Jim Harper
Senior Fellow

March 24, 2015

Benjamin M. Lawsky
Superintendent of Financial Services
New York Department of Financial Services
One State Street
New York, NY 10004-1511

Re: DFS-29-14-00015-RP
"Regulation of the Conduct of Virtual Currency Businesses"

Dear Superintendent Lawsky:

I am pleased to offer this comment on DFS-29-14-00015-RP, "Regulation of the Conduct of Virtual Currency Businesses."

Digital currency systems like Bitcoin deserve care and attention because they are a revolutionary technology with profound potential to increase global financial inclusion, to enhance liberty and dignity for many populations, provide law-abiding people with greater financial privacy, and offer a more stable money supply in countries with poorly managed currency. There are uses of the "blockchain" technology underlying Bitcoin that may go even further, extending the Internet's power as a communications system to an even more powerful global administrative system.

The natural right of competent people to transact on whatever terms they prefer (absent force, fraud, or harm to others) has given way over the last century to comprehensive, prescriptive regulation of financial services. The merits and net benefits of the financial regulatory system that has arisen are subject to debate, so its extension to digital currencies must meet high standards.

This is for good reason. Digital currencies such as Bitcoin hold out benefits not only to American consumers, markets, and jobs, but to billions of people around the world who are financially marooned and needlessly kept in poverty simply because their countries lack financial integration. Poorly formed government regulation that impedes Bitcoin's adoption will thwart badly needed global economic progress.

The “BitLicense” proposal does not meet those high standards. The evidence that it will produce net benefits is weak, and the likelihood that it will have greater costs than benefits is high. Your department has not met its burden of showing that the “BitLicense” is good for New York or the Bitcoin ecosystem.

In particular, the Department of Financial Services has not complied with regulatory law in New York that requires it to articulate the merits of the proposal. Your department has failed to respond as required by New York’s Freedom of Information Law to a request for the “[e]xtensive research and analysis” that it cited when it introduced the regulation. And the department has improperly failed to produce an assessment of the proposal’s effects on New York jobs. This has deprived the Bitcoin community and New Yorkers interested in the economic benefits of Bitcoin from commenting intelligently on the proposal, defeating the purpose of notice-and-comment rulemaking.

The regulation itself, while modestly improved in its second draft, has significant and fundamental remaining weaknesses. Malformed nomenclature—referring to Bitcoin as “virtual” rather than digital currency—is used in creating an unwarranted technology-specific regulation. The “BitLicense” includes mandatory customer surveillance provisions that duplicate and complicate federal requirements. These requirements are inconsistent with your department’s role in protecting consumer privacy, and they are out of step with currents in Fourth Amendment law.

Your awareness of Bitcoin’s tremendous potential is obvious. Your proposal to regulate in this area, though, is not up to standard. The “BitLicense” proceeding should be suspended until the department can articulate a rationale for any regulations it ultimately proposes.

The Department Has Not Released its Research and Analysis

When your department officially announced the “BitLicense” proposal in the *New York State Register*, you said in the legally required statement of needs and benefits:

> *Extensive research and analysis by the Department of Financial Services … has made clear the need for a new and comprehensive set of regulations that address the novel aspects and risks of digital currency.*

Though the announcement did not cite and summarize your study, as New York’s State Administrative Procedure Act §202-a(3)(b) (“SAPA”) requires, in early August your department promised to produce your research within 20 business days in response to a Bitcoin Foundation Freedom of Information Law request.

In early September, however, your office indicated that it would delay production of this material for as much as 120 days. While confirming the existence of the research, the delay threatened to extend beyond the end of the comment deadline. The non-release of the research ultimately did prevent the Bitcoin community from offering comments enlightened by your department’s articulation of the purpose of, necessity for, and benefits to be derived from the “BitLicense.”

The second round of comments will soon conclude, still without any articulation of how the regulation is meant to serve beneficial ends, except for a cursory, 121-word assertion in the original release.

That cursory statement says that digital currency has “novel aspects” without saying what they are or identifying the public interest goals to which they are relevant. It says that existing laws do not cover digital currency business activity, which does nothing but imply the existence of benefits from regulation. And it says that regulation is “necessary” for safety and soundness, protection from risks, and so that “persons or entities engaged in new virtual currency business activity have a framework within which they can grow.”

