



October 20, 2014

**VIA FEDEX AND EMAIL (dana.syracuse@dfs.ny.gov)**

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Office of General Counsel  
New York State Department of Financial Services  
One State Street, New York, NY 10004

**Re: Regulation of the Conduct of Virtual Currency  
Businesses – Addition of Part 200 to Title 23 NYCRR**

Dear Mr. Syracuse:

Xapo, Inc. (the “**Company**”) respectfully submits the following comments on the Regulation of the Conduct of Virtual Currency Businesses (the “**BitLicense Proposal**”) proposed by the New York State Department of Financial Services (the “**NYDFS**”) on July 23, 2014.

The Company appreciates the efforts undertaken by the NYDFS in crafting a set of regulations for a novel technology such as virtual currency protocols—the implications and applications of which are currently not fully understood. We look forward to continuing to engage with NYDFS to reach an appropriate and balanced set of regulations.

We believe that regulation of virtual currencies is a good thing and to be effective will need to balance the protection of consumers and prevention of illicit uses with the promotion of continued industry innovation and growth. With the right balance, regulation of virtual currencies will foster more adoption both directly, through increased end-user confidence, and indirectly, through more compelling product offerings that enhance the image and usability of virtual currencies generally. Further, by achieving such balance, regulators will be able to leverage aspects of virtual currency technologies to their immediate benefit. This balance of fostering protection without unduly inhibiting growth or innovation is crucial, and if structured correctly can result in a positive outcome for regulators, consumers and virtual currency providers.

That said, we do not believe that the BitLicense Proposal, in its current form, strikes the right balance. There are four areas where the BitLicense Proposal in its current form makes it difficult, if not impossible, for legitimate businesses to engage in a “Virtual Currency Business Activity” in New York:

1. the BitLicense Proposal is overly broad in scope and application;
2. obtaining a license entails a number of logistical hurdles that will serve as an impediment for many legitimate businesses that might endeavor to do so;
3. assuming a license has been obtained, compliance is extremely costly, and entails onerous and subjective limitations on a licensee’s business; and
4. the NYDFS has nearly unlimited discretion to revoke or suspend a license at any time, which makes the investment in a legitimate business in New York unsustainable.

The net effect of these factors for anyone engaging in a “Virtual Currency Activity” to operate in New York is unquantifiable risk, substantial expense, and possible impairment on such company’s

business operations. We unfortunately believe that this will lead to virtual currency businesses choosing not to provide their services to customers in New York.

## **1. The Scope of the BitLicense is Overly Broad and Subject to Selective Application**

The definitions of “*Virtual Currency Business Activity*” and “*New York Resident*” render the scope of the BitLicense overly broad. Under the proposed formulation, any business even tangentially related to a virtual currency would have difficulty in determining whether it needs to seek to obtain a BitLicense to operate within New York (or arguably even outside of New York). Accordingly, the definitions would grant the NYDFS discretion to selectively apply the BitLicense Proposal. The BitLicense Proposal is also overbroad due to its failure to distinguish between financial services activities to which the extensive Anti-Money Laundering (“**AML**”), record-keeping and reporting requirements should be applicable and non-financial services activities to which such requirements should not apply.

The potential for selective application and the failure of the BitLicense Proposal to distinguish between financial activities and otherwise will present New York businesses with heightened regulatory risk that may cause businesses to choose to operate outside of New York. This would have a chilling effect on innovation and industry improvement. We believe that it would be beneficial for the NYDFS to clarify the scope of the applicable definitions of the BitLicense Proposal to remove any risk of subjective application or enforcement and to more appropriately describe the entities and activities to be covered thereby. Doing so would be a first step in assisting companies in assessing regulatory risk associated with operating in New York.

## **2. A BitLicense Application Would be Difficult to Prepare and Subject to Selective Rejection**

If a company is able to determine that it falls within the purview of the BitLicense Proposal, there are a number of logistical hurdles to obtaining a license. We support appropriate due diligence of companies seeking to obtain the ability to engage in certain financial activities in New York. However, certain aspects of the licensure process are onerous or vague, making it difficult for a company to assess the likelihood of obtaining a license. Where the ability to operate in New York hinges on a relative unknown, many businesses may choose to avoid operating in New York to avoid the expense of a licensing attempt.

