Washington and Lee Law Review Online

Volume 71 | Issue 2 Article 4

9-2014

Did New York State Just Anoint Virtual Currencies by Proposing to Regulate Them, or Will Regulation Spoil Them for Some?

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Abstract

This Essay previews issues raised by the general subject of regulating virtual currencies and the specific efforts of New York State's Department of Financial Services' proposed Virtual Currency Regulatory Framework (the BitLicense) in particular. It focuses on five topics in the proposal and their interplay with the current regulation of "money services" and "money transmission" in other states, using the Commonwealth of Virginia and the State of Washington approaches on a few common topics for comparison purposes. It also asks whether regulation of virtual currencies is likely to cause more widespread adoption of virtual currencies or to frustrate the proponents and current users and so reduce the use of virtual currencies.

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I. Introduction

My late mother was a free thinker. She favored legalizing lots of products and behaviors to (a) remove their mystique or "cool factor," (b) make it easier to tax them, and (c) make them less attractive to criminals. She preferred regulating behaviors to criminalizing them. This year, as laws went into effect legalizing marijuana,[1] Mom's preference for regulating behavior rather than criminalizing it keeps coming to mind. I keep wondering what

1. *See, e.g.*, Niraj Chokshi, *Oregon Expects Up To $40 Million in New Revenue Annually If Voters Legalize Pot This Fall*, WASH. POST (Aug. 11, 2014), http://www.washingtonpost.com/blogs/govbeat/wp/2014/08/11/oregon-expects-up-to-40-million-in-new-revenue-annually-if-voters-legalize-pot-this-fall/ (last visited Sept. 22, 2014) (discussing the impact of Oregon's proposal to legalize marijuana) (on file with the Washington and Lee Law Review). Colorado and Washington legalized the recreational use of marijuana in 2012, and voters in Alaska and the District of Columbia will vote on similar legislation this fall. *Id.*

Mom would think about virtual currencies, another "product" that might have "just arrived" because of recent federal and pending state efforts to regulate aspects of their use.

Virtual currencies were regulated for some purposes at the federal level when the Treasury Department took its first steps in March 2013[2] and subsequent steps in 2014.[3] New York State's Department of Financial Services (DFS) announced in July 2014 the first specific licensing scheme (hereinafter referred to as "BitLicenses") for those engaging in "virtual currency business activity."[4] New York State's proposed BitLicense regime would require licensure,[5] prudential regulation,[6] certain transaction reporting,[7] and numerous user disclosures.[8]

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2. *See* FIN. CRIMES ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2013-G001, APPLICATION OF FINCEN'S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES (2013), http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf [hereinafter 2013 FinCEN Guidance] (clarifying "the applicability of the regulations implementing the Bank Security Act ("BSA") to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies").

3. *See* FIN. CRIMES ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2014-R001, APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS (2014), http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R001.pdf (explaining the application of FinCEN's regulations, specifically the Bank Secrecy Act, to virtual currency mining operations); FIN. CRIMES ENFORCEMENT NETWORK, DEP'T OF THE TREASURY, FIN-2014-R002, APPLICATION OF FINCEN"S REGULATIONS TO VIRTUAL CURRENCY SOFTWARE DEVELOPMENT AND CERTAIN INVESTMENT ACTIVITY (2014), http://www.fincen/gov/news_room/rp/rulings/pdf/FIN-2014-R002.pdf (responding to concerns about a company's qualifications as a money transmitter under the BSA when that company produces and distributes software to facilitate its purchase of virtual currency); U.S. INTERNAL REVENUE SERVICE, IRS NOTICE 2014-21 (Mar. 25, 2014), http://www.irs.gov/pub/irs-drop/n-14-21.pdf (describing "how existing general tax principles apply to transactions using virtual currency").

4. *See* Regulation of the Conduct of Virtual Currency Businesses, XXXVI N.Y. Reg. 14 (July 23, 2014) [hereinafter BitLicense Proposed Regulations] (discussing the licensing requirement for all virtual currency transactions). The full text of the regulations is referenced in the administrative register notice and can be found at http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf.

5. *See id.* § 200.3 (establishing requirements for licensure).

6. *See id.* § 200.7 (requiring the Licensee to comply with applicable laws, rules, and regulations).

7. *See, e.g.*, *id.* § 200.15(j)(5) (requiring the Licensee to designate individuals who shall "[p]rovide periodic reporting, at least annually, to the board of directors, senior management, or appropriate governing body").

8. *See, e.g.*, *id.* § 200.19(a) (requiring the Licensee to disclose "all material risks associated with its products, services, and activities"); *id.* § 200.14

New York State's proposed regulations will suit one of Mom's three tests—making products easier to tax. It also might make the use of virtual currencies safer. However, for proponents and many users of virtual currencies such as Bitcoin, regulation might "ruin" the mystique that virtual currencies and Bitcoin in particular have enjoyed. It is not clear whether encumbering virtual currencies is part of New York's strategy.

This Essay lays out the key features of New York State's BitLicense proposal and makes some preliminary observations about its features in Part II. In Parts III through V, it asks questions about regulating emerging technologies that are based on regulatory activity related to virtual currencies from March 1, 2013 to August 21, 2014. However, it does not answer all of these questions, primarily because the proposal is not final and is likely to be adjusted before becoming final.

