

VIRTUAL CURRENCY BUSINESSES: AN ANALYSIS OF THE EVOLVING REGULATORY LANDSCAPE

by Meghan E. Griffiths *

I. INTRODUCTION	303
II. WHAT IS VIRTUAL CURRENCY?	306
III. THE EVOLVING REGULATORY LANDSCAPE.....	308
A. <i>Anti-Money Laundering and Money Transmitter Laws</i>	308
1. <i>Regulation at the Federal Level by the U.S. Department of Treasury Financial Crimes Enforcement Network</i>	309
a. <i>Users</i>	311
b. <i>Miners</i>	311
c. <i>Administrators and Exchangers</i>	312
2. <i>Prosecution of Anti-Money Laundering and Money Transmission Laws</i>	315
3. <i>Regulation at the State Level</i>	317
a. <i>Texas</i>	318
b. <i>Kansas</i>	319
c. <i>Washington</i>	320
d. <i>New York</i>	321
e. <i>California</i>	322
B. <i>Other Federal Regulation Regarding Virtual Currency Activity</i>	323
1. <i>Internal Revenue Service</i>	323
2. <i>Commodity Futures Trading Commission</i>	324
3. <i>Securities and Exchange Commission</i>	326
4. <i>Consumer Financial Protection Bureau</i>	328
IV. WHERE DO WE GO FROM HERE?	329

I. INTRODUCTION

Whether virtual currency businesses boom or go bust remains to be seen. The jury is out on whether Bitcoin or some other digital currency garners widespread acceptance by merchants and consumers as a substitute

* Partner in the Austin office of Andrews Kurth, LLP. J.D., The University of Texas School of Law, 2004; B.A. The University of Texas at Austin, 1995.

for the U.S. dollar for the electronic payment of goods and services.¹ Proponents of virtual currency tout a number of its benefits.² They extol it as a fast and flexible electronic payment option that will benefit customers because of lower transaction fees than most major credit cards.³ They claim merchants will see cost savings because payments in Bitcoin are “non-recourse,” which means no potential chargebacks like with credit card transactions.⁴ Some businesses assert digital currency technology will improve the financial services industry by enabling lower cost instant payment transactions across borders in different currencies.⁵ Thrill-seeking investors also hope for financial gains from investment in virtual currencies as Bitcoin exchange rates against the U.S. dollar have changed dramatically over time with prices fluctuating from \$13 per Bitcoin in the beginning of January 2013 to more than \$1,100 by the beginning of December 2013 (although back down to around \$260 by mid-2015).⁶ As major retailers like Dell,⁷ Overstock.com,⁸ eBay,⁹ and PayPal¹⁰ issue announcements that they already accept or are considering accepting Bitcoin, virtual currency has begun to garner some legitimacy with consumers, merchants, and investors.¹¹

On the other hand, there remain significant hurdles to its widespread acceptance. The Silk Road and Mt. Gox scandals, among others, have raised valid consumer protection concerns regarding digital forms of currency such as vulnerability to cyber-attack, susceptibility to fraudulent activity, risk of

1. See Jaroslaw Adamowski, *New Research Links Bitcoin Price Spikes to Media Hype*, COINDESK (Nov. 19, 2014), <http://www.coindesk.com/reasons-behind-bitcoins-price-media-hype/>, archived at <http://perma.cc/RG92-82RD>.

2. See Kim Lachance Shandrow, *5 Reasons Merchants Should Start Accepting Bitcoin Now*, ENTREPRENEUR (Sept. 4, 2014), <http://www.entrepreneur.com/article/237026>, archived at <http://perma.cc/BHA4-AVWQ>. Though they are each slightly different, this article will use the terms “digital currency,” “virtual currency,” and “cryptocurrency” interchangeably. *What is the Difference Between Cryptocurrency and Digital Currency?*, MAXCOINWORLD (Apr. 28, 2014), <http://www.maxcoinworld.com/233/what-is-the-difference-between-cryptocurrency-and-digital-currency/>, archived at <http://perma.cc/ZDCK-CKMS>.

3. See Shandrow, *supra* note 2.

4. See *id.*

5. See *Executive Summary for Financial Institutions*, RIPPLE, <https://www.ripple.com/integrated/executive-summary-for-financial-institutions> (last visited Apr. 1, 2015), archived at <http://perma.cc/PGW4-BRWF>.

6. *Bitcoin Price Index Chart*, COINDESK, <http://www.coindesk.com/price/> (last visited Apr. 1, 2015), archived at <http://perma.cc/44CZ-WPLZ>.

7. *Dell Now Accepts Bitcoin*, DELL, <http://www.dell.com/learn/us/en/uscorp1/campaigns/bitcoin-marketing> (last visited Apr. 1, 2015), archived at <http://perma.cc/EX66-5MB6>.

8. *Bitcoin on Overstock.com*, OVERSTOCK.COM, <http://www.overstock.com/bitcoin> (last visited Apr. 1, 2015), archived at <http://perma.cc/CH3L-EZK6>.

9. Caelainn Hogan, *Ebay's Paypal Embraces Virtual Currency Bitcoin. Could Help Bitcoin Get Some Respect*, WASH. POST (Sept. 10, 2014), <http://www.washingtonpost.com/news/morning-mix/wp/2014/09/10/ebays-paypal-embraces-anarchic-virtual-currency-bitcoin/>, archived at <http://perma.cc/Z7Y7-6YHJ>.

10. *Id.*

11. See Cameron Graham, *Out of the Spotlight, Bitcoin Gains Legitimacy*, WIRED (Sept. 15, 2014), <http://www.wired.com/2014/09/bitcoin-gains-legitimacy/>, archived at <http://perma.cc/5HWR-Z9ZU>.

currency devaluation, and lack of consumer protection.¹² The now defunct Silk Road marketplace, an online black market that was shut down by the Federal Bureau of Investigation (FBI) in 2013, tarnished the reputation of Bitcoin as the digital cryptocurrency was the means by which users of the site purchased illicit goods and services with relative anonymity.¹³ Ross Ulbricht, the site's mastermind, was ultimately sentenced to life in prison for running the online drug marketplace.¹⁴ Mt. Gox, once Bitcoin's biggest exchange, also dealt a significant blow to the virtual currency industry when it suspended trading in February 2014, shuttered its website, and filed for bankruptcy after announcing that more than \$400 million worth of customer Bitcoins had vanished without recourse due to computer hackings.¹⁵ The extreme volatility of the Bitcoin price index—a speculator's dream for some—raises concern for more conservative, risk averse investors.¹⁶ And the non-recourse nature of virtual currency transactions—a benefit for merchants—creates consumer risk as it eliminates traditional credit card protections for purchasers.¹⁷

While it remains uncertain how pervasive the fledgling virtual currency industry will become, one thing is certain: regulation for businesses that operate in the virtual currency space will increase.¹⁸ Federal and state regulators have taken notice of the growing digital currency phenomena, and they are currently grappling with regulatory issues within their purview.¹⁹ Virtual currency businesses have drawn particular attention from federal and state agencies responsible for monitoring and investigating financial crimes, and in recent years administrative and judicial decisions have provided some guidance regarding the evolving regulatory requirements for virtual currency businesses.²⁰

12. See Charles Poladian, *Silk Road Shutdown: NY US Attorney Seizes \$28 Million in Bitcoins Belonging to Ross Ulbricht*, INT'L BUS. TIMES (Oct. 26, 2013), <http://www.ibtimes.com/silk-road-shutdown-ny-us-attorney-seizes-28-million-bitcoins-belonging-ross-ulbricht-1442640>, archived at <http://perma.cc/5KH2-2UM8>; Yoshifumi Takemoto, *Mt. Gox Files for Bankruptcy, Hit With Lawsuit*, REUTERS (Feb. 28, 2014), <http://www.reuters.com/article/2014/02/28/us-bitcoin-mtgox-bankruptcy-idUSBREA1R0FX20140228>, archived at <http://perma.cc/M73G-GNCV>.

13. See Poladian, *supra* note 12.

14. See Kate Vinton, *Silk Road Creator Appeals Life Sentence*, FORBES (June 5, 2015), <http://www.forbes.com/sites/katevinton/2015/06/05/silk-road-creator-ross-ulbricht-appeals-life-sentence/>.

15. See *Risks to Consumers Posed by Virtual Currencies*, CONSUMER ADVISORY (Aug. 2014), available at http://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf, archived at <http://perma.cc/HB5T-WT36>.

16. See Consumer Financial Protection Bureau, *Risks to Consumers Posed by Virtual Currencies*, CONSUMER ADVISORY (Aug. 2014), available at http://files.consumerfinance.gov/f/201408_cfpb_consumer-advisory_virtual-currencies.pdf, archived at <http://perma.cc/HB5T-WT36>.

17. *Id.*

18. See U.S. Gov't Accountability Office, *Virtual Currencies: Emerging Regulatory, Law Enforcement, and Consumer Protection Challenges*, GAO-14-496 (May 2014), available at <http://www.gao.gov/assets/670/663678.pdf>, archived at <http://perma.cc/7L4M-T5LW>.

19. *Id.*

20. *Id.* at 25 n. 61.