Section 200.4 of the BitLicense includes a number of deliverables that are consistent with the application requirements for obtaining a money transmitter license in New York, which we support. However, several provisions are unduly onerous and even go beyond the conventional money transmitter license application requirements. First, Section 200.4(a)(5) requires fingerprints and photographs of each Principal Officer, Principal Stockholder, and Principal Beneficiary of the applicant, as applicable, and “*for all individuals to be employed by the applicant.*” The statement also implies that the application would need to be updated for each new hire “to be employed” by the company. The employee fingerprinting and photograph deliverable is unduly burdensome, without clear benefit.

Section 200.4 also contains a number of vague deliverables, which create uncertainty for the applicant as to how to comply and would afford the NYDFS substantial latitude to reject a company’s application for a license. For instance, Section 200.4(a)(3) requires “*detailed biographical information*” for certain individuals; Section 200.4(a)(9) asks for “*details of banking arrangements*”; Section 200.4(a)(10) asks for “*all policies and procedures*”; and Section 200.4(a)(14) includes a catch all for “*such other additional information as the superintendent may require.*”

We note that the NYDFS has provided clear and reasonable guidance for obtaining a money transmitter license by creating a detailed checklist for its applicants. We believe that the BitLicense Proposal should specify deliverables for obtaining a BitLicense with the same level of clarity and reasonableness. This would allow companies to prepare appropriately, while reducing the risk of selective rejection.

Finally, we would appreciate insight into the cost of obtaining a license. Section 200.5 authorizes a licensing fee but does not provide any guidance as to amount of the fee. Recognizing that the NYDFS will have to expend resources in connection with reviewing application materials, we would propose that this fee be aligned with that of the conventional money transmission licensure process. We believe the amount should address the reasonable costs of the NYDFS in reviewing applications, but not serve as a barrier to licensing.

### **3. A BitLicense Would be Difficult to Maintain**

If a company has sufficient clarity to determine whether its operations are within the scope of the BitLicense and it has successfully applied for and obtained licensure on the basis of clear deliverable requirements, it will nonetheless face undue burden in maintaining the BitLicense. Subjective factors give NYDFS discretion to invalidate a license for a number of reasons. In addition, various provisions applicable to maintaining a BitLicense are onerous without enhancing regulatory protection or enforcement value.

#### *Subjective Metrics Mean Impossible Compliance*

The BitLicense Proposal contains a number of subjective metrics that rely on the NYDFS to determine compliance by assessing what would be appropriate under the circumstances. Due to these subjective metrics, the superintendent will have broad discretion to determine whether a licensee is in compliance. This subjectivity thus makes it difficult, if not impossible, for a licensee to know whether or not they may be in compliance in the future, which makes the costs of managing and investing in their business in New York incalculable and unduly burdensome.

Specifically, the BitLicense Proposal employs subjective standards to areas that are highly material to a licensee's business. These provisions include Section 200.8(a), governing minimum capital requirements, Section 200.9(a), addressing bonding, Section 200.10, providing discretion over approval of new product lines, and Section 200.11, providing discretion over approval of corporate transactions. These provisions directly impact any licensee's business operations. For instance, the more capital a company is required to keep in reserve, the less such company has to deploy. Further, bonding can be quite expensive especially for nascent industries and may include collateral requirements to further lock up a company's capital. Lack of guidance over approval of new product lines or corporate transactions may also bring a business to a detrimental standstill.

We believe that any regulations affecting the operation of a business should utilize objective criteria so a licensee can comply and assess its ability to comply on an ongoing basis. Failure of the regulations to provide this clarity may be perceived by companies as representing undue compliance risk and rendering the cost of operating in New York unjustified.

#### *Expensive and Difficult for Business*

The BitLicense Proposal includes a number of ongoing requirements that will severely impair a licensee's business. Certain of these requirements are duplicative of existing frameworks promulgated by regulators (including the NYDFS). This would force virtual currency businesses in New York to bear an extremely high cost of operations and detrimentally disadvantage such businesses as against their non-New York counterparts.