II. New York State's BitLicense Proposal

On July 17, 2014, New York State's DFS proposed a comprehensive regulatory regime for those who support Bitcoin transactions or trade in Bitcoin.[9] This regime covers Bitcoin as media for transmitting value from one person to another and as a form of property.[10] It requires persons and entities that wish to engage in "virtual currency business activity" involving New York persons to first obtain a BitLicense to operate.[11] It also provides for mandatory disclosures,[12] an elaborate customer-identification

(requiring the Licensee to provide quarterly financial statements).

9. *See* BitLicense Proposed Regulations, *supra* note 4 (discussing the licensing requirement for all virtual currency transactions). For more information, see *Press Release, NY DFS Releases Proposed BitLicense Regulatory Framework for Virtual Currency Firms*, N.Y. STATE DEP'T OF FINANCIAL SERVS. (July 17, 2014), http://www.dfs.ny.gov/about/press2014/pr1407171.html (last visited Sept. 22, 2014) [hereinafter *Press Release*] (on file with the Washington and Lee Law Review).

10. *See* BitLicense Proposed Regulations, *supra* note 4, § 200.2(m) (defining "virtual currency").

11. *Id.* § 200.3(a).

12. *Id.* § 200.14.

program,[13] and more transaction reporting than the federal Bank Secrecy Act[14] requires.[15]

The proposal's definition of the key term "virtual currency business transaction" is expansive.[16] The definition covers most, but not all, of the types of electronic payments and financial services issues that my frequent co-author Stephen T. Middlebrook and I have been writing about for some years.[17]

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13. *Id.* § 200.15(g).

14. Currency and Foreign Transactions Reporting Act, Pub. L. No. 91-508, 84 Stat. 111 (codified as amended in scattered sections of 31 U.S.C.).

15. *Compare* BitLicense Proposed Regulations, *supra* note 4, § 200.14 (imposing detailed reporting requirements for all BitLicensees), *with* 31 U.S.C. §§ 5313–16 (2012) (imposing less onerous reporting requirements for currency transactions and transportation of currency above certain amounts).

16. *See* BitLicense Proposed Regulations, *supra* note 4, § 200.2(n)

> *Virtual Currency Business Activity* means the 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, holding, 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.

17. *See, e.g.*, Stephen T. Middlebrook & Sarah Jane Hughes, *Regulating Cryptocurrencies in the United States: Current Issues and Future Directions*, 40 WM. MITCHELL L. REV. 813, 815–22, 825–27 (2014) [hereinafter *Regulating Cryptocurrencies in the United States*] (reviewing recent cryptocurrency developments and discussing the expansive definition of "money transmitting" in 18 U.S.C. § 1960 (2012)); Stephen T. Middlebrook & Sarah Jane Hughes, *Virtual Uncertainty: Developments in the Law of Electronic Payments and Financial Services*, 69 BUS. LAW. 263, 264–69 (2013) (discussing developments in cryptocurrency law in 2013); Sarah Jane Hughes, Stephen T. Middlebrook, & Broox W. Peterson, *Developments in the Law Concerning Stored-Value Cards and Other Electronic Payments Products*, 63 BUS. LAW. 237, 255–62 (2007) (explaining the e-gold Ltd. prosecution and the definition of "money transmission" on which the case was centered).

As a prototype for virtual currency regulations, New York's prescriptive proposal immediately drew negative attention from the Bitcoin community[18] and others.[19] The balance of this Part presents some of the most salient features of the BitLicense proposal and offers preliminary thoughts on them.

The BitLicense proposal would require anyone who engages in "Virtual Currency Business Activity" to obtain a license,[20] meet certain capital requirements,[21] maintain records,[22] file financial reports,[23] be subject to examination,[24] and maintain collateral to secure any virtual currency held on behalf of others.[25] Licensees also will be required to appoint compliance officers and establish compliance policies;[26] create, monitor, and maintain both anti-money laundering programs[27] and cybersecurity programs;[28] and

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18. *See, e.g.*, Erik Voorhees, *Reflection on the NYDFS BitLicense Proposal and the Right of Privacy*, MONEY & ST. (July 18, 2014), http://moneyandstate.com/reflections-right-privacy-response-nydfs-bitcoin-proposal (last visited Sept. 22, 2014) (criticizing New York's BitLicense regulations) (on file with the Washington and Lee Law Review); Tone Vays, *Top 5 Issues with the NYSDFS BitLicense Proposal*, COINTELEGRAPH (July 24, 2014, 11:18 PM), http://cointelegraph.com/news/112141/top-5-issues-with-the-nysdfs-bitlicense-proposal (last visited Sept. 22, 2014) (explaining various issues with the BitLicense proposal and providing links to three additional commentaries on the BitLicense proposal) (on file with the Washington and Lee Law Review); Ryan Selkin, *Bitcoin at a Crossroads: Tackling the BitLicense*, TWO BIT IDIOT (July 19, 2014, 9:20 AM), http://two-bit-idiot.tumblr.com/post/92143258184/bitcoin-at-a-crossroads-tackling-the-bitlicense (last visited Sept. 22, 2014) (dividing aspects of the proposed BitLicense into "the good, the bad, and the ugly") (on file with the Washington and Lee Law Review).