This article examines the evolving legal status of virtual currency and emerging federal, state, and judicial decisions affecting businesses involved in the virtual currency space.²¹ It concludes any business structured around Bitcoin or other virtual currency should monitor closely the evolving regulatory landscape as the price of failing to maintain a proactive compliance program is high.²² While predicting the direction of the regulation is difficult, existing administrative rulings, memoranda, and judicial decisions indicate that virtual currency businesses should pay close attention to federal and state money transmitter registration and licensing requirements, tax obligations, commodities, and securities law.²³

This article also suggests that increased regulatory obligations for virtual currency businesses may be the price of legitimizing the industry.²⁴ While many in the industry oppose regulation because of compliance costs, the current state of regulatory uncertainty presents other, perhaps more costly, risks for legitimate virtual currency businesses.²⁵ The perceived consumer protection risks associated with virtual currencies limit the market share of legitimate businesses, and regulatory uncertainty can stymie investment by sophisticated institutional investors.²⁶ While settling the uncertain regulatory landscape may cause growing pains for the virtual currency industry, these pains appear necessary in order to move the industry out of the Internet shadows and into the mainstream.²⁷

II. WHAT IS VIRTUAL CURRENCY?

The North American Securities Administrators Association describes virtual currency as “an electronic medium of exchange that, unlike real money, is not controlled or backed by a central government or central bank.”²⁸ Virtual currency such as Bitcoin or Litecoin is not legal tender, but it is “used to purchase goods or services where accepted”²⁹ It can be bought or sold through virtual currency exchanges and is “stored in an electronic wallet, also known as an e-Wallet.”³⁰ Individuals and groups

21. See *infra* Parts II–IV. The scope of this article narrowly addresses recent developments in money transmitter, tax, securities and commodities regulation affecting virtual currency businesses. See *infra* Parts II–IV. It does not purport to provide a comprehensive compilation of all potential areas of governmental regulation for such business. See *infra* Parts II–IV.

22. See *infra* Part IV.

23. See *infra* Part IV.

24. See *infra* Parts II, IV.

25. See *infra* Part IV.

26. See *infra* Part IV.

27. See *infra* Parts II–IV.

28. *Informed Investor Advisory: Virtual Currency*, NORTH AM. SEC. ADMIN. ASS’N (Apr. 2014), <http://www.nasaa.org/30631/informed-investor-advisory-virtual-currency/>, archived at <http://perma.cc/9CJM-X9AW>.

29. U.S. GOVT. ACCOUNTABILITY OFFICE, *supra* note 18, at 4.

30. *Informed Investor Advisory: Virtual Currency*, *supra* note 28.

create, hold, and use virtual currency.³¹ It can “be purchased, sold[,] and exchanged with other virtual currencies or real currencies, like the U.S. dollar.”³² Virtual currency has no intrinsic value; its value is only what a buyer is willing to pay for it.³³

Bitcoin, the most common form of virtual currency, is an open source, distributed peer-to-peer digital currency developed by Satoshi Nakamoto, a mysterious unknown software developer (or developers).³⁴ Bitcoin is a decentralized digital currency, which means that “[n]o single institution controls the [B]itcoin network.”³⁵ A computer network process called “mining” awards Bitcoin when miners perform complex proof-of-work computations on the Bitcoin system.³⁶ Bitcoin is then generated and deposited into the miner’s e-Wallet.³⁷ Transactions are recorded in a distributed public database or public ledger known as the Blockchain.³⁸

Unlike sovereign currency, Bitcoin transmission does not occur by going through an intermediary such as a financial institution or a traditional money transmitter.³⁹ “When users transfer [B]itcoins, the recipient provides [its] [B]itcoin address to the sender, and the sender authorizes the transaction with [a] private key.”⁴⁰ The Blockchain registers each transaction which contains associated Bitcoin addresses, transaction dates, and time.⁴¹ Transfer of Bitcoin does not require disclosure of the sender’s identity, which gives users some degree of anonymity and raises concerns among law enforcement regarding potential use for money laundering and trafficking schemes.⁴²

A variety of entities operate in the virtual currency space.⁴³ These generally include:

31. *Id.*

32. Odia Kagan & Frank A. Mayer, III, *Virtual Currency, Real Risk*, PEPPERLAW (Jan. 28, 2015), http://www.pepperlaw.com/publications_update.aspx?ArticleKey=3125, archived at <http://perma.cc/TSX4-FUZH>.

33. *Id.*

34. See Satoshi Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, available at <https://bitcoin.org/bitcoin.pdf> (last visited Apr. 1, 2015), archived at <http://perma.cc/HG8T-J9MX>; see also Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, HASTINGS SCI. & TECH L.J. 162, 159 (2012).

35. *What is Bitcoin?*, COINDESK, <http://www.coindesk.com/information/what-is-bitcoin/> (last visited Apr. 1, 2015), archived at <http://perma.cc/AW4L-987F>.

36. U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 18, at 7 (the total number of Bitcoins that can ever be in circulation is said to be slightly below 21 million, which is expected to be generated at or near the year 2140).

37. *Id.*

38. *Id.* at 6, 9.

39. *Id.* at 25.

40. *Id.* at 6.

41. *Id.*

42. *Id.*

43. *Guidance: Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*, DEP’T OF THE TREASURY FIN. CRIMES ENFORCEMENT NETWORK (Mar. 18, 2013), available at http://fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf, archived at <http://perma.cc/UK5Z-UZFP> [hereinafter FIN-2013-G001].

- Users—persons or businesses who acquire virtual currency and use it to purchase goods or services;
- Miners—persons or businesses that mine for virtual currency;
- Exchangers—a person operating a business that facilitates “the exchange of virtual currency for real currency, funds, or other virtual currency;”
- Administrators—“a person engaged as a business in issuing . . . a virtual currency, and who has the authority to redeem . . . such virtual currency;”
- Merchants/Retailers—business that accept virtual currency for the purchase of goods or services;
- Financial Institutions—banks, credit unions, and the like; and
- Investors—a person or business that invests in virtual currency.⁴⁴

The regulatory landscape for these entities continues to evolve, but how regulators view these entities and their regulatory obligations varies based on the regulator’s statutory purview and enforcement authority.⁴⁵

III. THE EVOLVING REGULATORY LANDSCAPE

Early industry efforts marketed Bitcoin as an unregulated, anonymous electronic payment method beyond the borders of a central government.⁴⁶ It would be folly to assume that to be the case today.⁴⁷ In recent years, virtual currency activities have received close scrutiny from federal and state authorities charged with regulating and enforcing anti-money laundering laws, taxes, financial institutions, securities, and commodities.⁴⁸

A. Anti-Money Laundering and Money Transmitter Laws

Federal and state regulators with responsibility for regulating payment transactions and enforcing anti-money laundering (AML) laws have taken the lead in regulating virtual currency activity.⁴⁹ An important question that any virtual currency business should ask is whether its operations subject the company to federal and state registration requirements as a money transmitter.⁵⁰ If so, the business should make sure it complies with Bank Secrecy Act (BSA) regulations and AML requirements before becoming

44. *Id.*

45. *See infra* Part III.

46. *Cf.* U.S. GOV’T ACCOUNTABILITY OFFICE, *supra* note 18.

47. Ruling: *Request for Administrative Ruling on the Application of FinCEN’s Regulations to a Virtual Currency Payment System*, FIN-2014-R012, DEP’T OF THE TREASURY FIN. CRIMES ENFORCEMENT NETWORK, 5 (2014), available at http://www.fincen.gov/news_room/tp/rulings/html/FIN-2014-R012.html, archived at <http://perma.cc/SW5Q-9NYV> [hereinafter FIN-2014-R012].

48. *Id.*

49. *Id.*

50. *See* 31 C.F.R. § 1010.100(ff) (2014).

fully operational, or it may face criminal and/or civil enforcement action for failure to do so.⁵¹

The U.S. Department of Treasury's Financial Crimes Enforcement Network Bureau (FinCEN) has issued several administrative rulings regarding money transmitter registration requirements and related obligations for virtual currency businesses.⁵² Federal authorities have prosecuted virtual currency businesses engaged in illicit activity for violations of federal anti-money laundering and money service business registration requirements.⁵³ Forty-seven states and the District of Columbia have money transmitter licensing requirements, and some have issued memoranda or, in the case of New York, proposed regulations regarding licensing requirements for virtual currency businesses.⁵⁴ The following is an overview of federal and state activity regarding money transmitter regulation for virtual currency businesses.⁵⁵

1. Regulation at the Federal Level by the U.S. Department of Treasury Financial Crimes Enforcement Network

FinCEN, operating under the authority of the Bank Secrecy Act (BSA) and related anti-money laundering provisions, collects and analyzes information about financial transactions in order to combat domestic and international money laundering, terrorist financing, and other financial crimes.⁵⁶ The BSA and corresponding regulations impose a wide range of anti-money laundering obligations and registration requirements on money transmitters.⁵⁷

A money transmitter is a category of money services business (MSB) under BSA regulations.⁵⁸ The term "money transmitter" means "[a] person that provides money transmission services[,] or any other person engaged in the transfer of funds."⁵⁹ The BSA further defines money transmission services as "the acceptance of currency, funds, or other value that substitutes for currency from one person *and* the transmission of currency, funds, or other

51. See, e.g., U.S. Department of Justice, *Ripple Labs, Inc. Resolves Criminal Investigation* (May 5, 2015), <http://www.justice.gov/opa/pr/ripple-labs-inc-resolves-criminal-investigation>.