Restrictions on Use of Retained Earnings. The BitLicense Proposal includes a restriction on what a licensee can do with its retained earnings. Section 200.8(b) provides:

*Each Licensee shall be permitted to invest its retained earnings and profits in only the following high-quality, investment-grade permissible investments with maturities of up to one year and denominated in United States dollars...*

The section then lists a number of instruments in which a licensee can invest. It's unclear whether the provision requires that profits must be kept in the business (and unclear whether the NYDFS might read in such a requirement) or if dividends to shareholders are permitted. What is clear though is that this provision would operate to severely limit any virtual currency business in its ability to deploy retained earnings. For instance, as drafted, a virtual currency business would be prohibited from rolling profits to invest in its own business or even the virtual currency associated with its products.

The Company does not believe there is a regulatory justification for this limitation over retained earnings. As such, this section should clarify that these are the types of instruments deemed suitable for investment of retained earnings and profits, where the board has exercised its business judgment to approve such investment (but to not otherwise require such investment or any blanket restriction on the use of retained earnings). The ability of a company's board of directors to make business decisions regarding the investment of retained earnings and profits is critical to a business and also the growth of any industry. Restricting virtual currency businesses in this way would dissuade businesses from deciding to operate in New York.

Requiring Consent for New Products. Section 200.10 requires consent of the NYDFS in connection with:

*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 section of the BitLicense Proposal would require consent for almost any change to a licensee's business given the breadth of the language. Also, the provision and the use of "plan or proposal" grants unbridled regulatory authority over a licensee's product roadmap. Further, the section does not include any mention of a time period within which the superintendent must respond, which means a product rollout could be stalled indefinitely. Lastly, when read in conjunction with Section 200.11 (discussed below), dual consent could be required in connection with a change of control, merger or asset deal where new products are being acquired in connection with the deal—meaning a deal could effectively be held up indefinitely.

It's not clear that product roadmap oversight by a regulator (if determined to be an appropriate exercise of regulatory power) actually would yield any tangible benefit on the consumer protection front. Additionally, the logistical undertaking of keeping up with the requests would be monumental, if not impossible (especially in light of the numerous reports the NYDFS stands to receive and decisions it will have to make under the current BitLicense Proposal). Furthermore, existing regulatory frameworks regarding data security and financial transactions, use of personally identifiable information and the like could serve to protect consumers in lieu of this onerous requirement.

Section 200.10 means that a licensee would have no certainty about its ability to execute on its proprietary product roadmap and its product offering would necessarily be subject to the discretion of the NYDFS. This provision unnecessarily restricts the operations of a virtual currency business without delivering any concomitant consumer benefit and would weigh heavily on a company's decision about whether to operate in New York.

Restriction on Corporate Transactions. Section 200.11(a) would restrict a licensee from engaging in a change of control transaction without first obtaining the prior written consent of the NYDFS. Regulatory oversight of certain transactions may be a good thing for consumers but the BitLicense Proposal's formulation goes too far. This provision will unduly hamper individual company growth and industry growth due to 1) the extremely low 10% threshold for triggering the consent requirement, 2) the lengthy 120 day waiting period for obtaining consent, and 3) lack of carveouts for certain transactions.

The low 10% threshold would likely impair venture capital financing activities as a 10% change of ownership would not be atypical. The 120 day waiting period would also have a chilling effect and otherwise serve as an impediment to even get parties to the table for a deal, particularly where market conditions change rapidly, as is the case currently facing the virtual currency industry. The consent

requirement could effectively bring growth in the virtual currency industry to a relative standstill by making capital raising extremely difficult. This state of affairs would serve to significantly disadvantage virtual currency companies subject to the BitLicense Proposal versus their competitors who are not so restricted.

Section 200.11(b) requires the superintendent's consent with respect to a "plan" in the event of a merger or other significant transaction. As written, this means the NYDFS must approve the terms of any definitive agreement pertaining to a merger. This will almost certainly serve to block most significant corporate transactions as parties would need to engage in a regulatory process at or before the term sheet stage in order to be sure the superintendent would approve the "plan". The waiting period would also create an unacceptable business risk in trying to engage in any such transactions.