There may be respects in which regulation improves safety and soundness and controls risks better than common law contract, tort law, and market processes enhanced by Bitcoin’s naturally transparent operation, but this summary statement reveals nothing about what risks exist, how the “BitLicense” regulation controls them, or why a special, technology-specific regulation is superior to integration of Bitcoin into existing regulation of financial services.

Many of the proposals in the second draft of the “BitLicense” appear to match or parallel existing financial services regulation. Before they are extended to Bitcoin and other digital currencies, the public should know what problems they solve and how well. Many elements of the “BitLicense” proposal may be longstanding practices, but custom alone is not a sound basis for regulation or for extending regulation to a new area. Nobody should want financial services regulations to remain in place or extend to digital currency simply because things have been done that way in the past.

The Bitcoin community and the New York Department of Financial Services can come together over universal interests like consumer protection, security, privacy, and law enforcement if there is a two-way conversation. Keeping hidden the purpose of, necessity for, and benefits from the “BitLicense” proposal does not allow that to happen.

The Department has Failed to Produce the Required Jobs Analysis

As with the “needs and benefits” statement, SAPA requires a “job impact statement” in order to minimize any unnecessary adverse impact on existing jobs and to promote the development of new employment opportunities, including opportunities for self-employment, for residents of New York. *See* SAPA § 201-a(1).

Where it is apparent from the nature and purpose of a rule that it may have a substantial adverse impact on jobs or employment opportunities, an agency must issue a “job impact statement” which contains information on the following:

> (1) the nature of such impact;
> (2) the categories of jobs and employment opportunities affected by the rule;
> (3) the approximate number of jobs or employment opportunities affected in each category;
> (4) any region of the state where the rule would have a disproportionate adverse impact on jobs or employment opportunities;

> (5) any measures which the agency has undertaken both to minimize any unnecessary adverse impact on existing jobs and to promote the development of new employment opportunities. *See id*. § 201-a(2)(b).

In addition, the agency must include a discussion of the impact of the rule on opportunities for self-employment, if such impact is measurable. *See id*. § 201-a(2)(i).

A "substantial adverse impact on jobs or employment opportunities" is a decrease of more than 100 full-time annual jobs and employment opportunities, including opportunities for self-employment, in New York in the two-year period commencing on the date the rule is to take effect. *Id*. § 201-a(6)(c). If the information available is insufficient either to enable it to determine whether the rule will have a substantial adverse impact on jobs or employment opportunities, or to prepare a job impact statement, the agency must issue a statement indicating the information which it needs to complete the job impact statement and requesting the assistance of other state agencies and the public in obtaining such information. *See id*. § 201-a(2)(c).

The department's announcement of the original "BitLicense" draft did not do this. Instead, it included the following:

> A Job Impact Statement is not being submitted with this proposed regulation because 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. The proposed regulation is intended to protect members of the public by imposing a regulatory framework on persons or entities that wish to engage in virtual currency business activity involving the State of New York or New York residents and to provide the market with guidance and clarity with regard to the use of virtual currency. Based on the feedback the Department of Financial Services (the 'Department') has received from virtual currency businesses to date, the Department believes that the proposed regulation will have a positive impact on jobs and employment opportunities in New York by allowing for the establishment and growth of legitimate virtual currency businesses.

Businesses that may be subject to your department's licensing rules, with all their broad grants of discretion, may not provide your office with a searching or critical analysis of the regulation's likely impact on jobs. The political science around this is clear. They will tell you what they think you want to hear.

It is hardly "apparent" that the "BitLicense" will not lead to a decrease of 100 full-time jobs and employment opportunities. Indeed, shortly after the release of the "BitLicense," major Bitcoin firms announced that they would decline to do business in New York.[1] The Bitcoin Foundation produced a primer for small firms on how to avoid the jurisdiction of New York, which emphasized turning away New York contacts and customers.[2]

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[1] *See, e.g.,* Stan Higgins, "Circle: BitLicense Would Force Us to Block New York Customers," CoinDesk (Aug. 13, 2014) http://www.coindesk.com/circle-bitlicense-block-new-york-customers/.