52. Cf., U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 18, at 6.

53. *Id.*

54. *Id.*

55. See 31 C.F.R. § 1010.100(ff).

56. The Currency and Financial Transaction Reporting Act of 1970, Pub. L. No. 91-508, 84 Stat. 114, *amended by* U.S. Patriot Act of 2001, (codified at 12 U.S.C. §§ 1829(b), 1951-59, 31 U.S.C. §§ 5311-30); The Bank Secrecy Act, Pub. L. No. 107-56, 115 Stat. 272 (codified as amended in scattered sections of 31 U.S.C.).

57. 31 CFR §§ 1022.210, 1022.380 (2014).

58. *Id.* § 1010.100(ff).

59. FIN-2014-R012, *supra* note 47, at 5.

value that substitutes for currency to another location or person by any means.”⁶⁰

In general, money transmitters must (a) register with FinCEN, (b) implement an anti-money laundering program based on a comprehensive risk assessment of its exposure to money laundering,⁶¹ (c) and comply with recordkeeping, reporting, and transaction monitoring obligations set forth in FinCEN’s regulations.⁶² Examples of attendant obligations include requirements to file (a) currency transaction reports for transactions involving more than \$10,000;⁶³ (b) suspicious activity reports reporting substantial transactions or pattern of transactions “involv[ing the] use of the money service business to facilitate criminal activity;”⁶⁴ and (c) record-keeping related to the sale of negotiable instruments.⁶⁵ To the extent a company’s transactions constitute a “transmittal of funds” under FinCEN’s regulations, the company must also comply with funds transfer and travel rules, which require various identifying data for certain transmittals over \$3,000.⁶⁶

Various types of virtual currency businesses fall under FinCEN’s interpretation of the money transmitter definition.⁶⁷ FinCEN’s rulings regarding the applicability of the term generally turn on the facts and circumstances of the activities of the virtual currency business and for whose benefit the business is conducting its service.⁶⁸ Although there are a variety of business entities within the virtual currency space, FinCEN has categorized virtual currency businesses into three main categories; users, exchangers, and administrators.⁶⁹ FinCEN has found that users are exempt from BSA registration and reporting requirements, whereas exchangers and administrators are generally subject to BSA obligations, unless they fall within an exemption to the money transmitter definition.⁷⁰ Merchants who accept virtual currency for the payment of goods or services are also generally exempt.⁷¹

60. *Id.*

61. 31 C.F.R. §§ 1022.210, 1022.380 (2014).

62. *Id.* Chapter X Parts 1010, 1022.

63. *Id.* § 1022.310.

64. *Id.* § 1022.320(a)(2)(iv).

65. *Id.* § 1010.415.

66. *Id.* §§ 1010.100(ddd), 1010.410(e), 1010.410(f).

67. *Id.* § 1010.100(fff).

68. FIN-2014-R012, *supra* note 47, at 5.

69. FIN-2013-G001, *supra* note 43, at 2.

70. *Id.* at §§ 1010.100(ddd), 1010.410(e), 1010.410(f).

71. *Id.* at § 1010.100(fff).

a. Users

FinCEN characterizes a user as “a person that obtains virtual currency to purchase goods or services on the user’s own behalf.”⁷² Such activity, according to FinCEN, does not fit within the definition of the MSB.⁷³ On March 18, 2013, FinCEN issued an administrative ruling that specified that “[a] user of virtual currency is not [a money service business] under FinCEN’s regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations.”⁷⁴

FinCEN has also held that a corporate investor that invests in virtual currency solely for the benefit of the company is a user despite certain activities it engages in to exchange or convert virtual currency.⁷⁵ In a January 30, 2014 ruling, FinCEN determined that when a company “invests in a convertible virtual currency for its own account, and when it realizes the value of [that] investment, it is acting as a user of that convertible virtual currency within the meaning of the guidance.”⁷⁶ This decision came in response to a question regarding whether a company’s periodic investment in convertible currency and its production and distribution of software to facilitate the company’s purchase and sale of the currency for purposes of its own investment would make the investment a money transmitter under the BSA.⁷⁷ FinCEN found that it would not, but an important point made in the ruling was that “[t]he software would not be sold or provided to any third party for resale, and it would be reserved for the sole use of the [c]ompany’s counterparties.”⁷⁸

b. Miners

Whether a miner is a money transmitter depends on the company’s business model.⁷⁹ In its ruling on March 18, 2013, FinCEN stated that how a person obtains virtual currency—whether it be through purchasing, mining, harvesting, earning, creating, etc.—is not material to the legal characterization of a user.⁸⁰ However, the ruling left open the question of whether a company that mines Bitcoin and then converts it to real currency is a user or

72. FIN-2014-R012, *supra* note 47, at 5.

73. FIN-2013-G001, *supra* note 43, at 2.

74. FIN-2013-G001, *supra* note 43, at 1 (emphasis in original).

75. Jamal El-Hindi, *Application of FinCEN’s Regulations to Virtual Currency Software Development and Certain Investment Activity FIN-2014-R001*, FIN. CRIMES ENFORCEMENT NETWORK 2, (Jan. 30, 2014), http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R001.pdf, archived at <http://perma.cc/4LEE-DQ5E> [hereinafter FIN-2014-R001].

76. *Id.* at 4.

77. *Id.*

78. *Id.* at 1.

79. FIN-2013-G001, *supra* note 43, at 2.

80. *Id.*

an exchanger.⁸¹ FinCEN answered this question in a January 31, 2014, ruling: whether a miner is a user or exchanger turns on “what the person uses the convertible virtual currency for, and for whose benefit.”⁸² FinCEN found:

[t]o the extent that a user mines Bitcoin and uses the Bitcoin solely for the user’s own purposes and not for the benefit of another, the user is *not* an MSB under FinCEN’s regulations, because these activities involve neither “acceptance” nor “transmission” of the convertible virtual currency and are not the transmission of funds within the meaning of the Rule.⁸³

Under the facts presented to FinCEN, the mining company indicated that it would, from time to time, “convert Bitcoin that it has mined into a real currency or another convertible virtual currency, either because the seller of the goods or services [it] wishes to purchase from will not accept Bitcoin, or because [it] wishes to diversify [its] currency holdings . . .”⁸⁴ The company said it would also make distributions to its shareholders.⁸⁵ FinCEN determined that, so long as the company was conducting these transactions for its “own purposes and not as a business service performed for the benefit of another,” the conversion of Bitcoin into another currency did “not in and of itself make the user a money transmitter.”⁸⁶ FinCEN did caution, however, that “[a]ny transfers to third parties at the behest of sellers, creditors, owners, or counterparties involved in these transactions should be closely scrutinized, as they may constitute money transmission.”⁸⁷ For example, a user wishing to purchase goods and services at the direction of a seller or creditor may engage in money transmission.⁸⁸

c. Administrators and Exchangers

Businesses that fall under FinCEN’s definition of an administrator or exchanger must register and meet BSA obligations, unless a limitation or exemption from the definition of money transmitter applies.⁸⁹ FinCEN defines an administrator as “a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.”⁹⁰ The administrator of a centralized virtual currency repository will, for example, “be a

81. *Id.* at 5–6.

82. FIN-2014-R001, *supra* note 75, at 2.

83. *Id.* at 1 (emphasis omitted).

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.* at 3.

88. *Id.*

89. FIN-2013-G001, *supra* note 43, at 1.

90. FIN-2014-R012, *supra* note 47, at 2.

money transmitter to the extent that it allows transfers of value between persons or from one location to another.”⁹¹

FinCEN defines an exchanger as “a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.”⁹² FinCEN’s regulations state that currency means “[t]he coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance.”⁹³ In contrast, virtual currency is “a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency.”⁹⁴ FinCEN further characterizes convertible virtual currency as a type of virtual currency that “either has an equivalent value in real currency, or acts as a substitute for real currency.”⁹⁵

FinCEN has determined that a company is an exchanger if its business engages in accepting and converting its customer’s real currency into virtual currency for transmission to a merchant.⁹⁶ In an October 27, 2014 ruling, the agency held:

An exchanger will be subject to the same obligations under FinCEN regulations regardless of whether the exchanger acts as a broker (attempting to match two (mostly) simultaneous and offsetting transactions involving the acceptance of one type of currency and the transmission of another) or as a dealer (transacting from its own reserve in either convertible virtual currency or real currency).⁹⁷

This ruling came in response to an inquiry from a company that planned to set up a convertible virtual currency payment system that would “provide virtual currency-based payments to merchants in the United States and (mostly) Latin America, who wish[ed] to receive payment for goods or services sold in a currency other than that of the legal tender in their respective jurisdictions.”⁹⁸ The intended market for the system was the Latin American hotel market where “merchants face[d] substantial foreign exchange risk when dealing with overseas customers” due to inflation and currency controls.⁹⁹ The system would have allowed customers to pay for hotel reservations using a credit card with the payment going to the virtual currency company rather than directly to the hotel.¹⁰⁰ The company would

91. FIN-2013-G001, *supra* note 43, at 4.

92. FIN-2014-R012, *supra* note 47, at 5.

93. 31 C.F.R. § 1010.100(m) (2014).

94. FIN-2014-R001, *supra* note 75, at 2.

95. *Id.*

96. FIN-2014-R012, *supra* note 47, at 3.

97. *Id.*

98. *Id.* at 1.

