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Good Afternoon, Superintendent Lawsby and members of the New York State Department of Financial Services. Thank you for the opportunity to provide my thoughts on the important issues arising out of the regulation of virtual currencies, also known as “digital currencies”. My name is Judie Rinearson and I am a partner at Bryan Cave’s New York office. I am a lawyer whose practice focuses on payments laws, in particular prepaid and emerging payments. My payments career began, however, focusing on much more traditional payment products. As an attorney for American Express here in New York City, I was the lawyer responsible for American Express Travelers Cheques, and in that role I became very familiar with state money transmitter licensing laws. I since have spoken and written frequently on the topic of how state money transmitter licensing laws apply to both traditional and emerging payments. I am very pleased to be here today to discuss the regulation and possible licensing of bitcoin and other virtual or digital currencies.

Before addressing the questions submitted in your letter of January 10, 2014, I think it is important to discuss the underlying products themselves. Do virtual currencies matter? Are virtual currencies beneficial and useful products for mainstream use? Or are they mostly tools for crooks and fraudsters? Where one comes out on this seminal issue drives much of the subsequent regulation and legislation. I have been working with a number of bitcoin companies,

and I've spent considerable time researching the topic and reviewing the products. I have concluded that bitcoin and other similar virtual and digital currencies *are* essentially beneficial products that consumers and businesses will increasingly use and rely on, on a global basis. No, they will not replace fiat currencies, but they will provide an important alternative option. These currencies are faster and more efficient to transfer than existing currencies, more secure and less expensive, particularly for international transactions. I also personally think it is useful to have a few non-government backed payment options – to help move funds where needed when the usual payment methods cannot be relied upon. (The classic example is the usage of bitcoin to assist dissidents struggling under repressive governments). And finally, from a public policy perspective, providing a workable regulatory framework under US law will keep bitcoin and other similar currencies here, on-shore, rather than pushing them off shore where they cannot be effectively supervised and monitored. So for these and many other reasons, I believe that the continued growth of bitcoin and other virtual currencies is a good thing. If you want to make sure that bitcoin and virtual or digital currencies are available for our children and grandchildren, we need to have good, responsible, *but reasonable*, regulation today. These issues matter and that's why we're here. I should add that my focus today is on state money transmitter licensing for virtual and digital currencies. I know others have raised the suggestion that such products be regulated as securities or commodities, but I will not be addressing those issues.

Now to your questions.

1. The feasibility of the Department issuing a “BitLicense” specific to virtual currency transactions. I believe that such licensing is feasible. Moreover, I don't think such a licensing regimen needs to be all that different from what currently exists for money transmitters and

currency exchanges. The most challenging part about licensing bitcoin and virtual currencies is the value fluctuations of such products. But I think there are ways that this can be addressed.

To start, let's consider the goals of the state money transmitter licensing process. There are 4 primary goals:

- First, to make sure the licensed company and its staff have the knowledge and experience necessary to operate a regulated payments business. This means that the applicant and its officers must demonstrate their understanding not only about what state laws apply, but also federal anti-money laundering laws and the commensurate compliance obligations. Typically, applicants must provide copies of their AML compliance program and procedures, and must submit resumes of senior staff to show their experience.
- Second, to make sure the licensed company is not owned or operated by criminals, fraudsters, terrorists, or organized crime. Obviously the ability to move funds across borders is powerful and sensitive. Those who apply for such licenses must be fingerprinted, and undergo background checks. They must provide personal financial details, resumes, prior addresses, and other background data as well. And all of this data must be verified by the state.
- Third, to make sure the licensed company has the financial resources needed to run a payments business. This is a safety and soundness concern – and applicants will typically provide audited financials and must have a minimum net worth.
- Fourth, to protect consumers who do business with such entities, by requiring surety bonds, holding “permissible investments” equal to the amount of outstanding funds held, requiring disclosures at the point of sale and on receipts, making the entities subject to

examination and by funding a state insurance fund to help consumers in the event of a business closure or bankruptcy

In my view, the first two requirements for traditional money transmitters (experience and backgrounds checks) can easily be applied to operators of virtual and digital currency exchanges. There are, however, some interesting and difficult issues arising from the last two requirements (safety and soundness, and protection of consumers against loss).