19. *See, e.g.*, JERRY BRITO & ELI DOURADO, COMMENTS TO THE NEW YORK DEPARTMENT OF FINANCIAL SERVICES ON THE PROPOSED VIRTUAL CURRENCY REGULATORY FRAMEWORK (2014), http://mercatus.org/sites/default/files/BritoDourado-NY-Virtual-Currency-comment-081414.pdf. Messrs. Brito and Dourado address issues they have with the proposed Virtual Currencies Regulatory Framework not discussed in this Essay; readers will want to read their work in full.

20. *See* BitLicense Proposed Regulations, *supra* note 4, § 200.3(a).

21. *Id*. § 200.8.

22. *Id*. § 200.12.

23. *Id*. § 200.14.

24. *Id*. § 200.13.

25. *Id*. § 200.9.

26. *Id*. § 200.7.

27. *Id*. § 200.15.

28. *Id*. § 200.16.

have and share with the DFS their business-continuity plans.[29] The DFS will have authority to review and approve each licensee's advertising and marketing materials.[30] Licensees will be required to make detailed disclosures to customers before a transaction.[31] In addition, and beyond some types of consumer financial disclosure requirements, the licensee will be required to obtain the user's acknowledgement of each disclosure,[32] provide receipts for transactions,[33] and establish a complaint resolution procedure.[34]

The proposal also goes well beyond the requirements for banks and others involved in "electronic fund transfers" governed by federal law:[35] Licensees must implement an anti-fraud policy and provide for customers who are defrauded to receive compensation.[36] Additionally, in contrast to the manner in which many non-bank providers operate, BitLicense holders will be required to obtain advance approval from the DFS for material changes to their products and services.[37]

A. Proposed Definition of "Virtual Currency"

The BitLicense proposal defines "virtual currency" as "any type of digital unit that is used as a medium of exchange or form of digitally stored value or that is incorporated into payment system technology."[38] The term is to be "broadly construed," but it does not include digital units used solely as part of customer affinity or rewards programs that can only be redeemed by designated merchants and may not be converted to cash; nor does

29. *Id.* § 200.17.

30. *Id.* § 200.18(b).

31. *Id.* § 200.19(a)–(c).

32. *Id.* § 200.19(d).

33. *Id.* § 200.19(e).

34. *Id.* § 200.20.

35. *See infra* notes 83–84 and accompanying text (describing Regulation E, the regulatory framework governing institutions involved in electronic fund transfers).

36. BitLicense Proposed Regulations, *supra* note 4, § 200.19(g).

37. *Id.* § 200.10.

38. *Id.* § 200.2(m).

the term include currencies used only within online gaming platforms.[39] The proposed definition does not follow the Financial Crimes Enforcement Network (FinCEN) regulatory scheme, which only covers virtual currencies that are used as substitutes for "legal tender."[40] Without this limitation in the proposed BitLicense definition, it is unclear what prevents the BitLicense proposal from applying to other electronic forms of legal tender—specifically, electronic access to dollar-denominated demand deposit accounts.[41]

B. Definition of "Virtual Currency Business Activity"

Under the proposed regulations, a license is required for those individuals and entities that wish to engage in "Virtual Currency Business Activity."[42] The term is defined to include "transmitting" virtual currency; "securing, storing, holding or maintaining custody or control" of virtual currency for others; buying and selling virtual currency "as a customer business"; performing "retail conversion services"; or "controlling, administering, or issuing a Virtual Currency."[43] The scope of activities included here is significantly broader than that traditionally covered by the "money services" and "money

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39. *Id*.

40. *See* 2013 FinCEN Guidance, *supra* note 2, at 1 (noting that virtual currency is not legal tender and explicitly stating that FinCEN guidance only applies to virtual currencies that are "convertible" into legal tender). Under the FinCEN scheme, only certain virtual currency activities constitute "money transmission." *See id.* at 3 (concluding that certain administrators and exchangers of virtual currency fall within the definition of "money transmitters" and are thus subject to federal regulation). For more information, see THE CLEARING HOUSE & INDEP. CMTY. BANKERS OF AM., VIRTUAL CURRENCY: RISKS AND REGULATION (2014).

41. *See* Stephen T. Middlebrook, Analysis of the New York State Department of Financial Services Proposed BitLicense Regulations 12 (Jul. 27, 2014) (unpublished manuscript) [hereinafter Middlebrook Manuscript] (noting that the use of term "fiat currency" at § 200.2(d) carries with it many unhelpful connotations that may obscure legal and policy discussions about virtual currency, and suggesting that the DFS use the term "legal tender" instead of "fiat currency") (on file with the Washington and Lee Law Review).

42. BitLicense Proposed Regulations, *supra* note 4, § 200.3(a).

43. *Id*. § 200.2(n).

transmitter" statutes upon which these regulations are based.[44] For example, it is unclear whether providing software services, which enable some of these activities, might trigger a licensing obligation.

The proposed BitLicense also might apply to depository institutions that are generally exempt from similar money transmitter requirements.[45] Although there is a limited exemption from the BitLicense requirements for entities licensed as exchange services,[46] banks that want to provide virtual currency services would appear to be required to obtain the additional BitLicense.[47] This problem may be resolved if the final regulation more effectively distinguishes between "legal tender" and virtual currency acting as a substitute for legal tender.