99. *Id.*

100. *Id.*

then transfer the equivalent in Bitcoin to the merchant out of its reserve of Bitcoin.¹⁰¹ The company would have no agreement with the customer and would only make the payment to the merchant.¹⁰²

FinCEN held that the company would be an exchanger under the arrangement even though the payment came from the company's virtual currency reserve.¹⁰³ The agency also held that the system would not fall under the payment processor exemption to the money transmitter definition because it did not meet the condition that the entity operate through clearance and settlement systems that admit only BSA-regulated financial institutions.¹⁰⁴ FinCEN also concluded that the exemption for a person that only "[a]ccepts and transmits funds only integral to the sale of goods or the provision of services, other than money transmission services, by the person who is accepting and transmitted the funds"¹⁰⁵ was inapplicable because money transmission was the sole purpose of the company's system.¹⁰⁶ FinCEN's ruling did not assert that the hotel merchant would be a money transmitter.¹⁰⁷ Based on this and prior rulings, it appears that merchants that receive Bitcoin or virtual currency for payment and then convert it to sovereign currency for their own personal use are not money transmitters.¹⁰⁸

In a separate October 27, 2014, ruling, FinCEN held that a "company's proposed convertible virtual currency trading and booking platform . . . would make the [c]ompany a money transmitter under BSA" regulations.¹⁰⁹ The platform would have consisted "of a trading system . . . to match offers to buy and sell convertible virtual currency for currency of legal tender . . . and a set of book accounts in which prospective buyers or sellers of one type of currency or the other [customers] can deposit funds to cover their exchanges."¹¹⁰ FinCEN held that the platform contemplated two money transmission transactions—"one between the [c]ompany and [c]ustomer wishing to buy virtual currency, and another between the [c]ompany and the [c]ustomer wishing to sell such virtual currency at the same exchange

101. *Id.*

102. *Id.*

103. *Id.* at 3.

104. *Id.* See 31 C.F.R. § 1010.100(ff)(5)(ii)(B) (2014). Exempting from the money transmitter definition a person that "[a]cts as a payment processor to facilitate the purchase of, or payment of a bill for, a good or service through a clearance and settlement system by agreement with the creditor or seller." *Id.* Providing that for the payment processor exemption to apply, the entity must use a clearance and settlement system that intermediates solely between BSA-regulated institutions. *Id.*

105. 31 C.F.R. § 1010.100(ff)(5)(ii)(F) (2014).

106. FIN-2014-R012, *supra* note 47, at 4.

107. *Id.*

108. *Id.*

109. Jamal El-Hindi, *Request for Administrative Ruling on the Application of FinCEN's Regulations to a Virtual Currency Trading Platform*, FIN-2014-R011, FIN. CRIMES ENFORCEMENT NETWORK, available at http://fincen.gov/news_room/tp/rulings/pdf/FIN-2014-R011.pdf (last visited Feb. 25, 2015), available at <http://perma.cc/J6N6-Q88> [hereinafter FIN-2014-R011].

110. *Id.* at 1.

rate.”¹¹¹ FinCEN found that the exemption for money transmission integral to the provision of the company’s service was inapplicable, as was the exemption for payment processors.¹¹² Specifically, FinCEN held that the customer would not receive payment as a seller or creditor from a buyer or debtor for the provision of non-money transmission-related goods or services and the company would not be operating through a clearing settlement system that only admits BSA-regulated financial institutions as members.¹¹³

As these decisions make clear, FinCEN takes the position that “a person is an exchanger and a money transmitter if the person accepts convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency.”¹¹⁴ The method of funding the transaction is not relevant to the definition of money transmitter.¹¹⁵ Thus, any virtual currency business that engages in similar activity should closely examine its obligation to register with FinCEN.¹¹⁶

2. Prosecution of Anti-Money Laundering and Money Transmission Laws

Law enforcement officials have prosecuted virtual currency businesses that facilitate crimes for failing to comply with money transmitter registration requirements.¹¹⁷ The Department of Justice (DOJ), on behalf of FinCEN, has also brought criminal and civil action against at least one company that failed to timely register as a MSB and to develop attendant AML compliance procedures.¹¹⁸

Precedent that Bitcoin qualifies as “money” or “funds” for purposes of federal criminal money laundering and illegal money transmission laws stems from indictments related to the Federal Bureau of Investigation’s (FBI) seizure of the Silk Road website.¹¹⁹ In February 2014, the Department of Justice (DOJ) indicted Ross Ulbricht, Silk Road’s alleged owner, on charges of participating in a narcotics trafficking conspiracy, engaging in a criminal enterprise, conspiring to commit computer hacking, and conspiring to commit money laundering.¹²⁰ Before trial the defendant moved to dismiss

111. *Id.* at 4.

112. *Id.* at 4–5.

113. *Id.* at 5.

114. *Id.* at 3.

115. *Id.*

116. *See id.*

117. *See S. Comm. On Homeland Sec. Governmental Affairs* (2013) (testimony of Mythili Raman, Acting Assistant Att’y Gen.).

118. *Supra* note 51.

119. U.S. Attorney’s Office, New York Field Office, *Operator of Silk Road 2.0 Website Charged in Manhattan Federal Court*, FED. BUREAU OF INVESTIGATION (Nov. 6, 2014), <http://www.fbi.gov/newyork/press-releases/2014/operator-of-silk-road-2.0-website-charged-in-manhattan-federal-court>, archived at <http://perma.cc/E4T7-Q945>.

120. *United States v. Ulbricht*, 31 F. Supp. 3d 540, 546 (S.D.N.Y. 2014).

the charges.¹²¹ With respect to the count regarding money laundering, he alleged that he could not “have engaged in money laundering because all transactions occurred through the use of Bitcoin and thus there was therefore no legally cognizable ‘financial transaction.’”¹²² He claimed that because Bitcoins are not monetary instruments, transactions involving Bitcoin cannot form the basis for a money laundering conspiracy.¹²³ The court rejected his argument.¹²⁴ It held that “[t]he money laundering statute is broad enough to encompass use Bitcoins in financial transactions,” and that one can launder money using Bitcoin.¹²⁵ After a widely-publicized trial, Ulbricht was ultimately convicted and ordered to spend the rest of his life in prison.

The Silk Road Scandal also resulted in the indictment of Charles Shrem, former vice chairman of the Bitcoin Foundation and chief executive officer of a Bitcoin exchange company, and Robert Faiella, an underground Bitcoin exchanger who went by the moniker “BTCKing,” on grounds of operating an unlicensed money transmitting business in violation of 18 U.S.C. § 1960 and conspiracy to commit money laundering in violation of 18 U.S.C. § 1956(h).¹²⁶ Their companies engaged in Bitcoin exchange for the Silk Road website.¹²⁷ Like the *Ulbricht* case, the court rejected a motion to dismiss on the grounds that Bitcoin is not money under section 1960; that operating a Bitcoin exchange does not constitute transmitting under section 1960, and that the defendant was not a money transmitter under the statute. The defendants later pled guilty to operating an unlicensed money transmitting business.¹²⁸

The story of Ripple Labs also provides a cautionary tale for start-up companies that fail to comply with MSB requirements before going operational. In May 2015, Ripple Labs, a California-based company that utilizes its own virtual currency to facilitate an on-line, real-time currency trading and cash management exchange service, entered into a settlement agreement with FinCEN and the DOJ to resolve a civil and criminal action

121. *Id.*

122. *Id.* at 548. The opinion noted that “the money laundering statute defines a ‘financial transaction’ as involving, [inter alia], the movement of funds by wire or other means, or . . . involving one or more monetary instruments, or . . . involving the transfer of title to any real property, vehicle, vessel, or aircraft” *Id.* at 568 (quoting 18 U.S.C. § 1956(c)(4)).

123. *Id.* at 569.

124. *Id.* at 570.

125. *Id.*

126. *United States v. Faiella*, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014).

127. *Id.*

128. See U.S. Attorney’s Office, New York Field Office, *Bitcoin Exchangers Plead Guilty in Manhattan Federal Court in Connection with the Sale of Approximately \$1 Million in Bitcoins for Use on the Silk Road Website*, FED. BUREAU OF INVESTIGATION (Sept. 4, 2014), <http://www.fbi.gov/newyork/press-releases/2014/bitcoin-exchangers-plead-guilty-in-manhattan-federal-court-in-connection-with-the-sale-of-approximately-1-million-in-bitcoins-for-use-on-the-silk-road-website>, archived at <http://perma.cc/L6HP-4AKZ>.

against the company.¹²⁹ The government found that, as an exchanger, Ripple was required to register with FinCEN, yet it sold its virtual currency before doing so. Ripple Labs was also charged with failing to establish and maintain an appropriate AML program and failing to have policies, procedures and internal controls in place to comply with BSA and AML laws. Ripple, which is backed in part by Silicon Valley-based venture capital, reportedly complied with the investigation and ultimately agreed to pay a \$700,000 penalty, \$450,000 of which was designated to settled issues raise by the U.S. Attorney's investigation.¹³⁰ It also agreed to migrate one of its subsidiaries to a FinCEN-registered MSB and meet a variety of regulatory requirements, such as compliance with applicable AML, Funds Transfer Rule and Funds Travel Rule requirements.¹³¹ The full cost of compliance with the settlement is unclear, but the result is an indicator that businesses should embrace compliance *before* becoming operational and stay on top of developments in the regulatory sphere. A piecemeal approach to regulatory compliance can be a costly business strategy.