1) **Net worth and permissible investment requirements:** Can these requirements be met with virtual currencies rather than traditional fiat currencies? That depends. These two requirements are very different. Net worth requirements are intended to show that the company is appropriately capitalized and can pay its debts. These requirements are always stated in a fiat currency. If a state requires \$1 million in net worth for a licensee, but a virtual currency exchange is holding value solely bitcoin (whether equivalent to \$1 million or not), that in my view would not appear to meet a state's requirement to have a minimum net worth of \$1 million *in US dollars*.

By contrast, permissible investment requirements are in place to cover the value being held by the licensee for its customers. If an exchange has been given 25 bitcoin by its customer to hold and/or transfer, then given the current volatility of virtual/digital currencies, that risk should be covered with 25 bitcoin, and not by another currency which may lose value vis-à-vis the 25 bitcoin. Thus, until the fluctuations in the value of virtual and digital currencies has declined, holding permissible investments in any currency or securities *other than the virtual/digital currency itself* might be quite risky. It would be well worth considering requiring at this early stage, permissible investments to be held solely in the virtual/digital currency provided by the customer.

I must concede that these are difficult issues. Even for net worth, it might be appropriate to consider crediting the licensee for at least some of the virtual/digital currency held by an exchange. Perhaps under a new BitLicense rule, virtual currency exchanges or transmitters can count a percentage of their virtual/digital currency holdings towards the net worth requirements. Similarly perhaps a percentage of the permissible investments can be held in highly rated securities issued in a fiat currency. I don't claim to have all the answers, but it is clearly important that we explore these and other options.

**2. Protection of consumers through bonds and insurance funds.** Again, problems arise from the volatility of virtual and digital currencies. How would a state impose a bond requirement when the amount of value being held can change so quickly? How could a state insurance fund be expected to cover all risk when a consumer purchases and holds bitcoin or other similar currencies? Yes, these are also hard issues, but that doesn't mean we throw up our hands and say "too hard to do - - too hot to handle." While establishing a reasonable bond or insurance fund requirement based on prior transaction history makes sense, nevertheless I believe this is one time when we have to let consumers make their own decisions and take their own risks – but with eyes wide open and full disclosure. Bonds and state insurance funds cannot be expected to protect consumers who choose to purchase and use payment products with values that fluctuate daily. So in these instances, it seems to me that the state's role has to be focused on disclosure. When an individual opens an account with a licensed entity to hold virtual or digital currency, before opening the account he or she must read and click a disclosure or release that says something like this:

“Yes, I understand that my purchase of [currency] is subject to fluctuations in value. I understand that the value of my purchase may increase or decrease daily, and could even cease to have any value at all. I understand and agree that I may not be protected under any state or federal law or regulation for any losses that I incur.”

This provides appropriate warnings to consumers without stifling their ability to acquire virtual or digital currencies.

The overall approach I have suggested above is just the first step in the process of developing appropriate regulation. While I am certain there are many improvements that can be made to my proposal on licensing, the basic concept underlying this approach is this: It is a way to give consumers the ability to purchase and use bitcoin and other virtual or digital currencies from licensed providers who have been reviewed, examined and approved by the state. It allows virtual and digital currency companies who want to be compliant with both state and federal law to do so and to be a model for other entities who want to do business in this space. It protects our payment system and our nation from potential companies that may be owned or operated by criminal elements. Finally, it protects states from overextending their limited resources when consumers elect to use financial products that may present risk.

2. What types of virtual currency transactions and activities should require regulation? I like the ocean analogy. Bitcoin and virtual currency are like fish that move smoothly under the water of cyberspace and the internet, and often can be used solely to purchase digital goods or services also found “under the water.” These don’t need regulation. But once the fish are out of the water - - once the currencies can be exchanged for dollars or other fiat currencies - - then true

risk arises. So certainly exchanges that buy and sell, or convert bitcoin and other similar currencies to dollars, euros, or other fiat currencies - - need to be licensed. I would also argue that any time an entity is holding onto (and having access to) another person's value, currency or funds for the purpose of transmitting the value to another person - - such as remittance companies - - that person also needs to be regulated. I should note that there might be a different rule for entities that set up wallets without having access to a consumer's private key and therefore cannot access or move the value. At least such arrangements would require a closer look.