[2] Bitcoin Foundation, A Bitcoin Primer on Jurisdiction (Aug. 2014) https://bitcoinfoundation.org/wp-content/uploads/2014/08/Bitcoin-Jurisdiction-Primer.pdf.

If the consequences for New York jobs were not apparent at the time, since the original “BitLicense” proposal came out, hundreds of millions of dollars have been invested in Bitcoin firms outside of New York. Bitcoin related start-ups are on pace to raise over $1.2 billion this year. And other states and foreign governments have suggested that they would pass more favorable regulation to encourage growth of Bitcoin related startups in their jurisdictions. In a recent report, the UK government said: “Digital currency firms [agree] that the proposed BitLicense regime, at least as initially drafted, would be too wide in scope and would impose very high compliance costs on digital currency firms and risk damaging the sector.”

Given the critical role that finance plays in the state of New York, the New York Department of Financial Services should provide a full jobs impact statement. Conducting notice and comment without integrating jobs effects undercuts the purpose of pubic rulemaking. The awkward terminology to which the second draft clings—calling it “virtual” as opposed to digital currency—shows that the department is not moving far enough in the direction of dialogue with the Bitcoin community.

Digital, Not “Virtual”

The topic under consideration in the “BitLicense” rulemaking is digital currency. “Digital” is the correct adjective because it distinguishes these currencies from analog ones, which are most recognized for their tangible form-factors, such as rectangular pieces of paper or cylinders of metal.

Oddly, the new draft clings to the phrase “virtual currency” but excludes actual virtual currencies from the definition of the term. True virtual currencies are digital units that exist within gaming platforms or loyalty programs. In their isolated game or business ecosystems, virtual currencies may serve well, but they do not cross over into mainstream commerce and financial services (i.e., they are non-convertible). Because of this, the risks they pose to consumers are far lower than digital and fiat currencies do.

The “BitLicense” proposal leaves true virtual currencies as linguistic orphans with no word to describe them, because the proposal downgrades Bitcoin and similar currencies to “virtual.” The better approach is to treat digital currencies as the superset and virtual currencies as a subset.

Though “virtual” has recently come to mean “on a computer or the Internet,” its longstanding meaning is: “very close to being something without actually being it” or: “being such in essence or effect though not formally recognized or admitted.”[3] Classing Bitcoin as a “virtual” currency suggests that it is not real, even while the Bitcoin network processes tens of thousands of transactions worldwide each day. While people continue to call Bitcoin a “virtual currency,” they will tend to think that the system based on pieces of paper and metal is “real” while the fully digital system is not.

Bitcoin is a digital currency, interesting to the department and the state of New York because of its very real potential effects. In natural language, virtual currencies are excluded from the scope of the current

[3] Merriam-Webster.com definition of “virtual,” http://www.merriam-webster.com/dictionary/virtual.

"BitLicense" draft, which deals with digital currencies. The "BitLicense" proposal should comport itself to natural usages.

Regulation should be Activity-Based, not Technology-Based

Perhaps because the concepts at issue are confused—and without the explanation New York administrative law requires—the "BitLicense" is an inadvisable technology-specific regulation.

Bitcoin does not create any new financial services. Rather, it is a new technology for performing existing functions, such as making payments, storing value, and so on. There are differences between Bitcoin and other forms of money, but its uses are familiar, and they are direct parallels to well-known financial services. This counsels placing Bitcoin-based financial services in the same functional categories as existing financial services and regulating them the same way.

The principle of technological neutrality in regulation serves important consumer benefits. If the provision of goods and services is regulated without regard to the technology used to provide them, new competitors can enter existing markets and use new technologies to improve service and lower costs for consumers. If new technologies are regulated separately and distinctly, this Balkanizes the marketplace, hampering head-to-head competition among providers of the same services that would reduce costs and improve quality for consumers.

The Bitcoin Foundation's comment on the first draft of the "BitLicense" proposal illustrated this dynamic perspicaciously through analogy to the automobile market.[4] As the foundation noted, in just the last few years hybrid and all-electric vehicles have entered the automobile market. These innovations represent forward progress in fuel efficiency, style, and other public and consumer interests.