3. Regulation at the State Level

Virtual currency business should also pay close attention to state licensing requirements for money transmitters.¹³² Requirements vary by jurisdiction, but state money transmitter requirements generally include licensing, minimum net worth, bonding, and reporting obligations.¹³³ It is unclear how many states will treat virtual currency businesses as money transmitters and under what conditions, but some have issued memoranda, legislation and proposed regulations affecting virtual currency businesses.¹³⁴ This section addresses recent activity in Texas, Kansas, Washington, New York, and California.¹³⁵

129. U.S. Department of Treasury, *FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger*, FINCEN (May 5, 2015), available at http://www.fincen.gov/news_room/nr/pdf/20150505.pdf.

130. *Id.*

131. *Id.*

132. See *State Regulatory Requirements for Virtual Currency Activities*, CONF. ST. BANK SUPERVISORS (Dec. 16, 2014), available at <http://www.csbs.org/regulatory/ep/Documents/CSBSDraftModelRegulatoryFrameworkforVirtualCurrencyProposal--Dec.162014.pdf>, archived at <http://perma.cc/P6BK-QR34>.

133. *See id.*

134. Emily Schmall & Jill Craig, *States Differ on Need for Bitcoin Oversight*, ASSOCIATED PRESS, <http://www.washingtontimes.com/news/2014/nov/27/states-differ-on-need-for-bitcoin-oversight/?page=all> (last visited Apr. 1, 2015), archived at <http://perma.cc/P4FP-8VTG>.

135. *See id.*

a. Texas

On April 3, 2014, the Texas Department of Banking (TDB) issued a supervisory memorandum regarding the legal status of virtual currency for currency exchange and money transmission requirements under the Texas Money Services Act.¹³⁶

First, the TDB Memorandum determined that Texas does not require a currency exchange license to conduct any type of transaction exchanging virtual with sovereign currencies.¹³⁷ The agency's determination turned on the definition of currency under section 151.501(b)(1) of the Texas Finance Code and the finding that virtual currency is not currency for purposes of the code because it is not legal tender.¹³⁸

Second, the TDB made several determinations regarding money transmitter licensing requirements for virtual currency businesses.¹³⁹ The outcome of the TDB's determinations turned on whether virtual currency constitutes money or monetary value under the Money Services Act.¹⁴⁰ The agency held that virtual currency is not under section 151.301(b)(3) of the Texas Finance Code, which provides that "[m]oney' or 'monetary value' means currency or a claim that can be converted into currency through a financial institution, electronic payments network, or other formal or informal payment system."¹⁴¹ As previously stated, the department determined that virtual currency is not "currency" because it is not legal tender.¹⁴² In addition, it determined that cryptocurrency is not a claim because the owner has no right or guaranteed ability to convert that unit to sovereign currency.¹⁴³ Thus, the department found that virtual currency is a type of good or service and, absent involvement of sovereign currency in the transaction, no money transmission can occur.¹⁴⁴

Using this reasoning, the department adopted a somewhat more lenient view than FinCEN of what actions constitute money transmission.¹⁴⁵ The TDB held the following regarding the regulatory treatment of common types of transactions involving cryptocurrency:

136. Charles F. Cooper, *Regulatory Treatment of Virtual Currency Under the Texas Money Services Act*, Supervisory Memorandum 1037, TEX. DEP'T OF BANKING (Apr. 3, 2014) (hereinafter "TDB Memorandum"), available at <http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf>, archived at <http://perma.cc/5WKA-N6K7>; TEX. FIN. CODE ANN. § 151 (West Supp. 2014).

137. *Id.*

138. See FIN. § 151.501(b)(1) (defining currency for purposes of currency exchange as "the coin and paper money of the United States or any country that is designated as legal tender and circulates and is customarily used and accepted as a medium of exchange in the country of issuance.").

139. Cooper, *supra* note 136, at 2–3.

140. See *id.* at 3.

141. TEX. FIN. CODE § 151.301(b)(3) (West Supp. 2014).

142. See Cooper, *supra* note 136, at 35.

143. *Id.*

144. *Id.* at 2–3.

145. *Id.* at 2–5; *Cf.*, GAO-14-96, *supra* note 18, at 6.

Exchange of cryptocurrency for sovereign currency between two parties is not money transmission Exchange of one cryptocurrency for another cryptocurrency is not money transmission Transfer of cryptocurrency by itself is not money transmission Exchange of cryptocurrency for sovereign currency through a third party exchanger is generally money transmission Exchange of crypto-currency for sovereign currency through an automated machine is usually but not always money transmission.¹⁴⁶

Regarding Bitcoin ATMs, the department held that, whether the machine is a money transmitter turns on the configuration of the machine—that is, whether the machine operates as an intermediary between a buyer and seller through an exchange site or whether the machine conducts the transaction directly between the customer and the machine’s operator.¹⁴⁷ In the latter case, there would be no money transmission because “at no time is money received in exchange for a promise to make it available at a later time or different location.”¹⁴⁸ The agency held that businesses that are money transmitters will have to “comply with all applicable licensing provisions of Texas Finance Code Chapter 151 and of Title 7, Texas Administrative Code, Chapter 33” (e.g., net worth requirements, third party security audits of their computer system, etc.).¹⁴⁹

The TDB based its opinion regarding what constitutes money transmission on applicable Texas state law, and at least one other state follows the same approach.¹⁵⁰

b. Kansas

On June 6, 2014, the Office of the State Bank Commissioner (OSBC) issued a guidance document reaching essentially the same conclusion as the TDB.¹⁵¹ Interpreting the Kansas Money Transmitter Act (KMTA), the OSBC held that “[t]he act of two-party currency exchange by itself is not covered by the KMTA” or regulated by the OSBC regardless of whether it is an exchange of sovereign currency or virtual currency.¹⁵² The OSBC followed the guidance of Texas regarding the regulatory treatment of

146. See Cooper, *supra* note 136, at 3–4.

147. *Id.* at 4.

148. *Id.*

149. *Id.*

150. Kansas Office of the State Bank Commissioner, *Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act Guidance Document MT 2014-01* (June 6, 2014), available at http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf, archived at <http://perma.cc/U4XZ-P9NR> [hereinafter MT-2014-01].

151. *Id.*

152. *Id.* at 1–2 (describing the findings of the OSBC after interpreting the Kansas Money Transmitter Act).

common types of transactions involving cryptocurrency.¹⁵³ The agency similarly held that those businesses that are money transmitters will have to comply with all applicable licensing, reporting, net worth, investment requirements, security audit, and other obligations under the KMTA.¹⁵⁴

c. Washington

The Washington State Department of Financial Institutions (WSDFI) however, follows a more expansive view of what constitutes money transmission under the Washington Uniform Money Services Act.¹⁵⁵ The WSDFI has determined that the definition of money transmission includes digital currency.¹⁵⁶ On December 8, 2014, the WSDFI issued an Interim Regulatory Guidance that held the following regarding registration requirements for virtual currency businesses:

- “Exchanging sovereign currency for virtual currency, or vice versa,” are transactions that are money transmission and require a money transmitter license.¹⁵⁷
- Exchanging virtual currency for virtual currency is money transmission.¹⁵⁸
- “Offering virtual currency wallets for storing value” is money transmission.¹⁵⁹
- “Exchanging sovereign or virtual currencies between privately held wallets” between two individuals not engaged in a business is money transmission.¹⁶⁰

The divergent views of Texas and Washington indicate that virtual currency businesses should closely examine the requirements of each state in

153. *See id.*

154. *Id.* at 5.

155. WASH. REV. CODE § 19.230.005 (West 2014).

156. *See id.* (describing that “‘Money transmission’ means receiving money or its equivalent value to transmit, deliver, or instruct to be delivered the money or its equivalent value to another location, inside or outside the United States, by any means including but not limited to by wire, facsimile, or electronic transfer. ‘Money transmission’ does not include the provision solely of connection services to the internet, telecommunications services, or network access. ‘Money transmission’ includes selling, issuing, or acting as an intermediary for open loop stored value devices and payment instruments, but not closed loop stored value [devices].” *See id.* § 19.230.010(18)); *see also* WSDFI, BITCOIN AND VIRTUAL CURRENCY REGULATION, available at <http://www.dfi.wa.gov/cs/bitcoin.htm> (last visited Apr. 1, 2015), archived at <http://perma.cc/9U9Y-3L9A>.

157. Letter from Deborah Bortner, Director, Division of Consumer Sciences, to Virtual Currency Companies Operating, or Wishing to Operate in Washington State, 4 (Dec. 8, 2014), available at <http://www.dfi.wa.gov/cs/pdf/virtual-currency-interim-guidance.pdf>, archived at <http://perma.cc/V2TT-HPES>.

158. *Id.*

159. *Id.*

160. *Id.*

which they do business because, depending on state law, regulators could have differing views of money transmission activity.¹⁶¹

d. New York

New York was the first state to adopt specific regulations for virtual currency business licensing.¹⁶² On June 24, 2015, after lengthy consideration, the New York State Department of Financial Services (DFS) issued final licensing requirements and regulations for businesses that engage in “Virtual Currency Business Activity.”¹⁶³ The New York rules would require any person who engages in Virtual Currency Business Activity to obtain a license with the DFS and would prohibit each licensee from conducting any Virtual Currency Business Activity through an agent when the agent is not a licensee.¹⁶⁴ The definition of Virtual Business Activity is broader than FinCEN’s definition of money transmitter.¹⁶⁵

Under the rule, any business conducting any one of the following types of activities involving New York or a New York resident would have to register and comply with the rule’s obligations:

1. [R]eceiving [v]irtual [c]urrency for [t]ransmission or [t]ransmitting [v]irtual [c]urrency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of [v]irtual [c]urrency;
2. [S]toring, holding, or maintaining custody or control of [v]irtual [c]urrency on behalf of others;
3. [B]uying and selling [v]irtual [c]urrency as a customer business;
4. [P]erforming [e]xchange [s]ervices as a customer business; or
5. [C]ontrolling, administering, or issuing a [v]irtual [c]urrency.¹⁶⁶

Merchants and consumers that utilize virtual currency solely for the purchase or sale of goods or services would be exempt from the licensing requirements.¹⁶⁷ Software development is also excluded.¹⁶⁸ Persons who are chartered under New York banking law and approved by the superintendent to engage in Virtual Currency Business Activity are also exempt.¹⁶⁹ To

161. *See id.* at 3.