What doesn't need to be licensed? Bitcoin to other virtual currency transfers that don't involve fiat currencies; bitcoin or virtual currency "mining" for personal use (including exchanging such mined currency for personal use); bitcoin or virtual/digital currency acceptance services for merchants. For these other activities, I see little need for new or extensive regulation at this time.

3. Should Entities that are regulated be required to follow specifically tailored anti-money laundering guidelines? Certainly regulated virtual currency exchanges and virtual currency remittance companies will need to comply with anti-money laundering laws. Whether specifically tailored laws are required is unclear, however. It appears that the US Treasury's Financial Crimes Enforcement Network (FinCEN) has concluded that existing laws governing non-bank money services businesses (MSBs) are sufficient, and I tend to agree. In March 2013, FinCEN issued interpretive guidance to clarify the applicability of the regulations implementing the Bank Secrecy Act (BSA) to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies. (See [http://fincen.gov/statutes\\_regs/guidance/html/FIN-2013-](http://fincen.gov/statutes_regs/guidance/html/FIN-2013-)

G001.html) The guidance refers to these persons as “users,” “administrators,” and “exchangers,” and defines each term. A user of virtual currency is *not* an MSB under FinCEN’s regulations and therefore is not subject to MSB regulations. However, an administrator or exchanger *is* considered an MSB under FinCEN’s regulations, and is specifically designated under the category of a “money transmitter” rather than as a provider or seller of prepaid access, or a dealer in foreign exchange.

Therefore, US law seems pretty clear. Under the MSB regulations, a bitcoin or other virtual currency exchange or an administrator must have an effective AML compliance program in place.

What are the issues arising out of AML compliance? The keys to a solid AML compliance program are identification verification, transaction monitoring and reporting. When it comes to transaction monitoring and reporting, the beauty of bitcoin and many virtual or digital currencies is that they actually are not as anonymous as many assumed. In fact they provide a highly robust digital trail with public ledgers that record all transactions.

The big issue, as I see it, is ID collection and verification and Know Your Customer (KYC) rules. A licensed exchange that opens an account for buyers or sellers of virtual or digital currency should request and verify certain identifying information in order to open an account. Moreover, even after the account is opened, depending on the volume and nature of its usage, the licensed exchange should comply with ongoing monitoring, customer due diligence or “know your customer” requirements.

As with traditional payment methods, the regulated entity must refuse to enter into any relationship or conduct any transaction for a customer who does not provide the necessary data, does not pass the identification verification requirements or who otherwise appears on the List of Specially Designated Nationals and Blocked Persons published from time to time by OFAC.. This is a process that many compliant bitcoin and similar exchanges and their customers are perfectly willing and able to do.

One of the most common questions I receive in this area is this: “Sure, your US regulated entity knows its customer and has screened the customer appropriately. But how do you know who is on the *other side* of the transaction?” I would respond that the goal is not just to have a handful of compliant regulated US entities but to have established standards for virtual and digital currency exchanges around the globe. Long term, I envision a world with a network of global regulated and licensed virtual currency exchanges and remittance companies connected together, like a network of small islands on our ocean. A US regulated entity that chooses to do business only with other similarly regulated entities provides a safe and secure avenue for its customers who want the advantages of a virtual or digital currency but also the comfort of knowing whom they are dealing with and knowing that the transaction complies with all applicable laws. This may not be easy to achieve under the current virtual currency technology platforms, but it is a goal for the industry and one to which I hope we can all aspire.

4. Should entities that are regulated be required to follow specifically tailored consumer protection guidelines?

Yes, but only to a certain extent. There are some disclosures unique to virtual and digital currencies. As noted earlier, I would recommend some specific disclosure requirements for consumers regarding the risk of loss and currency fluctuations. Other unique risks – such as the irreversibility of transactions, the impact of a loss of one’s private key, or the impact of a computer crash, should also be clearly disclosed.