The definition of "Virtual Currency Business Activity" is limited to activities "involving New York or a New York resident."[48] This phrase is so broad that it raises more questions about the proposal's scope than it answers. For nearly all virtual currency participants, but particularly for math-based currencies such as Bitcoin, it is extremely difficult to prevent one's business activities from involving a particular jurisdiction or certain residents in many jurisdictions. More attention to this portion of the BitLicense proposal should be given in order to clarify the application to New York residents who use virtual currencies while traveling to other states and similar in-person interactions with providers.[49] Mr. Middlebrook recently suggested that the

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44. *See, e.g.*, WASH. REV. CODE § 19.230.010(17)–(19) (2012) (defining "money services," "money transmission," and "money transmitter"); VA. CODE ANN. § 6.2-1900 (2012) (providing definitions of various terms, including "money transmission" and "money transmitter").

45. *See, e.g.*, WASH. REV. CODE § 19.230.030 (requiring licensure for businesses engaged in money transmission); VA. CODE ANN. § 6.2-1901 (requiring licensure for businesses "selling money orders or engag[ing] in the business of money transmission").

46. BitLicense Proposed Regulations, *supra* note 4, § 200.3(c).

47. *See id.* § 200.3(a) ("No Person shall, without a license obtained from the superintendent as provided in this Part, engage in any Virtual Currency Business Activity.").

48. *Id.* § 200.2(n).

49. The potential extraterritorial application of the DFS proposal may run afoul of the Commerce Clause to the United States Constitution. As the United States Court of Appeals for the Seventh Circuit explained in *Midwest Title Loans, Inc. v. Mills*, 593 F.3d 660 (7th Cir. 2010), *cert. denied*, 131 S. Ct. 83

DFS should craft a jurisdictional "safe harbor" delineating what steps a virtual currency business would need to take in order to be assured that it was not engaged in activity involving New York and thus not subject to regulation.[50]

C. Liquidity Requirements

The BitLicense proposal requires that entities holding virtual funds on behalf of another person must hold the *same type and amount of virtual currency* that the bank owes the person who deposited the funds.[51] This requirement will mean that the entity that is serving as the transfer agent will need to hold precisely the same virtual currency and the identical amount in that currency—that is, $1,000 worth of Bitcoin for each $1,000 of

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(2010):

> The interference [by the State of Indiana] was with a commercial activity that occurred in another state[, Illinois]. Each title loan that Midwest made to a Hoosier was in the form of a check, drawn on an Illinois bank, that was handed to the borrower at Midwest's loan office and could be cashed there. Illinois was also where the conditional transfer of title to the collateral was made (the handing over of the keys-the "pawn"), and where the payments required by the loan agreement were received by Midwest. The contract was, in short, made and executed in Illinois, and that is enough to show that the territorial-application provision violates the commerce clause.

Id. at 669. The Seventh Circuit upheld an injunction entered by a district court against enforcement of an Indiana Code provision that involved the extraterritorial application of a law designed to limit predatory lending practices. *See id.* at 667–69 (affirming the injunction and concluding that "allow[ing] Indiana to apply its law against title loans when its residents transact in a different state that has a different law would be arbitrarily to exalt the public policy of one state over that of another"); *see also* IND. CODE § 24-4.5-1-201 (2014) (requiring extraterritorial application of certain provisions and state licensure requirements for out-of-state lenders marketing to and soliciting loans from residents of Indiana). The Seventh Circuit concluded that the violation of the Commerce Clause resulted, as described above, from the fact that the consumer borrower physically traveled into Illinois to execute the transaction and that all events related to it took place in Illinois, where the transaction was not covered by Indiana's laws. *Midwest Title Loans,* 593 F.3d at 669. New York may face similar issues if it tries to apply the DFS regulations to virtual currency transactions between non-New York citizens and New York residents living outside New York.

50. Middlebrook Manuscript, *supra* note 41, at 12.

51. BitLicense Proposed Regulations, *supra* note 4, § 200.9(b).

Bitcoin being transferred, not $1,000 in some form of virtual currency such as Dogecoin.[52]

The requirement of like-kind holdings is new even for money transmitters, who are more likely by state statutes and regulations to be required to hold funds or other forms of "permissible investments" in certain ranges. For example, Washington State requires that licensees "shall maintain, at all times, permissible investments that have a market value computed in accordance with generally accepted accounting principles of not less than the amount of the licensee's average outstanding money transmission liability," describes how to calculate the average outstanding amount of liability, and grants the director authority to limit the types of holdings by regulation unless the type is "money, time deposits, savings deposits, demand deposits, and certificates of deposit issued by a federally insured financial institution."[53] Washington State's Money Services Act also deals with liquidity issues in three additional provisions—in terms of requirements for surety bonds or security,[54] tangible net worth for holders of money transmitter licenses,[55] and types of permissible investments.[56]

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52. *See Comparison of Cryptocurrencies*, BITCOIN WIKI (last updated Sept. 22, 2014, 1:34 PM), https://en.bitcoin.it/wiki/List_of_alternative_crypto currencies (last visited Sept. 22, 2014) (showing launch dates, market caps, and protocols for 15 of the largest cryptocurrencies, including Dogecoin and Bitcoin) (on file with the Washington and Lee Law Review).

53. WASH. REV. CODE § 19.230.200(1)-(2) (2013) (requiring licensees to maintain permissible investments that have a market value computed in accordance with generally accepted accounting principles of not less than the amount of the licensee's average outstanding money transmission liability).

54. *See id.* § 19.230.050(1) (mandating that amount of the surety bond or other security must be equivalent to the previous year's money transmission dollar volume, with a minimum amount of "at least $10,000 not to exceed $550,000"). The director may require security up to $1,000,000 if a licensee's financial condition "so requires," including when it has experienced a reduction in net worth, financial losses, or in other cases. *Id.* § 19.230.050(6).