Finally, there are certain types of transactions that would otherwise fall within the BitLicense Proposal's definition of a "*change of control*" that do not necessarily introduce a new player into a company's corporate structure and thus need not be subject to regulatory oversight. Examples include corporate reorganizations, and certain categories of change of control, merger or asset sale transactions that do not require regulatory oversight.

We believe that the provision should be eliminated since with or without consent a licensee would need to maintain compliance after the consummation of a deal. This is where the NYDFS would be able to maintain oversight and ensure regulatory compliance of its licensees without impairing capital raises or M&A deal flow. If the provision will be retained, it should be amended to 1) include a definition of "*change of control*" that describes change in control as a function of actual control, 2) change the requirement of consent to instead require notice (at which point, ongoing compliance with the licensure requirements could be evaluated by NYDFS), and 3) include safe harbors and carveouts for transactions that, by their nature, do not require regulatory oversight.

A 100% Reserve Requirement. Section 200.9 requires companies to maintain a 100% reserve of virtual currency they store on behalf of others and prohibits the sale, lending or other use of the virtual currency. Although the Company could maintain compliance with this requirement, as it is a custodian of the bitcoins stored with it and does not sell, transfer, assign, lend, hypothecate, pledge, or otherwise use or encumber these, we believe that it will harm the industry as a whole by preventing reasonable innovation. We believe that the provision should be revised to require not a 100% reserve but rather clear and concise disclosure to consumers where entities are engaged in fractional banking of the type addressed by the provision, with a detailed statement of the risks associated with such company's products.

Stifling such product innovation in the virtual currency space could harm consumers, is inconsistent with the regulations applicable to traditional banks, and could dissuade virtual currency businesses from operating in New York.

Record Retention, Reporting and AML Compliance Requirements. The BitLicense Proposal includes a number of provisions addressing record retention, AML and reporting procedures, such as Section 200.12 and 200.15. The issue with these sections is that they are addressed elsewhere by existing federal and state regulations and such duplication of regulatory regimes would require a licensee to expend vast resources without any corresponding regulatory benefit. Further, even where addressed by such other regulations, the BitLicense Proposal heightens obligations of a licensee in certain areas, which will result in onerous compliance obligations that do not enhance enforcement value for regulators. Lastly, the compliance provisions do not adequately take into account the nature of the technology underlying virtual currencies.

For instance, the BitLicense Proposal would require record retention for ten years even though five-year retention under the Bank Secrecy Act ("**BSA**") is widely accepted as the standard for best practices. Further, the BitLicense Proposal requires reporting of certain transactions within 24 hours. This is notably out of sync with the 25 day e-filing period under the BSA. The interest served by these heightened requirements will be costly, difficult and, in some cases, impossible to comply with in

practice. Also, the standards established as industry norms under the BSA need not be exceeded as the enforcement interests would otherwise be served by the BSA's tried and true metrics.

Many of the reporting and record-keeping provisions contained in the BitLicense Proposal are also duplicative of existing AML reporting regulations. Duplicative reporting does not otherwise advance the interest of preventing nefarious activities. Rather, the compliance departments of virtual currency companies would need to harmonize multiple frameworks at great expense. Compliance with duplicative provisions may not contribute to the enforcement infrastructure in any meaningful fashion but would result in a more costly compliance burden for licensees.

Technology necessarily impacts this discussion due to the unique characteristics of the public ledger systems underlying many virtual currencies. Unlike traditional money transmitters, where high level transaction records are deleted after the five-year retention period expires, virtual currency ledgers will exist for so long as the currency is being maintained by the network (which adds enforcement value versus traditional fiat ledgers). However, a transaction can be initiated within a virtual currency network with or without the assistance of a solution like the Company's. This means that complying with Section 200.15(d)(1) of the BitLicense Proposal may be technically impossible due to its requirements regarding tracking information about parties to transactions.

The costs associated with onerous and duplicative compliance with certain provisions in the BitLicense Proposal could easily be obviated by having such provisions defer to or be harmonized with the already existing regulatory frameworks without sacrificing any enforcement value. Further, the BitLicense Proposal should sufficiently account for virtual currency technologies so as not to render compliance technically impossible. Absent doing so, virtual currency companies, in deciding whether to operate in New York, will have to consider whether to invest the time and expense necessary to attempt to comply with duplicative regulatory requirements with which compliance may be difficult or even technically impossible.