162. *See* New York State Department of Financial Services, *New York Codes, Rules, and Regulations*, TITLE 23 DEP’T OF FIN. SERV., CHAPTER 1 REGULATIONS OF THE SUPERINTENDENT OF FINANCIAL SERVICES, PART 200 VIRTUAL CURRENCIES (2014), available at <http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf> [hereinafter NYDFS Rules].

163. *Id.*

164. *Id.* at 7.

165. *See id.* at 5.

166. *Id.* at 6.

167. *Id.* at 7.

168. *Id.* at 6.

169. *Id.* at 7.

conduct exchange services would also be exempt from licensing requirements and have approval to engage in Virtual Currency Business Activity.¹⁷⁰ The rule would require licensees to maintain and enforce certain compliance policies, such as policies with respect to minimum capital requirements, custody and protection of customer assets, financial disclosures, change in control filings, anti-fraud, anti-money laundering, cyber security, privacy and information security, consumer protection, and other policies required under the rules.¹⁷¹

When the rules were first proposed, the department received more than 3,700 comments from individuals, Bitcoin companies, financial institutions, and other companies interested in the proposed regulations.¹⁷² According to reports, the DFS intends to make revisions to the proposed rules available for public comment and issue a final version in January 2015.¹⁷³ Although Texas and Kansas have taken a different approach to virtual currency regulation, many in the Bitcoin and virtual currency industry believe New York's rules could become a model for other states.¹⁷⁴ For example, the Conference of State Bank Supervisors (CSBS) issued a draft model proposal for state regulation of virtual currency businesses that largely echoed the New York Department of Financial Services (NYDFS) model.¹⁷⁵

e. California

In June 2014, the California state legislature lifted a ban on the use of Bitcoin and other alternative currencies to make digital currency legal in purchasing goods and transmitting payments.¹⁷⁶ Prior to the legislation, California's Department of Financial Institutions received significant attention from the virtual currency industry when it issued a May 30, 2013, cease and desist letter to the Bitcoin Foundation alleging that the non-profit may be conducting the business of money transmission in the state without a

170. *Id.*

171. *Id.*

172. *Comments Regarding the Proposed Virtual Currency Regulatory Framework*, DEP'T FIN. SERV., http://www.dfs.ny.gov/legal/vcrf_comments.htm (last visited Apr. 1, 2015), archived at <http://perma.cc/T2UU-BF5C>.

173. Pete Rizzo, *Lawsky: NYDFS Considering Transitional BitLicense for Small Startups*, <http://www.coindesk.com/lawksy-nydfs-considering-transitional-bitlicense-small-startups> (last visited Apr. 1, 2015), archived at <http://perma.cc/EM8Z-HGP8>.

174. See Brian Fung, *Why Bitcoin Advocates Might Like New York's New Proposed Rules for Virtual Currency*, WASH. POST (Dec. 18, 2014), <http://www.washingtonpost.com/blogs/the-switch/wp/2014/12/18/why-bitcoin-advocates-might-like-new-york-new-proposed-rules-for-virtual-currency/>, archived at <http://perma.cc/PN24-P52K>.

175. *State Regulatory Requirements for Virtual Currency Activities: CSBS Draft Model Regulatory Framework and Request for Public Comment*, CONF. ST. BANK SUPERVISORS, (Dec. 16, 2014), available at <http://www.csbs.org/regulatory/ep/Documents/CSBS%20Draft%20Model%20Regulatory%20Framework%20for%20Virtual%20Currency%20Proposal%20--%20Dec.%2016%202014.pdf>, archived at <http://perma.cc/P6BK-QR34>.

176. California Assemb. B. 129, 2013–2014 Sess. State Assemb. (Cal. 2014).

license and was potentially subject to civil monetary penalties of \$1,000 for each violation, \$1,000 per day under section 2151 of the California Financial Code, or criminal prosecution under section 2152 of the California Financial Code.¹⁷⁷

California's Department of Business Oversight examined digital currencies and how to proceed under state law.¹⁷⁸ The Department of Business Oversight ultimately decided against regulating digital currency under existing rules and instead asked the legislature to take up the issue.¹⁷⁹ A bill requiring licensure for virtual currency businesses is currently under consideration by the California legislature.¹⁸⁰

There remains a question whether California will pass legislation for virtual currency business similar to those regulations passed in New York or whether the state—home to many Bitcoin and virtual currency startups—will follow a different path.¹⁸¹

B. Other Federal Regulation Regarding Virtual Currency Activity

Other federal regulators have also taken action or begun investigating virtual currency issues within their regulatory purview.¹⁸² This section addresses actions taken by the Internal Revenue Service (IRS), the Commodity Futures Trading Commission (CFTC), and the Securities and Exchange Commission (SEC).¹⁸³

1. Internal Revenue Service

On March 25, 2014, the Internal Revenue Service issued notice that virtual currency is property for United States federal tax purposes.¹⁸⁴ This

177. Danny Bradbury, *California Issues Cease and Desist Letter to Bitcoin Foundation*, COINDESK (June 23, 2013), <http://www.coindesk.com/california-issues-cease-and-desist-letter-to-bitcoin-foundation/>, archived at <http://perma.cc/K3CS-MEP7>.

178. Katie Orr, *California Considering Virtual Currency Regulations*, KBPS (Dec. 8, 2014), <http://www.kpbs.org/news/2014/dec/08/california-considering-virtual-currency-regulation/>, archived at <http://perma.cc/Q79R-XPBK>.

179. James Nash, *California Agency Ends Plan to Regulate Digital Currency*, BLOOMBERGBUSINESS (May 22, 2015), <http://www.bloomberg.com/news/articles/2015-05-22/california-agency-abandons-plans-to-regulate-digital-currency>.

180. A.B. 1326, 2015–16 Gen. Assemb., Reg. Sess. (Cal. 2015).

181. Fung, *supra* note 174.

182. See, e.g., *IRS Virtual Currency Guidance: Virtual Currency is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, INTERNAL REVENUE SERV. (Mar. 25, 2014), <http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>, archived at <http://perma.cc/K3WU-BBZT>; *Testimony of CFTC Chairman Timothy Massad Before the U.S. Senate Committee on Agriculture, Nutrition, & Forestry* (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6>, archived at <http://perma.cc/T63T-GYKS>.

183. *Id.*

184. *Notice 2014-21*, INTERNAL REVENUE SERV., available at <http://www.irs.gov/pub/irs-drop/n-14-21.pdf>, archived at <http://perma.cc/YEP9-WDC6>.

means that “[g]eneral tax principles applicable to property transactions apply to transactions using virtual currency.”¹⁸⁵ The IRS stated that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.
- Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue Form 1099.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.¹⁸⁶

The notice also stated that a taxpayer who mines virtual currency realizes gross income from the activity based upon the fair market value of the virtual currency as of the date of receipt of the transaction.¹⁸⁷ Taxpayers who fail to treat virtual currency transactions in a manner consistent with the notice may be subject to penalties.¹⁸⁸

2. *Commodity Futures Trading Commission*

Businesses that accept Bitcoin as payment for goods and services have a need to hedge exposures to fluctuations in virtual currency value.¹⁸⁹ At present, many merchants deal with this risk by converting Bitcoin to sovereign currency shortly after obtaining it.¹⁹⁰ Another way to hedge volatility in virtual currency exchange rates is through the use of financial derivatives.¹⁹¹ The Commodity Futures Trading Commission (CFTC) regulates financial derivative products and their markets, including commodity futures and options.¹⁹² The CFTC also investigates and prosecutes violations of the Commodity Exchange Act (CEA) and related regulations.¹⁹³

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. See Jeffrey D. Neuburger & Jonathan P. Mollod, *The Exciting Present and Uncertain Future of Bitcoins and Digital Currency*, 20 WESTLAW JOURNAL SECURITIES & REG. 2 (2014).

190. *Id.*

191. U.S. Gov't Accountability Office, *supra* note 18, at 18. A financial derivative is a contract whose value is based on one or more underlying reference items, such as an asset, index, or interest rate. *Id.*

192. 7 U.S.C. § 2 (2012).

193. *Id.* §§ 1–26; 17 C.F.R. §§ 1.2–.75 (2014).

