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VIA EMAIL

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Re: BitLicense Proposal – Addition of Part 200 to Title 23 NYCRR

I represent Matthew Taylor Mellon II and am writing to convey his comments concerning the BitLicense Proposal that the Department of Financial Services (DFS) published on July 23, 2014 in the New York State Register. As an entrepreneur and enthusiastic supporter of virtual currencies, Mr. Mellon would like to propose modifications to the BitLicense Proposal. Last week, Superintendent Benjamin Lawsky told a gathering at Cardozo Law School that "the biggest consumer protection is making sure the entity that you regulate doesn't collapse." Virtual currency entrepreneurs could not agree more. However, there are aspects of the BitLicense Proposal that would create an existential threat to certain virtual currency businesses and would stifle entrepreneurial innovation. In the interest of helping the DFS improve its regulations, this letter offers specific suggestions for modifying the BitLicense Proposal.

These comments are directed to three sections of the BitLicense Proposal: Section 200.10, which concerns approval requirements for material changes to a virtual currency business, and Sections 200.8 and 200.9, which concern capital requirements and custody of customer assets. These are not the only sections of the BitLicense Proposal that can be improved. However, various trade groups and virtual currency companies have already submitted comments that articulate many of the concerns that Mr. Mellon has with other provisions. Rather that duplicate those comments, which you undoubtedly have reviewed and carefully considered, this letter focuses on these three sections, which, if implemented without modification, will limit entrepreneurial innovation, drive jobs out of New York, and harm consumers by limiting their access to virtual currency services.

Section 200.10: Requirements Concerning Material Changes to Business

Section 200.10(a) of the BitLicense Proposal requires every Licensee to "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, service, or activity, involving New York or New York Residents." This preapproval requirement would stifle entrepreneurial creativity, particularly if a similar requirement is adopted in other jurisdictions. The DFS could meet its supervisory goals by modifying this requirement to simply require Licensees to notify the superintendent of planned material changes to the Licensees' business. Accordingly, this provision should be changed to require Licensees to "notify the superintendent in writing at least two weeks before offering a new product, service, or activity, or making a material change to an existing product, service, or activity, involving New York or New York Residents." In addition, the DFS should clarify that it will treat any such notification as confidential and non-public.

One of the most promising aspects of financial virtual currency businesses is their capacity to challenge traditional banking models by offering new financial products and services. As you know, financial virtual currency companies are rapidly evolving. Every week a financial virtual currency company comes up with a new way to make use of cryptocurrencies to offer new financial services to consumers. In this way, financial virtual currency companies are very different from banks that the DFS regulates. These banks tend to offer relatively well-established products that are easily recognized and understood by DFS employees. Requiring virtual currency companies to wait for the DFS's approval before creating or changing financial products would dramatically slow the development that has been taking place. Given the novelty of the proposed products, DFS employees will be reluctant to affirmatively sign off on new products quickly. In addition, it often will be difficult for DFS employees to understand a new financial product before they see the product in action. Accordingly, it would help both financial virtual currency companies and the DFS to allow innovation to begin before the DFS takes a formal position on whether individual innovations are appropriate.

The delay caused by requiring DFS preapproval of new products and services would be greatly magnified if other states adopt similar provisions. As Superintendent Lawsky acknowledged at Cardozo Law School last week, it is likely that other states will use New York's regulations as a model. The Superintendent made clear that the DFS takes the responsibility of serving as a model seriously. It therefore should not adopt a preapproval requirement that would be unworkable if other states adopt the same requirement. As drafted, the preapproval requirement applies to virtual currency companies in any state that conduct financial transactions for a New York Resident. If all the states adopt analogous requirements, then a financial virtual currency company based in New York that operates in all 50 states would have to obtain approvals from 50 different regulators before creating or changing a financial product. This would put the brakes on entrepreneurial experimentation and would cause many virtual currency companies to shut down, to cease innovating, or to suspend service to residents of New York and other states that adopted preapproval provisions. It would cost some New Yorkers their jobs. This is particularly important because the DFS declined to include a Job

Impact Statement for the BitLicense Proposal, stating in the New York State Register that "it is evident from the subject matter of the regulation that it will not have an adverse impact on jobs and employment opportunities in New York State." This is by no means evident. To the contrary, the preapproval requirement is likely to have an adverse impact on employment opportunities in New York because it will drive jobs in the virtual currency sector out of New York.