#### **4. A BitLicense Would be Subject to Selective Suspension or Revocation**

Where a company has successfully obtained and is properly maintaining a BitLicense, it remains subject to the discretion given to NYDFS over suspension or revocation thereof. Section 200.6(c) provides as follows:

*The superintendent may suspend or revoke a license issued under this Part on any ground on which the superintendent might refuse to issue an original license, for a violation of any provision of this Part, for good cause shown... 'Good cause' shall exist when a Licensee has defaulted or is likely to default in performing its obligations or financial engagements or engages in unlawful, dishonest, wrongful, or inequitable conduct or practices that may cause harm to the public.*

The words of Section 200.6(c) allow for suspension or revocation of a license "for any violation". The definition of "good cause" also expands the ability of the NYDFS to suspend or revoke a license for conduct arguably outside the purview of the BitLicense Proposal. In sum, absent strict compliance, which may be impossible as a technical matter (as discussed above), or otherwise for good cause, which is subject to broad discretion, the NYDFS would have unilateral discretion to suspend or revoke a licensee's license.

The BitLicense Proposal also includes draconian procedures in the context of a license subject to potential suspension or revocation. The licensee is entitled to a hearing but the notice period for the hearing is 10 business days. This means that a licensee that is at risk for losing their license has only 2 weeks to plan for a hearing that may dictate whether such licensee is able to carry on its business within the state of New York. Further, given the complexity of the BitLicense Proposal, the facts underlying the potential suspension or revocation may very well dictate a licensee's ability to mount a successful defense. However, the licensee is only entitled to receive notice concerning the time and place of the hearing, and the NYDFS is not required to provide any details about the substantive basis for the hearing.

Finally, the NYDFS is granted broad authority to obtain a preliminary injunction against a licensee, unrelated to any findings of fact at a hearing.

We believe that these provisions should be revised to afford companies sufficient information (such as a detailed list of the areas of evaluation by NYDFS) and a reasonable amount of time in which to prepare for a hearing. Also, any suspension or revocation of the license should be stayed during the pendency of the hearing. Absent such changes, the resultant unquantifiable business risk may mean that operating in New York is not cost-justified for virtual currency businesses.

### **Wait-and-See to Regulate for Success**

We believe that the BitLicense Proposal is overly broad in scope and a license is difficult to obtain, difficult, if not impossible, to comply with and easy to lose. That said, for a virtual currency business operating in New York, obtaining and maintaining a license thereunder will be the lifeblood of such operations and losing the license would be incredibly costly. As such, the business risk of operating a virtual currency business within New York may not be justified if the BitLicense Proposal were adopted in its current form. We have outlined above specific changes that we believe are necessary.

If the BitLicense framework is sufficiently burdensome such that legitimate virtual currency companies decide not to engage in business in New York or with New York residents, this will undoubtedly harm New York consumers. They will not have access to quality services for virtual currencies as the leading providers would not be able to operate in New York, but rather New York residents may be forced to turn to grey market players for transacting in virtual currency. We don't view this as the optimal outcome from a regulatory or consumer protection standpoint.

We believe that given the rapidly changing nature of the virtual currency industry, it would be prudent to engage in additional evaluation. This would afford time for the regulations to offer precision and objectivity for companies operating virtual currency businesses. It would also provide an opportunity to harmonize the BitLicense Proposal with the existing regulatory frameworks that are already promoting consumer protection, data security, anti-money laundering protection, and suspicious activity reporting. Initiatives on each of these fronts would serve to assuage anxieties and de-risk the overall impact of the current BitLicense Proposal, obviating the need for a virtual exodus from New York. Prior to the adoption of the BitLicense Proposal, we believe New York's existing money transmitter licensing regime affords clarity for virtual currency companies and protection for New York consumers.

Thank you for your and your office's efforts to date with respect to the BitLicense Proposal. We are happy to assist in any way we can to help achieve the best outcome for all parties.

Sincerely,



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Vice President, Legal