55. *See id* § 19.230.060 (requiring net worth to be "at least $10,000" and not more than $3,000,000; if the net worth declines to less than the required amount, the director may commence an action for license suspension pursuant to WASH. REV. CODE § 19.230.230).

56. *See id.* § 19.230.210(1)(a)-(f) (listing dozens of categories of acceptable investments, including cash, time deposits, savings deposits, demand deposits, certificates of deposit, senior debt obligations of insured depositary institutions, highly rated securities, and governmental bonds, among others).

The one-for-one ratio in the BitLicense requirement is more like the prevailing model for non-depository "money transmitters" in states such as Virginia, which also uses a one-to-one ratio requirement for monies being transmitted.[57] This means that a money transmitter in Virginia such as Western Union would have to hold identical value for the monies being transmitted.

A third model that requires neither the like-kind holding nor the one-to-one ratio is the "deposit" model, which relies on the principle of "fractional deposits."[58]

D. Anti-Money-Laundering and Customer-Identification Requirements

U.S. anti-money-laundering ("AML") laws generally allow for entity-driven, risk-based assessments and the implementation, monitoring, and repetitive adjustments and retraining of personnel to ensure compliance.[59] They give covered businesses considerable latitude to assess their own risks and to determine various means to avoid transactions and individuals or entities seeking to launder money through their facilities.

The proposed BitLicense regulatory scheme is more prescriptive than risk-based.[60] Customer identification is not a general requirement under state money service business or money transmitter acts.[61] The USA PATRIOT Act[62] imposed § 326 "customer identification program" requirements only on

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57. *See, e.g.*, VA. CODE ANN. § 6.2-1900 (2012).

58. *See* JOSHUA N. FEINMAN, RESERVE REQUIREMENTS: HISTORY, CURRENT PRACTICE, AND POTENTIAL REFORM 573 (1993), http://www.federalreserve.gov/monetarypolicy/0693lead.pdf (explaining that a fractional reserve system is "one with reserve requirements of less than 100 percent").

59. *See, e.g.*, 31 C.F.R. §§ 1000–1099 (2013) (containing the implementing regulations for FinCEN).

60. *See infra* notes 61–72 and accompanying text (comparing and contrasting the prescriptive portions of the BitLicense proposal, which includes suspicious activity reporting and record-retention requirements, with more risk-based, situational state and federal statutes already in place).

61. *See, e.g.*, VA. CODE ANN. §§ 6.2-1916–1917 (listing reporting requirements for licensees, none of which include customer identification).

62. Pub. L. No. 107-56, 115 Stat. 272 (codified as amended in scattered sections of 8, 12, 15, 18, 20, 31, 42, 47, 49, and 50 U.S.C.).

those "financial institutions"[63] that Treasury Department regulations required to adopt § 352 "anti-money-laundering-compliance programs."[64]

In contrast, the BitLicense scheme requires that the licensee capture customer identification information that includes the account holder's name and physical location.[65] The federal "customer-identification-program" requirement does not require capture or retention of the customer's "physical location."[66]

In addition to other new AML and customer-identification requirements in the BitLicense proposal, the proposal requires licensees to file "suspicious activity reports" with the State of New York, even if FinCEN's regulations would not require a filing.[67] The proposed regulations also require that suspicious activity reports be filed within twenty-four hours,[68] as opposed to the "within 30 days" period allowed by FinCEN.[69] The virtual currency community likely will see these requirements as problematic because they exceed the duties created under FinCEN's regulations.[70] Another issue that affects AML and the

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63. *See* 31 U.S.C. § 5312(a)(2) (2012) (defining "financial institution").

64. *See id.* § 5318(h) (requiring financial institutions to establish and maintain "anti-money laundering programs"). The interagency rule implementing the customer-identification program was codified at 31 C.F.R. § 103.121 (2013).

65. BitLicense Proposed Regulations, *supra* note 4, § 200.15(g)(1).

66. *See* 31 C.F.R § 1020.220 (2013) (requiring certain financial institutions to record and verify customers' names, addresses and the identities, account numbers, and federal tax identification (SSN or EIN) numbers if the transaction is being conducted on behalf of another person or entity). The Bitcoin community comments on the New York State proposal raised issues about the feasibility of a requirement to record the customer's physical location because of the ease of adopting a situs different from an actual situs, as well as attendant enforcement issues for a wallet or exchange that collected information that later proved to be inaccurate.

67. BitLicense Proposed Regulations, *supra* note 4, § 200.15(d)(3). FinCEN's regulations require a filing if a transaction is suspicious, or if it involves a transfer of $2,000 or more. *See* 31 C.F.R. § 1022.320 (2013) (requiring reports for transactions "of at least $2,000").

68. BitLicense Proposed Regulations, *supra* note 4, § 200.15(d)(2) (requiring the Licensee to report within twenty-four hours any transactions executed by one person in one day and exceeding $10,000).

69. *See* 31 C.F.R. § 1022.320(b)(3) (2013) (noting that money service businesses have thirty days to file suspicious activity reports).

70. This prospect could be especially intimidating because the DFS has

suspicious activity reporting responsibility include a ten-year record-retention period for transactions,[71] as compared with five years under FinCEN's regulations.[72] The more onerous DFS proposals concerning the scope of suspicious activity reporting and the timeframe within which reports must reach the DFS both are vulnerable to preemption claims.