But I would urge caution about imposing too many other specific consumer protection provisions. There are already existing laws that protect US consumers – Section 5 of the FTC Act, the Consumer Financial Protection Bureau regulations, and other state and federal fair trade and fair advertising laws. Terms and conditions must be clear and conspicuous and disclosed in advance. It is illegal to mislead or deceive; it is illegal to run a Ponzi scheme. These things are already in our laws. I believe the existing protections – when coupled with an initial disclosure regarding risks – are sufficient at this time and I feel it is much too premature to begin imposing additional restrictions until this nascent industry has developed further.

5. Should entities that are regulated be required to follow specifically tailored regulatory examination requirements?

Examination of licensed virtual currency exchanges and transmitters is clearly an important process, and in my view is also quite feasible, although the process does raise some unique issues. First, let us consider what the current processes cover. Mandatory Examinations are regularly scheduled by the Department of Financial Services (DFS) for its New York money transmitter licensees. Examinations are typically scheduled with 2-4 months advance notice to allow for scheduling constraints for the on-site logistics and arrangements. A comprehensive examination questionnaire is sent to the licensee for completion *prior* to the arrival of the state examiners. Submission of documents is expected to be fulfilled at the onset of the examination

prior to the on-site visit, although additional requests for more detailed information or explanations may be received from the examiners throughout the process. .

The examination encompasses the following five broad areas of review referred to as “FILMS”:

1. FINANCIAL CONDITION
2. INTERNAL CONTROLS AND AUDITING (e.g., risk and management policies; internal and external audits; delegate/merchant monitoring and policy)
3. LEGAL AND REGULATORY COMPLIANCE (e.g., Anti-money laundering policy adherence, external reviews; consumer disclosures; privacy policies: GLBA)
4. MANAGEMENT (and Board) REVIEW
5. SYSTEMS AND TECHNOLOGY (including Security)

The goal of the examination is to assess the licensed money transmitter’s compliance with both New York and federal statutes and regulations. The review often focuses on anti-money laundering compliance as well as consumer protection issues. Following the examination, a rating will be assigned from a “1” (Highest level of compliance) to a “5” (Unsatisfactory) for each aspect of the operation and an overall rating will be given. A rating of “5” (Unsatisfactory) will require the licensee to create action plans to correct any deficiencies or violations of law that the examination has uncovered. If serious deficiencies and/or violations are discovered regulatory actions can result (i.e., fines or penalties; suspension or termination of license).

How would these procedures apply with respect to a virtual or digital currency exchange? In many respects the procedures will be the same - - reviewing financials, transaction data, AML and operational procedures and controls; interviewing staff; testing transactions. But the DFS will also needs to determine a new formula and framework tailored to capture the current and

changing value of the digital or virtual currency. The examination of internal controls and auditing would focus on compliance with notice and disclosure requirements, as well as confirming that the security measures surrounding the private key or other personally identifiable information is satisfactory. The review of systems and testing of transactions will also require additional study and scrutiny. This is feasible, but it will require some additional planning on the part of the state.

#### 6. The benefits and drawbacks of using virtual currency from a retail perspective.

The acceptance of bitcoin as a method of exchange by a growing group of merchants creates a market for virtual currencies. With Overstock's announcement and Manhattan's Bond New York becoming the first real estate brokerage to accept bitcoin as payment, we see evidence of the market's growing comfort with the digital currency. Moreover, as retail acceptance grows, the opportunities provided by digital currencies with respect to fast and efficient micro-transactions – everything from paying tolls to going to the laundromat – could open up many new possibilities.

One challenge is infrastructure. A retailer would need new technology for its online shopping cart and back end processing for tracking bitcoin sales. Retailers also need to implement tracking procedures for calculating tax payments in US dollars based upon bitcoin sales.

From a retail perspective, consumers and retailers must have confidence that virtual currencies do not present heightened data security risks. The strength of the underlying crypto currency and transaction validation are fundamental to consumer trust and acceptance. If the virtual currency at issue lacks a single, legal entity to provide recourse to users, this may also limit consumer trust

and acceptance. To help ease the way, virtual and digital currency exchanges, and other bitcoin companies, offer additional security features, including “bank level security,” encryption and backups.