In December 2014, in testimony before the United States Senate Committee on Agriculture, Nutrition, and Forestry, the CFTC Chairman, Timothy Massad, announced that the agency's authority extends to futures and swaps contracts in almost any commodity—including virtual currency.¹⁹⁴ Chairman Massad testified:

The CFTC's jurisdiction with respect to virtual currencies will depend on the facts and circumstances pertaining to any particular activity in question. While the CFTC does not have policies and procedures specific to virtual currencies like [B]itcoin, the agency's authority extends to futures and swaps contracts in any commodity. The CEA defines the term commodity very broadly so that in addition to traditional agricultural commodities, metals, and energy, the CFTC has oversight of derivatives contracts related to Treasury securities, interest rate indices, stock market indices, currencies, electricity, and heating degree days, to name just a few underlying products. Derivative contracts based on a virtual currency represent one area within our responsibility.¹⁹⁵

Prior to this testimony, the CFTC had not issued a formal pronouncement regarding whether virtual currency met the definition of a commodity under the CEA, instead taking the position that the CFTC would not make a formal determination on the extent of its regulatory authority until market circumstances require the determination.¹⁹⁶ However, many believed that virtual currency would fall within the CEA's broad definition of commodity, which is defined as certain agricultural goods and "all other goods and articles . . . and all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in."¹⁹⁷

Chairman Massad's testimony came after the CFTC authorized the first regulated Bitcoin swap exchange in the country¹⁹⁸ "The trading of USD/Bitcoin swaps will [accordingly] be subject to the rules and regulations of . . . the CFTC."¹⁹⁹

194. Testimony of Massad, *supra* note 183.

195. *Id.*

196. U.S. Gov't Accountability Office, *supra* note 18, at 18.

197. 7 U.S.C. § 1(a)(9).

198. *TeraExchange Launches First Regulated Bitcoin Derivatives Trading*, TERAEXCHANGE (Sept. 12, 2014) (Sept. 12, 2014), available at http://www.teraexchange.com/news/2014_09_12_Launches%20First%20Regulated%20Bitcoin%20Derivatives.pdf, archived at <http://perma.cc/Rf74-K54L>.

199. *Id.*

3. Securities and Exchange Commission

The Securities and Exchange Commission has not addressed the specific legal question of whether Bitcoins or other virtual currencies are securities.²⁰⁰ Some legal analysts have observed that virtual currency itself does not appear to fall within the scope of the definition of securities set forth in Section 2(a)(1) of the Securities Act.²⁰¹ However, the SEC has taken the position that “[a]ll issuers selling securities to the public must comply with the registration provisions of the securities laws, including issuers who seek to raise funds using Bitcoin. . . .”²⁰² The SEC has also prosecuted individuals and companies for unlawfully offering and selling securities involving investments in Bitcoin without properly complying with registration provisions of securities law.²⁰³

In *Securities and Exchange Commission v. Shavers*, the SEC “charged a Texas man and his company with defrauding investors in a Ponzi scheme involving Bitcoin. . . .”²⁰⁴ The SEC’s complaint charged Shavers and his company “with offering and selling investments in violation of the anti-fraud and registration provisions of securities law, specifically [s]ection 5(a), 5(c)[,] and 17(a) of the Securities Act of 1933, [s]ection 10(b) of the Securities Exchange Act of 1934 and Exchange Act Rule 10b-5.”²⁰⁵ At issue in the case was whether the Bitcoin Savings and Trust investments were securities as defined by federal securities law.²⁰⁶ Shavers contended that his transactions were all Bitcoin transactions and that no money ever exchanged hands.²⁰⁷ The SEC argued that Bitcoin Savings and Trust’s investments were both investment contracts and notes, and, thus, were securities.²⁰⁸

The SEC prevailed.²⁰⁹ The Eastern District of Texas found that, in the investment context, Bitcoin fell within the definition of a security as an investment contract.²¹⁰ The court relied on the definition of security under 15 U.S.C. § 77b, which states that a security is “any note, stock, treasury stock, security future, security-based swap, bond, . . . [or] investment

200. See *Is BitCoin Legal?*, COINDESK (Aug. 19, 2014), <http://www.coindesk.com/information/is-bitcoin-legal>, archived at <http://perma.cc/6JEF-7AEF>.

201. Matthew Kien-Meng Ly, *Coining Bitcoin’s ‘Legal-Bits’: Examining the Regulatory Framework for Bitcoin and Virtual Currencies*, 27 HARVARD J.L. & TECH. 2 (2014).

202. SEC Charges Bitcoin Entrepreneur With Offering Unregistered Securities, U.S. SEC. EXCHANGE COMMISSION (June 3, 2014), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370541972520#.VJDwDhaprzI>, archived at <http://perma.cc/T8XD-ZUUX>.

203. See SEC v. Shavers, No. 4:13-CV-416, 2013 WL 4028182, (E.D. Tex. Aug. 6, 2013).

204. U.S. SEC, SEC Charges Texas Man With Running Bitcoin-Denominated Ponzi Scheme, U.S. SEC. EXCHANGE COMMISSION (July 25, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539730583>, archived at <http://perma.cc/58MS-PEYN>.

205. *Id.*

206. *Shavers*, 2013 WL 4028182, at *2.

207. *Id.*

208. *Id.*

209. *Id.*

210. *Id.*

contract.”²¹¹ Under existing precedent, the court held that “an investment contract is any contract, transaction, or scheme involving (1) an investment of money, (2) in a common enterprise, (3) with the expectation that profits will be derived from the efforts of the promoter or a third party.”²¹² Seemingly in contradiction of the view of FinCEN and the IRS, the court opined that Bitcoin is a currency or form of money and therefore investors making an investment in BTCT “provided an investment of money.”²¹³ The court found that the other prongs of the investment contract were also met, and the court ordered Shavers to disgorge \$40,404,667 and pay a \$150,000 penalty.²¹⁴

Consistent with the *Shavers* precedent, the SEC also charged Bitcoin entrepreneur Erik Vorhees “for publicly offering shares in two [Bitcoin] ventures without registering them.”²¹⁵ The complaint addressed unregistered offerings of shares in two entities owned by Vorhees—FeedzeBirds and SatoshiDICE. Vorhees’ website FeedzeBirds paid individuals a fee in Bitcoins for tweeting sponsored messages.²¹⁶ Vorhees publicly offered shares in the company for Bitcoin on the internet.²¹⁷ He also offered public shares in SatoshiDICE, an on-line gambling website.²¹⁸ Vorhees’ company issued the shares, and then ultimately bought them back at a profit from investors before selling the company to a third-party.²¹⁹ The SEC alleged that Vorhees’ actions violated sections 5(a) and 5(c) of the Securities Act, which prohibit the direct or indirect sale of securities, offer to sell, or offer to buy securities through the mails or interstate commerce unless a registration statement is on file or is in effect.²²⁰ Vorhees ultimately agreed to “cease and desist from committing or causing any violations and any future violations of [s]ections 5(a) and 5(c) of the Securities Act.”²²¹ He also agreed to a

211. 15 § U.S.C. 77b(a)(1)(2012).

212. *Shavers*, 2013 WL 4028182, at *2 (citing *SEC v. W.J. Howey & Co.*, 328 U.S. 293, 298–99 (1946); *Long v. Shultz Cattle Co.*, 881 F. 2d 129, 132 (1989)).

213. *Id.* (holding “[i]t is clear that Bitcoin can be used as money. It can be used to purchase goods and services, and as Shavers stated, used to pay for individual living expenses. The only limitation of Bitcoin is that it is limited to those places that accept it as currency. However, it can be exchanged for conventional currencies, such as the U.S. dollar, Euro, Yen, and Yuan. Therefore, Bitcoin is a currency or form of money, and investors wishing to invest in BTCST provided an investment of money.”). *Id.*

214. *Final Judgment Entered Against Tregon T. Shavers, A/K/A/ ‘Pirateat40’ - Operator of Bitcoin Ponzi Scheme Ordered to Pay More than \$40 Million in Disgorgement and Penalties*, SEC LITIG. Release No. 23090, (Sept. 22, 2014), <http://www.sec.gov/litigation/litreleases/2014/lr23090.htm>, archived at <http://E8ZU-ZXCA>.

215. *SEC Charges Bitcoin Entrepreneur with Offering Unregistered Securities*, *supra* note 192.

216. Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order at 2, In re Erik T. Vorhees, 2014 WL 2465620 (2014) (No. 3-15902).

217. *Id.* at 3.

218. *Id.* at 2–3.

219. *Id.* at 2.

220. *Id.* at 5.

221. *Id.*

disgorgement of his profits of approximately \$15,000 and to pay a civil fine of \$35,000.²²²

The SEC has also begun review of a registration statement from the Winklevoss Bitcoin Trust, an entity that wants to offer Bitcoin-related securities.²²³ “The [trust] filed a registration statement for an initial public offering of its securities,” which would structure the public offering as an exchange-traded fund that would hold Bitcoins as its only assets.²²⁴ The trust has filed several amended registration statements and its application and operations remain pending.²²⁵

4. Consumer Financial Protection Bureau

A number of federal interagency working groups have begun to review virtual currency issues.²²⁶ The focus of their efforts has been primarily on Bank Secrecy Act concerns, anti-money laundering controls, and the investigation of crimes involving virtual currencies—rather than consumer protection issues.²²⁷ To increase focus on consumer protection, a General Accountability Office (GAO) report to the U.S. Senate Committee on Homeland Security and Governmental Affairs has recommended increased participation in interagency working groups by the Consumer Financial Protection Bureau (CFPB), an independent federal agency that is responsible for consumer protection in the financial sector.²²⁸

The extent of the CFPB’s involvement in virtual currency regulation remains to be seen, but increased participation by the CFPB in virtual currency working groups could eventually mean increased regulation focused on consumer protection issues.²²⁹ The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) created the CFPB, which has consumer protection supervisory authority over institutions that offer consumer financial products and services.²³⁰ The CFPB has authority to adopt “regulations that implement federal consumer financial protection laws, including the Electronic Fund Transfer Act [(EFTA)] and title X of the Dodd-Frank [Act].²³¹ According to the GAO report, the EFTA allows CFPB to enforce the EFTA, which “establishes basic rights, liabilities, and responsibilities of consumers who use electronic fund transfer services and

222. *Id.*

223. U.S. Gov’t Accountability Office, *supra* note 18, at 29.

224. *Id.* at 29.

