For the BitLicense Framework to accomplish its announced goals appropriate tailoring to achieve them while encouraging continued innovation will be vital.

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