My colleague, Mr. Middlebrook, asked two additional questions about the scope of the DFS's AML set of proposals: First, if DFS collects these suspicious activity reports, what will it do with the data?[73] And, second, will the data received enjoy the same protections, such as under the Right to Financial Privacy Act of 1978[74] and the Fair Credit Reporting Act,[75] that they currently have under federal law?[76]

E. Consumer Disclosures

The proposed BitLicense borrows disclosure requirements from other regulatory silos and takes them one or more steps further. For example, its prescriptive consumer disclosure requirements exceed those imposed under many of the models for

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been so aggressive in pursuing violations by foreign banks, particularly violations of the U.S. Bank Secrecy Act and economic sanctions laws. *See, e.g.*, Michael Virtanen, *NY Regulators Sanction Standard Chartered Bank*, YAHOO! NEWS (Aug. 19, 2014, 3:11 PM), http://news.yahoo.com/ny-regulators-sanction-standard-chartered-bank-181510618.html (last visited Sept. 22, 2014) (describing how DFS imposed a $300 million penalty on Standard Chartered Bank for failure to fix compliance problems with the terms of a two-year-old settlement regarding a federal prohibition against money laundering) (on file with the Washington and Lee Law Review).

71. BitLicense Proposed Regulations, *supra* note 4, § 200.12(a).

72. 31 C.F.R. § 1010.306(a)(2).

73. Middlebrook Manuscript, *supra* note 41, at 12–13.

74. *See* 12 U.S.C. §§ 3401–22 (2012) (creating, with exceptions, statutory rights to replace the Fourth Amendment protection for records held by "financial institutions" as that term is defined in 12 U.S.C. § 3401(1) in partial response to the Supreme Court's ruling in *United States v. Miller*, 425 U.S. 435 (1976)).

75. *See* 15 U.S.C. §§ 1681–1681x (2012) (containing limitations on sharing of information from consumers' credit histories with law enforcement agencies and others).

76. Middlebrook Manuscript, *supra* note 41, at 12–13.

analogous products.[77] An example of this is the BitLicense proposal requirement that licensees make initial disclosures that will inform customers of a long list of "material risks" associated with virtual currency, including (1) the fact that it is not legal tender or FDIC insured and may be adversely affected by legislative and regulatory change, (2) payment/transfer transactions are generally irreversible, and (3) there is no assurance that other parties will continue to accept virtual currency.[78] Additionally, BitLicensees must disclose "general terms and conditions" such as the customer's liability for unauthorized transactions; privacy policies; and the customer's right to receive statements, receipts, and prior notice of changes.[79] In addition to the initial sets of disclosures, the BitLicense proposal will require transactional disclosures to be made prior to each transaction, detailing the type and amount of the transaction and any fees to be assessed along with a warning that the transaction may not be reversed.[80] The BitLicense proposal also requires that a licensee ensure that all disclosures are "acknowledged as received by customers."[81] This acknowledgement requirement is unprecedented in U.S. regulation of financial services.

This disclosure scheme is far more rigid and detailed than that imposed on money transmitters and electronic payment providers. In contrast, the regulation implementing the federal Electronic Fund Transfer Act,[82] "Regulation E,"[83] does not require "material risk" disclosures, and its required initial disclosures focus on product features and limitations, liability, and fees.[84] Even in broker-dealer and investment advisor contexts, "material facts" disclosure requirements are limited to situations in which the provider owes a fiduciary duty to the customer.[85]

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77. BitLicense Proposed Regulations, *supra* note 4, § 200.19.

78. *Id.* § 200.19(a)(1)–(3), (6).

79. *Id.* § 200.19(b)(1), (4)–(7).

80. *Id.* § 200.19(c).

81. *Id.* § 200.19(d).

82. 15 U.S.C. §§ 1693–1693r (2012).

83. 12 C.F.R. § 205.7 (2013)

84. *Id.*

85. Investment advisors are considered to have fiduciary responsibilities to clients. *See* SEC. & EXCH. COMM'N, DUTIES OF BROKERS, DEALERS, AND

F. Consumer Recovery for Fraud

One of the most potentially burdensome provisions in the BitLicense proposal is language that appears to make licensees liable for fraud: "Licensees are prohibited from engaging in fraudulent activity and customers of Licensees that are victims of fraud shall be entitled to claim compensation from any trust account, bond, or insurance policy maintained by the Licensee."[86] This portion of the BitLicense proposal raises a number of issues. Among these are:

- The proposal renders licensees liable for engaging in fraudulent activity. That seems relatively straightforward. However, under the Money Services and Money Transmitter regimes in Washington State and Virginia used elsewhere in this Essay for comparison purposes, licensees are responsible for failure to perform—in the sense that they do not deliver the funds entrusted to them to the named beneficiary. They are not