Retailers and banks should conduct careful due diligence on privacy policies, data security, consumer notices and disclosures, and chargeback rates. Retailers will want to vet carefully any service provider or exchange that handles on line or POS transactions. Many retailers will elect to work with a bitcoin intermediary who offers business processing software and services that offer the option of transferring bitcoin immediately into dollars following the transaction. Retailers can also negotiate with exchanges for a ceiling and a floor for currency fluctuation. Some services also offer options to reduce currency fluctuation risks, by setting an exchange rate before a bitcoin transaction is made and immediately converting it to US dollars. Other contractual limitations may be available to reduce currency fluctuation risk..

In the retail context, it is also important for retailers to notify consumers about the critical differences when paying with virtual or digital currencies. For example, the irreversible nature of a bitcoin payments means that the consumer must be quite sure about the purchase being made. Also, with certain digital currencies, like bitcoin, there may be a delay in finalizing or confirming the transaction, which might make it difficult in an “immediate” POS environment such as a coffee shop.

Bottom line – Acceptance of bitcoin and other virtual or digital currency by merchants is truly a commercial transaction. In the short time that bitcoin has been in the marketplace, the number of merchants accepting bitcoin has multiplied. Further, the parties have established a negotiated set of rules that take into account the currency’s volatility. It appears that the contracts between

the parties have provided adequate protections. I have heard no complaints, and I see little reason for further regulatory involvement at this point.

7. Pricing, volatility and security of the virtual currency market from an investor perspective:

Bitcoin in particular has been very favored by investors. But investing in bitcoin or other virtual/digital currencies carries some risks. That is why it is important that investors be given up front disclosures regarding the risks before they invest.

There are many reasons why investors like bitcoin. By 2140 there will only be 21 million bitcoin in existence. This limited supply is attractive to some. Because of this enforced scarcity, it is different from government-issued currencies or even other types of virtual currency, where a central body can manipulate the amount of currency on the market. Bitcoin is also viewed as secure, efficient and low cost product. As a cutting edge payment vehicle, many investors view bitcoin (and similar products) as the wave of the future with a potential impact as large as the internet.

But of course there are also risks.

- Lack of intrinsic value. People compare bitcoin to commodities, like silver or gold—commodities that need to be mined, but bitcoin and other virtual currencies have no intrinsic use value and cannot be used for anything unless people accept that the currency has value. This makes investment risky because if merchants stop accepting the currency for the exchange of goods, or if governments shut down other exchange mechanisms, investors may be left holding pieces of code with no value.
- Operational risks. Bitcoin wallets are password protected, but if the wallet is hacked or the password is forgotten, there aren't the same password recovery options available as

there would be with a bank that can verify an investor's identity. Furthermore bitcoin or other similar virtual currencies, that cannot be accessed is essentially worthless. Another potential operational risk for investors is that electronic wallets (or any data files) which store bitcoin code may be vulnerable to corruption, accidental deletion, hacking, and will need to be updated to stay compatible with new operating systems.

- Volatility. In early 2013, investors traded bitcoin for less than \$20 each. In April 2013, the price had risen to above \$200, and by the end of November 2013 had reached over \$1200, only to crash to under \$700 in December 2013. When I checked last week, it was at about \$850. Due to pricing volatility, bitcoin and virtual currencies are not easy to insure. There are no governments to control rapid inflation or deflation of virtual currencies. .

Although there are such risks, we believe investors understand the nature of the risks. Given the ease with which we collected this information, it also appears that the bitcoin and virtual currency industries have been open and transparent about the risks. Appropriate disclosures must be made to all investors of course. Again, provided that necessary disclosures are made, further regulation does not yet appear to be necessary at the current time.

8. The future expectations and anticipated developments of the virtual currency market from the investor and retail perspective.

I am an optimist. I view the prospects for bitcoin and virtual/digital currencies to be quite good – especially from a merchant and investor perspective. I believe we'll see more merchants accepting bitcoin and virtual currencies and more investment in these products and related applications. Merchants and investors are the parties most capable of protecting themselves through the contracting process. The bigger question of course is the consumer perspective.

That is why we are here and that is why the work before us is so important. These are valuable products that can offer extraordinary efficiencies and opportunities not just for us but for future generations. What is critical is that we have a regulatory framework that works to protect consumers and the financial system, without stifling growth, innovation and long-term future of these important payment products.

Thank you for the opportunity to provide my views. I welcome any questions you may have..