225. *Id.*

226. *Id.* at 34.

227. *Id.* (located in introductory findings).

228. *Id.*

229. *See id.* at 15.

230. *Id.* at 16.

231. *Id.*

of financial institutions that offer these services.”²³² The Dodd-Frank Act gives CFPB authority to “to prescribe rules to ensure that the features of any consumer financial product or service, both initially and over the term of the product or service, are fully, accurately, and effectively disclosed to consumers in a manner that permits consumers to understand the costs, benefits, and risks associated with the product or service, in light of the facts and circumstances.”²³³

To date, the CFPB has issued consumer advisories related to virtual currency and has developed a process to take complaints regarding virtual currency activity.²³⁴ The CFPB has limited its participation in formal interagency working groups and has not proposed regulations related to the virtual currency industry.²³⁵ However, the GAO report recommends, and CFPB agrees that, “[t]o help ensure that federal interagency collaboration on virtual currencies addresses emerging consumer protection issues,” the CFPB should identify and involve itself with these interagency working groups in order to provide more focus on consumer protection issues.²³⁶ CFPB officials report they are currently reviewing how virtual currencies impact their statutory responsibilities.²³⁷

IV. WHERE DO WE GO FROM HERE?

As regulatory precedent regarding virtual currency continues to emerge, those who ignore regulatory obligations for virtual currency businesses do so at their own peril.²³⁸ The Ripple Labs experience demonstrates that developing an *ad hoc* compliance program as a business grows and develops can be a costly business strategy.

And more regulation is coming.²³⁹ While many in the virtual currency industry oppose regulation because of the costs of compliance and concerns that regulation will stifle innovation, it is also apparent that regulatory uncertainty presents other—perhaps more substantial—risks for legitimate

232. *Id.* at 16.

233. *Id.* at 16.

234. Consumer Financial Protection Bureau, *supra* note 16, at 6.

235. U.S. Government Accountability Office, *supra* note 18, at 49 (depicting a letter from William Wade-Gery to GAO Director Lawrence Evans).

236. *Id.* at 40.

237. *Id.* at 16.

238. See *SEC Charges Bitcoin Entrepreneur with Offering Unregistered Securities*, *supra* note 192; *Investor Alert: Bitcoin and Other Virtual Currency-Related Investment*, U.S. SEC. EXCHANGE COMMISSION (May 7, 2014), http://www.sec.gov/oiea/investor-alerts-bulletins/investoralertsia_bitcoin.html#VOZP_THF8-i, archived at <http://perma.cc/T393-CKUX>; *Bitcoin: More than a Bit Risky* (May 7, 2014), <http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/FraudsAndScamsP45645>, archived at <http://perma.cc/P2GG-DEUZ>.

239. See generally U.S. Government Accountability Office, *supra* note 18 (offering advice to legislature for regulating virtual currency).

virtual currency businesses.²⁴⁰ As regulators continue to issue consumer and investor advisories warning of the perils of buying and using virtual currency, perceived consumer protection and regulatory risk will limit the potential market share of legitimate businesses.²⁴¹ To the extent consumers hear the constant refrain that Bitcoin and virtual currency present significant risk in contrast to traditional payment methods, widespread acceptance by consumers will remain elusive.²⁴² In addition, regulatory uncertainty can stymie investment in virtual currency businesses.²⁴³ Sophisticated institutional investors are less likely to invest in virtual currency businesses that are not paying attention to their regulatory risks or, in the worst case scenario, subject to investigation or indictment.²⁴⁴ For entrepreneurs that need capital to grow their start-ups, regulatory uncertainty will, in the long term, limit the growth potential of their companies.²⁴⁵

These are not easy problems to fix because of the uncertain state of regulation.²⁴⁶ So what is the solution? First, businesses should make it a priority to have an active compliance strategy before going operational. Second, settling the regulatory landscape is a step in the right direction, and states should clarify their requirements for money transmitter licensing.²⁴⁷ The question is whether virtual currency regulation will look like the sweeping nature of the New York licensing scheme or follow the model of agencies such as FinCEN and the Texas Department of Banking, which have tried to work virtual currency activity into their existing regulatory structures.²⁴⁸

This author would posit that, without comprehensive coordination of federal and state regulators on virtual currency regulation, the latter approach appears to be the most reasonable and the least stifling to innovation in the virtual currency sector.²⁴⁹ When New York first proposed its regulations, authors rightly criticized the proposed regulations for various reasons.²⁵⁰ Among the many complaints, the initial definition of “Virtual Currency

240. *Id.* at 23–24.

241. *See id.* at 24.

242. *See Bitcoin: More than a Bit Risky supra* note 239.

243. *Virtual Currencies: Out of the Deep Web, Into the Light*, PRICE WATERHOUSE COOPERS 4–5 (2014), available at http://www.pwc.com/en_IM/IM/Publications/assets/banking/pwc_virtual_currencies_risk_opportunities.pdf, archived at <http://perma.cc/34YV-JCAZ>.

244. *See id.* at 4–5.

245. *Id.* at 5.

246. *Id.* at 4.

247. *See* Edmund L. Andrews, *Chris Larsen: Money Without Borders*, STAN. GRADUATE SCH. OF BUS. (Sept. 24, 2013), <http://www.gsb.stanford.edu/insights/chris-larsen-money-without-borders>, archived at <http://perma.cc/G9DU-2D56>; Proposed NYDFS Rules, *supra* note 162.

248. *See* Andrews, *supra* note 247; NYDFS Rules, *supra* note 162.

249. *See* Andrews, *supra* note 247; NYDFS Rules, *supra* note 162.

250. *See Excerpts From Superintendent Lawsky’s, Remarks on Virtual Currency and Bitcoin Regulations in New York City*, N.Y. ST. DEP’T FIN. SERV. (Oct. 10, 2014), http://www.dfs.ny.gov/about/speeches_testimony/sp141014.htm, archived at <http://perma.cc/4H5J-9PFS> [hereinafter *Lawsky’s Remarks*].

Activity” was very broad and potentially captured activity such as mining or selling for personal use and software development.²⁵¹ Critics claimed the regulations would impose greater burdens on virtual currency businesses than money transmitters with more stringent capital requirements, investment restrictions, disclosure requirements, etc.²⁵² Some of these concerns were addressed in the final version of the rule, although the rule did not address the concern that the cost of compliance will make it difficult for virtual currency startups. Regulator concern regarding identification of account holders is understandable from a money-laundering perspective, but to the extent the virtual currency regulations go beyond current requirements for money transmitters, the regulations could place undue burdens on virtual currency businesses.²⁵³

According to NYDFS Superintendent Benjamin Lawsky:

virtual currency sits at the crossroads of a more lightly regulated technology sector and more heavily regulated financial sector.

There is a basic bargain that when a financial company is entrusted with safeguarding customer funds and receives a license from the state to do so—it accepts the need for heightened regulatory scrutiny to help ensure that a consumer’s money does not just disappear into a black hole.²⁵⁴

Mr. Lawsky’s comments have some merit.²⁵⁵ To be sure, protection of consumer currency—whether virtual or sovereign currency—is a matter that legitimately falls within the public interest and reasonable regulation of payment transactions rightly falls within governmental purview.²⁵⁶ However, regulators should not place undue burdens on the type of technology that facilitates a payment transaction.²⁵⁷ To do so could stifle the growth of potentially game-changing technology in the payment transaction space.²⁵⁸

251. *Id.*; see Comments on Proposed Rules regarding the Regulation of the Conduct of Virtual Currency Businesses—Addition of Part 200 to Title 23 NYCRR from Chris Larsen, CEO Ripple Labs, to Benjamin M. Lawsky, N.Y. Superintendent of Fin. Servs., and Dana V. Syracuse, Off. of General Couns. for N.Y. St. Dep’t of Fin. Servs., at 3 (Oct. 21, 2014), available at http://www.dfs.ny.gov/legal/vcrf_0500/20141022%20VC%20Proposed%20Reg%20Comment%20243%20-%20Ripple%20Labs.pdf, archived at <http://perma.cc/BZ5G-J7KM>.

252. *Id.*; see DATA’s Public Comments to NYDFS Proposed Regulations: Title 23, Chapter I, Part 200: Virtual Currencies from Constance Choi, Founding Board Director & Secretariat of DATA, to Dana V. Syracuse, Off. of General Couns. for N.Y. St. Dep’t of Fin. Servs., at 18 (Oct. 21, 2014), available at http://www.dfs.ny.gov/legal/vcrf_0500/20141022%20VC%20Proposed%20Reg%20Comment%20242%20-%20DATA.pdf, archived at <http://perma.cc/3HSV-FNCB>.

253. *Id.*

254. *Lawsky’s Remarks*, *supra* note 250.

255. *Id.*

256. See U.S. Government Accountability Office, *supra* note 18, at 12.

257. See *Lawsky’s Remarks*, *supra* note 250.

258. See *Virtual Currencies: Out of the Deep Web, Into the Light*, *supra* note 244, at 5.