Replacing the preapproval requirement with a prenotification requirement would enable the DFS to fulfill its regulatory mission. The DFS would have the opportunity to review a product description before the product launched. If the product appeared to clearly pose a threat to New York consumers, then the DFS could use its regulatory powers to prevent the use of that product. In other cases, where the impact on New York consumers was clearly beneficial or where it would be difficult to assess the impact on consumers before consumers begin using the product, the DFS could monitor the product before taking action. This would give the DFS everything that it needs to protect consumers from dangerous financial products, while protecting consumers' access to new and innovative financial products. It also would help New York foster a growing industry that already is creating jobs in New York. In short, the DFS should change this provision in order to protect New Yorkers.

Finally, the DFS should clarify that all submissions to the DFS will be strictly confidential and non-public. Requiring public disclosure of a new product before its launch would place an additional burden on a virtual currency business by interfering with the business's ability to obtain patent rights for a new product in the U.S if there is a mismatch between the pre-launch disclosure and a later patent application. *See* 35 U.S.C. 102 (a)(1), (b)(1). Perhaps more importantly, a pre-launch disclosure could entirely defeat patentability in regions and countries that have adopted a so-called "absolute novelty" standard. *See, e.g.*, Article 54(2) of the European Patent Convention. On-line businesses are commonly advised to file patent applications simultaneously with launch to avoid the perils of pre-filing disclosure. Requiring a public disclosure before launch would force virtual currency businesses to shoulder the burden of preparing and filing patent applications simultaneously with that disclosure, rather than with launch, as is usually done.

<u>Sections 200.8 and 200.09: Capital Requirements and Custody of Assets</u>

Section 200.08 of the BitLicense Proposal requires each Licensee to not only "maintain . . . such capital as the superintendent determines is sufficient to ensure the financial integrity of the Licensee," but also to invest its retained earnings and profits only in a limited range of extremely conservative investments denominated in U.S. dollars. In addition, Section 200.09 requires Licensees to hold a bond or trust account in U.S. dollars in an amount acceptable to the superintendent. Section 200.09 further requires that whenever a Licensee holds virtual currency for a customer it must hold such virtual currency in the same type and amount as that which is owed or obligated and may not lend or otherwise use the virtual currency it holds for customers. These requirements exceed the requirement imposed on banks, and therefore put virtual currency businesses at a competitive disadvantage. In addition, they prevent financial virtual currency

businesses from offering consumers products that they desire. Because these requirements do not serve the interests of New Yorkers, the DFS should modify them by eliminating restrictions on the use of retained earnings and profits and permitting Licensees to lend or otherwise use virtual currency held in customer accounts when that use is clearly disclosed to the Licensee's customers.

The capital and asset custody requirements are excessive to the extent that they go beyond requiring a Licensee to maintain sufficient capital to maintain the integrity of the Licensee and sufficient virtual currency to expose customers to a level of risk that is acceptable to those customers. It is unfair to these companies and New York consumers to prevent consumers from putting their funds in a virtual currency company that, for example, engages in low-risk lending in order to offset effects of inflation. If consumers wish to put their funds in a financial virtual currency company that offers such a financial product, they should be permitted to do so.

It also is improper for the DFS to place severe restrictions on how companies invest retained earnings. Virtual currency companies should be encouraged to use their retained earnings as creatively as they wish, whether that be to invest in other promising virtual currency companies, to purchase virtual currencies, or invest in the dollar-denominated investments described in the BitLicense Proposal. If the DFS has determined that a financial virtual currency company has sufficient assets to ensure the company's integrity, then there is no reason to place restrictions on how that company invests its earnings. In addition, requiring these retained earnings to be held in investments denominated in U.S. currency both imposes unnecessary costs on virtual currency companies, which will be forced to exchange the virtual currency that they receive for U.S. currency, and undermines the virtual currency economy by artificially lowering demand for virtual currencies.

While these modifications to the BitLicense Proposal are critical to the future of virtual currency companies, the project the DFS has undertaken is not easily accomplished. There are many moving parts, and some implications of moving those parts are difficult to discern. If you, or any of your colleagues at the DFS, wish to discuss the issues raised in this letter, Mr. Mellon and I would be happy to make ourselves available. It is in everyone's interest to get this right.

Sincerely,

/s/ Jeffrey Alberts
Jeffrey Alberts

cc: Matthew Taylor Mellon II
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