

Matthew Gertler



October 20, 2014

Dana V. Syracuse
DFS Office of General Counsel
New York State Department of Financial Services
One State Street
New York, New York 10004

Re: Comments on Proposed Regulations of Virtual Currency Businesses—DFS-29-14-00015-P

Dear Mr. Syracuse,

I am a Juris Doctorate and MBA candidate at the USC Gould School of Law and Marshall School of Business. I am knowledgeable about the state regulations governing non-depository financial institutions (“*NDFIs*”), having previously worked in the legal and compliance department of a money transmitter, a credit card processor, and a consumer lender. Until now, the New York State Department of Financial Services (“*NYSDFS*”) has regulated NDFIs based on the services they perform, rather than on the technology they use. The money transmitter needed a money transmitter license because it transmitted money, not because it used SMS or Wi-Fi as the mode of transmission.

One business activity identified as a Virtual Currency Business Activity in the proposed regulations (“*BitLicense*”) is the transmission of Virtual Currency. In fact, many statutes in the *BitLicense* are pulled directly from New York’s money transmitter statutes, as well as the statutes of other NDFIs. In many instances, the language is verbatim. Accordingly, I question the need for a *BitLicense*. Section 1 considers this question and addresses how the five Virtual Currency Business Activities identified in the *BitLicense* already fit within New York law. Anticipating that the NYSDFS may still enact a version of the *BitLicense*, Section 2 identifies four major issues that need to be addressed before it is enacted.

I wrote this response because I do not want to see Bitcoin technology unnecessarily stymied. The views expressed in this letter are my own as the President of the Entrepreneur and Venture Capital Association at USC. Thank you for giving the Bitcoin community a chance to respond to the proposed regulations.

Sincerely,

Matthew A. Gertler

SECTION 1: HOW THE BITLICENSE FITS WITHIN CURRENT N.Y. BANKING LAWS

The proposed BitLicense defines “*Virtual Currency Business Activity*” as: (1) receiving Virtual Currency for transmission or transmitting; (2) holding or maintaining custody of Virtual Currency on behalf of others; (3) buying and selling Virtual Currency as a customer business; (4) allowing the exchange of Fiat Currency for Virtual Currency; and (5) controlling, administering, or issuing a Virtual Currency.¹ Many of these activities are pulled directly from the regulations governing NDFIs, such as money transmitters and check cashers. This section analyzes each of the identified activities to determine how they fit within New York’s current regulatory landscape, and whether this landscape is sufficient to regulate NDFIs that use Virtual Currency.

1. “Receiving Virtual Currency for transmission or transmitting the same...”

The New York Banking Laws governing money transmitters prohibit anyone from “engag[ing] in the business of receiving money for transmission or transmitting the same, without a license.”² As previously discussed, the business activity of “receiving Virtual Currency for transmission or transmitting the same” can be regulated under New York’s money transmitter statutes. In fact, this was the exact conclusion reached by the North Carolina Office of the Commissioner of Banks.³

Another issue that needs clarification is whether a company engaged in the business activity of transmitting Virtual Currency requires both a BitLicense, as well as a money transmitter license. Considering that many of the BitLicense statutes are copied directly from the money transmitter statutes, it seems redundant to have companies obtain both licenses. For this reason, a BitLicense should not be required to regulate the activity of transmitting Virtual Currency because it is already within the scope of New York’s money transmitter laws.

2. “Securing, storing, holding or maintaining custody...on behalf of others”

This business activity is not financial in nature and is therefore outside the scope of the NYSDFS’ authority. This relationship closely resembles that of a “bailee” and “bailor”. A bailee is defined as “a person with whom some article is left, [...] [and] is responsible for the safe return of the article to the owner when the contract is fulfilled.”⁴ Because the NYSDFS defines Virtual Currency as a digital unit, Virtual Currency is implicitly something that can be turned over to a third party to “store, hold, or maintain.” Moreover, the proposed language of the Virtual Currency definition insinuates that it is not actually currency, but rather, property. This definition is consistent with the Internal Revenue Service’s notice, which clarified that it considers Virtual Currency as property for U.S.

