New York To Bitcoin Startups: Get Permission Or Get Out

Posted Jul 21, 2014 by Elizabeth Stark (@starkness), Ryan Singer (@ryan_singer)

Editor's note: *Elizabeth Stark taught technology policy at Stanford and Yale and was a key organizer of the movement against SOPA. She is the founder of Threshold, a company building new ways to fund open innovation. Ryan Singer is an active entrepreneur in the bitcoin ecosystem. Ryan co-founded Tradehill, an institutional bitcoin exchange, and CryptoCorp, a security service for Bitcoin Wallets and applications.*

Bitcoin allows people to build financial technology without asking for permission, but if New York state has its way, this won't be the case for long.

The New York Department of Financial Services released a series of proposed regulations last week that could shut down the digital currency startup ecosystem as we know it. Deemed "BitLicense," it may help "Big Bitcoin" go legit, but not the small startups of a few guys and girls in a garage. If only companies that have already raised tens of millions of dollars in funding can succeed, we can say goodbye to the bitcoin startup ecosystem. In effect, New York's proposed regulations will throw the baby out with the bathwater.

Regulations meant to deal with situations like the Mt.Gox disaster are being applied in a dangerously far-reaching manner across the entire virtual currency ecosystem. Ben Lawsky, the NY State Superintendent of Financial Services who released the proposed regulations, is trying to do the right thing by engaging with the Reddit community and others in the space, but the rules he has proposed are so broad as to potentially force an entire startup industry out of NY state. While we understand his desire to balance innovation with consumer protection, his current proposal does not accomplish that goal. If passed in its current form, it will only allow the regulators to accumulate even more power while stifling an entire industry.

So what exactly do the BitLicense regulations cover? Here are some of our (least) favorite things that they would require small startups to do:

1. Submit fingerprints of all founders (and employees) to the FBI and disclose personal financial information of founders and officers to NY State.
2. Require them to hold an undetermined amount of U.S. dollar funds in bonds or trusts. Startups will not be able to predict the bonding or capitalization requirements until after they apply, making it difficult to project expenses or raise money.
3. Conduct expensive audits and security testing that no small startup could afford.
4. Hand over any untouched user assets to NY State after five years as "abandoned property."

Worse, the regulations would require every bitcoin and virtual currency-related startup to get permission from NY state before releasing any new product or service. So yes, if I have a bitcoin technology startup and I want to start selling T-shirts, I would have to get the permission of the state of New York before doing so. And there's a clear lack of technical understanding in the regulations: for example, they require that people dealing in bitcoin retain the physical address of any recipients of transactions. That's like saying to an email provider, you must retain the postal address of any recipient of any email. This is just not possible with current bitcoin technology.

The BitLicense regulations wouldn't just apply to companies, either. Under the current definition, they could encompass a technology as basic as a Reddit or Twitter tip bot, an app that allows users to send each other small amounts of a currency. They could kill open source projects and community endeavors while potentially subjecting contributors to personal criminal liability.

One of the worst parts is that they would force companies that are innovating in new technology to hold their funds in bonds and trusts when they don't even hold other people's money. Ethereum, Blockchain.info, Counterparty and Ripple are only a few projects building an entire new generation of financial technology. What they have in common is that they don't actually process any financial services. They write software for users to structure their own services. Because of this, they can't control, steal, or lose your money any more than the company that makes your web browser can. Treating a technology company or a software project like a financial services company is a clear path to kill innovation.

So in order to preserve the virtual currency startup ecosystem, we have a set of proposed changes we'd like to see enacted. There's a lot more that needs to be changed, but these could serve as a starting point for a discussion as to how to enable startups to prosper.

First, designate a "Startup Onramp," or a period of time during which new companies are not subject to the regulation. No small company with $20K of funding from an accelerator like Y Combinator is going to be able to afford the hundreds of thousands of dollars, or even millions, needed for compliance. This could even be based on valuation or transaction volume so as to protect small, bootstrapped startups.

Second, create an exception for *de minimis* amounts of virtual currency transmission, say, for transactions under $500 and accounts under $3,000, so that small companies doing small transactions could stay afloat without being saddled with massive compliance costs.

Lastly, clarify that these rules are only to cover companies that are holding users' money in the way a bank would, such as wallet services or exchanges, and not just to anyone building technology in the space.

For those who think this is just a New York state problem, California will likely follow suit, as well as a variety of other states, so it's critically important to get this right. Overreaching and covering the entire startup space, including companies and projects where there's no public interest in making them register, threatens the future of bitcoin. These policies would serve to bifurcate the market into "Big Bitcoin" — companies that want to deal with NY financial institutions and can afford to comply with heavy restrictions, and the broader startup ecosystem that will have to take pains to avoid doing business with anyone in NY state. Blocking New York IP addresses could become a way of life for virtual currency startups.

BitLicense may help to legitimize bigger companies like Coinbase and SecondMarket, but if enacted, New York will chase virtual currency startups out to Silicon Valley, or out of the country altogether. If New York is serious about maintaining its position as a hub for innovation, it will have to make drastic changes to its proposed regulations. Otherwise, startups will heed its warning and GTFO of New York.