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INVESTMENT ADVISERS, EXCHANGE ACT RELEASE NO. 34,69013, 3 (Mar. 6, 2013), http://www.sec.gov/rules/other/2013/34-69013.pdf [hereinafter SEC Release 34,69013] ("Investment advisers are fiduciaries to their clients, and their regulation under the Investment Advisers Act of 1940 ("Advisers Act") is largely principles-based."). Broker-dealers are not normally treated as fiduciaries to their clients. *Id.*; *see also id.* at 3, n.3 (acknowledging that broker-dealers "may have a fiduciary duty under certain circumstances"). State common law normally defines the instances in which broker-dealers owe duties to their customers, including when the broker-dealer exercises "discretion or control over customer assets, or [has] a relationship of trust and confidence with their customers"; the broker-dealer then "owes a fiduciary duty similar to that of investment advisors." *Id.* (citing United States v. Skelly, 442 F.3d 94, 98 (2d Cir. 2006) (additional citations omitted)). For more information and relevant case law, see SEC. & EXCH. COMM'N, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS AS REQUIRED BY SECTION 913 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 54–55 (2011), www.sec.gov/news/studies/2011/913studyfinal.pdf (explaining that a broker-dealer may have a fiduciary duty under some circumstances and citing to relevant case law). In the Study, the SEC's staff made recommendations for "enhanced retail customer protections" and also to "decrease retail customers' confusion about the standard of conduct owed to them when their financial professional provides them personalized investment advice." SEC Release 34,69013, at 6 (internal citations omitted).

86. BitLicense Proposed Regulations, *supra* note 4, § 200.19(g).

explicitly held liable for conduct that otherwise is "fraudulent."[87]

- The proposal does not define the word "fraud." Proving a prima facie case for fraud requires a showing of "a material misrepresentation of a fact, knowledge of its falsity, an intent to induce reliance, justifiable reliance by the plaintiff[,] and damages."[88] Because these elements are "narrowly defined," they require "proof by clear and convincing evidence."[89]
- The proposal does not describe a claims process. Despite the reference to claims, it is unclear whether the regulation is intended to create a private right of action for users generally (not just consumers) or whether it would limit a licensee's liability to the value of any trust account, bond, or insurance policy that the DFS may require of holders of BitLicenses.[90]

III. General Questions about Regulating New Technologies Such as Virtual Currencies

Since my first exploration of issues surrounding e-payments nearly twenty years ago,[91] I have been asking a series of questions about regulating them. These questions include:

- For what purposes do we regulate emerging technologies?
- At what point should we regulate emerging technologies?
- Could the point for regulation differ depending on the nature of regulations being contemplated?

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87. *See* VA. CODE ANN. § 6.2-1904(C) (2012) (requiring bond to remain in effect for five years after the licensee ceases to be in business); WASH. REV. CODE § 19.230.050 (2012) (same).

88. Eurycleia Partners, LP v. Seward & Kissel, LLP, 910 N.E.2d 976, 979 (N.Y. 2009).

89. Gaidon v. Guardian Life Ins. Co. of Am., 725 N.E.2d 598, 607 (N.Y. 1999).

90. Middlebrook Manuscript, *supra* note 41, at 13.

91. *See generally* Sarah Jane Hughes, *A Call for International Legal Standards for Emerging Retail Electronic Payment Systems*, 15 ANN. REV. BANKING L. 197 (1996).

- Can we expand existing regulatory schemes to encompass new technologies? Or, do new technologies require separate new regulations?
- Do proposed regulations specifically have unintended consequences that the regulators could avoid?
- Do these new services and products have privacy and data-security concerns that are comparable to or that exceed those in extant but analogous products and services? If they present new concerns, how do we manage those?

As the discussion above should demonstrate, these are exceedingly complex questions. The purposes for regulation—licensure, prudential regulation, and user protections, as well as anti-money-laundering and counter-terrorism style purposes—are common to most providers of financial services and products and to users including but not necessarily limited to consumers. Emerging technologies should not escape regulation for these traditional purposes—particularly not, as they so often claim, because they are young industries and eager to "innovate." In these connections, perhaps a de minimis approach should allow these innovators (and potential disruptors) to prepare to offer services and then be required to comply as they launch their services to the public.

Similarly, my view on the timing of regulation for any particular provider, as well as a class of providers, depends on the nature of the purpose for the regulation. Licensure and liquidity issues should come before the launch to individuals whose transactions and reputations can be damaged by failure to complete transactions or pay bills on time. Likewise, one can imagine expanding existing regulatory schemes—such as money services and money transmitter regulations under state laws, and remittance transfers and payroll card regulations under Regulation E[92]—to encompass new products and providers. In some respects, using existing regulations saves costs in terms of crafting whole new schemes such as the BitLicense, as well as in terms of known compliance duties that innovators can develop into their systems such as "privacy-by-design."

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92. *See supra* notes 83–85 and accompanying text (contrasting Regulation E with the proposed BitLicense regulations).

Finally, some of the new products will have new privacy and data security consequences that should be managed by regulators in the regulation's development and compliance phases. The BitLicense proposal creates some new privacy issues in the form of suspicious activity reporting to New York state authorities beyond the federal requirements, as noted above, and its extensive and prolonged record-keeping requirements also may expose users' data to additional threats related to data security.

IV. What Factors Should Drive the Decision to Regulate Virtual Currencies or Other New Electronic Payments Products and Services?

The 2013 and 2014 guidance from FinCEN[93] and the BitLicense proposal compel us to reconsider some basic questions about why we regulate emerging payments products and services. These questions include:

- Should government imperatives (deterrence of money laundering or countering the financing of terrorism and basic recognition of income rules) or users' concerns (ability to redeem value stored and resolution of transaction errors) drive the decision to regulate?
- Are these regulatory goals compatible?
- Are the available regulatory options suitable for both sets of goals?