¹ N.Y. D.F.S. §200.2 (n) (2014) (Proposed).

² N.Y. BNK. LAW §641.

³ Tyler, Taylor, “North Carolina Taking Different Approach to Regulating Virtual Currencies, No BitLicense Required,” COINFINANCE.COM, Aug. 26, 2014, <http://www.coinfinance.com/news/north-carolina-taking-different-approach-to-regulating-virtual-currencies> (“Virtual currency regulation is already within the scope of the NC Money Transmitters Act [...] a NCCOB spokeswoman told CoinFinance, adding that N.C. is treating virtual currency as ‘monetary value’ under their Money Transmitters Act”).

⁴ “Bailee, THEFREEDICTIONARY, <http://legal-dictionary.thefreedictionary.com/Bailee>.

Federal Tax purposes. Accordingly, holding Virtual Currency on behalf of others should be governed by New York's bailee-bailor laws and not a to-be-enacted BitLicense.

3. "Buying or selling Virtual Currency as a customer business"

The NYSDFS provides an extensive list on its website of businesses that it supervises.⁵ Absent from this list are currency exchanges. Even if such a business does not qualify as a "Currency Exchange," the NYSDFS does not supervise the business activity of buying and selling property. The buying and selling of Virtual Currency can be considered a contract between a buyer and seller. If one party to the transaction does not act in good faith and commits fraud against the other, the other party has a cause of action. The mere act of buying or selling Virtual Currency is therefore not an activity that falls within the jurisdiction of the NYSDFS.

4. "Performing retail conversion services [of Virtual Currency to Fiat Currency]"

The New York check cashing statute prohibits anyone from engaging in the business of cashing checks or money orders without first obtaining a license.⁶ Although the retail conversion services contemplated by the BitLicense are different from "check cashing" services, similar motives exist for regulating each type of business. Each business involves the exchange of Fiat Currency in return for some form of value. Both check cashing and Virtual Currency conversion services allow for potential money laundering. Accordingly, this business activity can be regulated under a modified Check Cashing statute that requires companies engaged in this activity to have Know-Your-Customer and other Anti-Money Laundering policies in place.

5. "Controlling, administering, or issuing a Virtual Currency"

Industry custom dictates that "Bitcoin with a capital 'B' is a peer-to-peer network that allows for the proof and transfer of ownership without the need for a trusted third party. The unit of that network is bitcoin with a little 'b.'"⁷ As defined in the BitLicense, Virtual Currency refers to "bitcoin" and not "Bitcoin." However, in regulating the business activity of "controlling, administering, or issuing a Virtual Currency," the BitLicense attempts to regulate the technology and not the digital unit. As previously mentioned, the NYSDFS has always regulated the business activity itself rather than the technology being used. This technology certainly can be applied to financial services, and in such instances, those companies should be regulated as financial institutions instead of being regulated for "controlling, administering, or issuing a Virtual Currency." Without knowing the business activity itself, it would be impossible to know whether the business activity was financial in nature and therefore within the NYSDFS' regulatory authority.

⁵ "Who We Supervise," THE NEW YORK DEPARTMENT OF FINANCIAL INSTITUTIONS, <http://www.dfs.ny.gov/about/whowesupervise.htm>.

⁶ N.Y. BNK. Law §367.

⁷ Vigna, Paul, "BitBeat: Is It Bitcoin, it bitcoin? The Orthography of the Cryptography," WALL STREET JOURNAL, <http://blogs.wsj.com/moneybeat/2014/03/14/bitbeat-is-it-bitcoin-or-bitcoin-the-orthography-of-the-cryptography/>.