These different models for regulation—government imperatives and user protections—are not mutually exclusive reasons to regulate emerging products, services, and providers. But if, unlike the BitLicense proposal, one set of concerns gets out in front of the other, its presence may drive other regulation in a manner that the other reason might not. Thus, we need to consider regulations in these areas as comprehensively as possible, even as we may decide not to regulate at one time for all of the potential reasons we ultimately might regulate the product. This type of measured approach has been on view with the incremental expansion of the Electronic Fund Transfer Act

93. *See supra* notes 2–3 and accompanying text (discussing FinCEN's 2013 and 2014 directions and guidance).

from its first passage through the Credit CARD Act of 2009[94] and Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.[95]

V. Must We Choose Between Protections for Consumers and Protections for All Users?

The BitLicense proposal contains provisions that could be helpful to consumers, such as the consumer fraud and claims process requirements, and others that are more generally useful for all users, such as licensure and liquidity requirements. Our recent regulatory history at the federal level has focused on consumers.[96] Therefore, as we comment on the BitLicense proposal or otherwise confront additional virtual currency regulatory efforts, we can ask ourselves at least three more questions:

- If we regulate emerging technologies that have both consumer and business uses, should regulations focus primarily on consumer protection?
- Or should we also provide some protection for business users?
- How can we best do both?

I will admit that I am still working on answers to these issues, even after all these years.

VI. Conclusion

As the title to this Essay suggests, New York State's bold move to propose BitLicense regulations for virtual currencies could prove to be the tipping point in the broader population's acceptance or adoption of virtual currencies. New York could

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94. Pub. L. No. 111-24, 123 Stat. 1734 (codified in scattered sections of 15 U.S.C.).

95. Pub. L. No. 111-203, 124 Stat. 1376–2223 (codified as amended in scattered sections of 7, 12, 15, and 31 U.S.C.).

96. *See, e.g.*, 12 U.S.C. § 5567 (2012) (providing protections for "whistleblowers" who report violations of the Dodd-Frank Act); *id.* § 5601 (requiring disclosures and providing "Reg. E" protections for senders of remittance transfers).

anoint virtual currencies by bringing them without question under the ambit of its own regulatory authority. For other devoted users of virtual currency today, the proposal could "spoil" the many forms of virtual currencies because, for these individuals, regulated products will have many of the same ills that government-created and government-managed "legal tender" carry—in other words, regulation could leave virtual currencies vulnerable to manipulation for monetary policy and other "political" purposes.

The proposed regulation raises the stakes for anyone interested in the future of virtual currencies. Its announcement puts it at the forefront of approaches to regulating virtual currencies and makes it the one against which other efforts to regulate virtual currencies for similar purposes will be measured. The BitLicense proposal certainly re-established state regulators as a source of innovation in the fields of prudential and consumer protection, regulation of payments providers, and new payments media, after some years in which federal laws preempted many state initiatives. In this respect, it should be applauded.

The Bitcoin community is not likely to embrace New York's BitLicense regime because most of its members prize their anonymity and freedom from both a centralized authority and government "money" creation.[97] The provisions that relate to customer identification, transaction reporting, and disclosures, as well as the one-to-one liquidity ratio, have already drawn significant numbers of negative comments in the comment period that was to have ended on September 5, 2014.[98] The comment

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97. *See* Jon Matonis, *ECB: "Roots of Bitcoin Can Be Found in the Austrian School of Economics,"* FORBES (Nov. 3, 2012, 11:04 AM), http://www.forbes.com/sites/jonmatonis/2012/11/03/ecb-roots-of-bitcoin-can-be-found-in-the-austrian-school-of-economics/ (last visited Sept. 22, 2014) ("[P]roponents see Bitcoin as 'a good starting point to end the monopoly central banks have in the issuance of money' and 'inspired by the former gold standard.'") (on file with the Washington and Lee Law Review). For a more comprehensive description of the Austrian School, see LUDWIG VON MISES INSTITUTE, WHAT IS AUSTRIAN ECONOMICS?, http://mises.org/etexts/austrian.pdf (summarizing theories of major proponents of free-market "money" and the origins of the school of economic theory particularly of Carl Menger).

98. *See Press Release*, *supra* note 9 (explaining the BitLicense proposal and its original public comment period); Matt Odell, *Industry Responses to BitLicense Guidelines*, COINPRICES (Aug. 13, 2014), https://www.coinprices.io/articles/news/industry-response-to-bitlicense-guidelines (last visited Sept. 22,

period has already been extended to October 21, 2014.[99] Beyond that, it is anyone's guess as to what will happen next in the regulation of virtual currencies in the United States—and whether this particular set of regulations will result in anointing virtual currencies with an aura of respectability to spur broader usage or will result in removing their attractiveness entirely for other users.

2014) (providing over a dozen critical responses to the proposal) (on file with the Washington and Lee Law review).

99. *See How to Submit Comments on Proposed Virtual Currency Regulatory Framework*, N.Y. DEP'T FIN. SERVICES, http://www.dfs.ny.gov/legal/vcrf_submit_comments.htm (last visited Sept. 22, 2014) ("A number of groups and individuals have also requested additional time to study the proposal given that it is the first of its kind and could potentially serve as a model for other jurisdictions. As such, . . . [c]omments will now be due October 21, 2014.") (on file with the Washington and Lee Law Review).