SECTION 2: PROBLEMS NEEDING TO BE ADDRESSED BEFORE ENACTMENT

If the NYSDFS enacts a version of the BitLicense, it is urged that the NYSDFS resolve the following issues beforehand:

1. Section 200.8(b): *“Each licensee shall be permitted to invest its retained earnings and profits in only the following high-quality, investment-grade permissible investments”*

On its face, this statute prohibits a Virtual Currency Company from investing its retained earnings or profits in its own business because doing so would not be considered a “permissible investment.” Moreover, the BitLicense requires licensure for companies that buy or sell Virtual Currency as a customer business.⁸ It is unclear how these companies can perform this business activity without violating the “permissible investments” provision. Lastly, the proposed regulations require a licensee to hold “Virtual Currency of the same type and amount as that which is owed or obligated to such other Person.”⁹ As a licensee grows, presumably the amount held will grow as well. Unless a licensee received outside funding every time it needed to hold a greater amount of Virtual Currency, it would either violate the “permissible investments” or “same type and amount” statutes. In either case, this statute needs to be revised or removed before the BitLicense is enacted.

2. Section 200.10(a): *“Each Licensee must obtain the superintendent’s prior written approval for any plan or proposal to introduce or offer a new product, service, or activity, or to make a material change to an existing product”*

The NYSDFS is required to approve or deny an application within 90 days of its filing.¹⁰ Assuming this is the same time frame a licensee must wait before receiving approval for a material change, it is unreasonable to require a licensee to wait 90 days before adding a new product or changing an existing one. Even if the superintendent reduced the number of days that a licensee must wait, these decisions need to be made in real-time. Certain business opportunities may only exist in the moment. Moreover, the NYSDFS has never previously required a non-depository financial institution to obtain prior approval for a material change in its business. The closest requirement comes from New York’s money transmitter laws, which only require prior approval for a change in control.¹¹

While the superintendent lists some reasons for this requirement in the BitLicense, these concerns exist with regards to the other NDFIs. Nevertheless, the NYSDFS has never imposed a “material change” requirement on such NDFIs. Accordingly, the NYSDFS has found a way to regulate NDFIs in a less discriminatory manner than that proposed under the BitLicense.

⁸ N.Y. D.F.S. §200.2(n)(3) (2014) (Proposed).

⁹ N.Y. D.F.S. §200.9(b) (2014) (Proposed).

¹⁰ N.Y. D.F.S. §200.6(b) (2014) (Proposed).

¹¹ N.Y. BNK. LAW§652-a.

3. Section 200.4(5) Application: “An application for a license [...] shall include [...] for all individuals to be employed by the applicant: (i) a set of completed fingerprints”

It is unreasonable to require a company with hundreds of employees to submit fingerprints for each employee. It is unclear what value the NYSDFS gains in obtaining the fingerprints of an entry-level salesperson, for example. Fingerprints should be limited to the principal officers and principal shareholders of an applicant, which is what the NYSDFS has previously required in other NDFI applications.¹²

4. Section 200.12(a) Books and Records: “Each Licensee shall [...] preserve all of its books and records [...] for a period of at least ten years.”

No other NDFI license issued by the NYSDFS imposes more than a 3 year recordkeeping requirement.¹³ The NYSDFS should articulate a reason for keeping the records for the full 10 years. Considering that data storage is inexpensive, the 10 year requirement would not impose an undue financial burden on licensees. However, requiring licensees to hold records for 10 years puts consumers at risk by keeping the data accessible to hackers for a longer period of time. To protect consumers and their data, the NYSDFS should reduce the 10 year recordkeeping time-period requirement.

¹² NY. BNK. LAW §369 (Check Cashers); N.Y. BNK. LAW §641 (Money Transmitters).

¹³ N.Y. BNK. LAW §586 (Budget Planners-3 years); NY. BNK. LAW §372 (Check Cashers-2 years); NY BNK LAW §349 (Licensed Lenders-2 years); NY.BNK. Law §651-B (Money Transmitters-“as the superintendent by regulation or order requires).