Should there be a new regulatory regime for each vehicle powered by new motor technology? Most people probably agree that there should not. The vehicles themselves should meet the same standards conventional vehicles do in terms of braking, impact absorption, and occupant protection, for example. They should have the same lights and signals as conventional vehicles. They should obey the same traffic laws and speed limits as all other vehicles, and they should travel on the same roads. Operating them should not require a new kind of license. This is technological neutrality in the area of automobiles.

Largely uniform regulation of motor vehicles—without regard to how they are propelled—means that new vehicle makes compete with old makes for consumer dollars. Function- or activity-based regulation lets new entrants force existing firms to improve, increasing quality and reducing prices even for consumers who do not adopt the newest technology.

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[4] *See* letter from Jim Harper, Global Policy Counsel, Bitcoin Foundation, to Ben Lawsky, Superintendent of Financial Services, New York Department of Financial Services (Oct. 8, 2014) https://bitcoinfoundation.org/wp-content/uploads/2014/10/Bitcoin-Foundation-Comment-on-NYDFS-BitLicense-Proposal.pdf. (Yes, I just called myself perspicacious.)

When a Bitcoin firm provides a financial service, it should be required to meet the same standards as non-Bitcoin financial services firms. This will make Bitcoin-based and non-Bitcoin-based financial services interchangeable to consumers. Competition among Bitcoin-based and non-Bitcoin-based financial services providers will improve the delivery of financial services to all New Yorkers whether they use Bitcoin or not.

The "BitLicense" proposal, here in its second draft, would still regulate Bitcoin-based financial services providers differently from conventional financial services providers, even when they are providing identical services from the perspective of the consumer. The result will be that one or the other form of financial service will be hindered in the marketplace by living under more costly, less cost-effective regulation. This will not produce the best results for New York's consumers, financial services firms, its economy, or jobs.

Comprehensive, Suspicionless Financial Surveillance

The second draft of the "BitLicense" proposal sticks by a deeply invasive surveillance regime aimed at users of digital currency. For readers of this comment who did not examine the draft, it is worth reproducing in full:

> Each Licensee shall maintain the following information for all Virtual Currency transactions including involving [sic] the payment, receipt, exchange or conversion, purchase, sale, transfer, or transmission of Virtual Currency:
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>> i) the identity and physical addresses of the party or parties to the transaction that are customers or accountholders of the Licensee and, to the extent practicable, any other parties to the transaction;
>> ii) the amount or value of the transaction, including in what denomination purchased, sold, or transferred;
>> iii) the method of payment;
>> iv) the date or dates on which the transaction was initiated and completed; and
>> v) a description of the transaction.

This obligation would exist without reference to any level of suspicion about the customer's actions or intentions. The finances of every Bitcoin user dealing with a "BitLicensed" firm would be comprehensively tracked. Yours truly will not do business with any such firm.

Given the importance of privacy to consumers, it is not an appropriate role for a consumer protection regulator to ensure that detailed consumer financial surveillance data is maintained in corporate storehouses. New York has law enforcement agencies and interests apart from the Department of Financial Services, and the department is better advised to work for the protection of consumer privacy.

The "BitLicense" proposal's surveillance measures are radically out of step with the trend toward strengthened protection of privacy under the U.S. Constitution's Fourth Amendment. Applying equally to state governments, the Fourth Amendment places a specific disability on law enforcement access to Americans' papers and effects. Information about the financial activities of U.S. companies and U.S.

consumers are rightly subject to constitutional protection, and outsourcing surveillance through mandates on the financial services industry is rightly regarded as state action regulated by the Constitution.

Fourth Amendment case law suggesting that Americans do not have a constitutional interest in financial information shared with third parties is controversial at best. The leading Supreme Court case with respect to financial services providers' rights, *California Bankers v. Schultz* (1974), was decided almost entirely on Due Process grounds, with the Court giving Fourth Amendment concerns minimal consideration. Its companion case in undercutting Americans' privacy rights, *U.S. v. Miller* (1976), was poorly reasoned and based on misapplication of the "reasonable expectation of privacy" test, which is increasingly falling out of favor with the Court.

In her essential concurring opinion in the recent *Jones* case (2012) dealing with GPS tracking, Justice Sonia Sotomayor specifically signaled her desire to reconsider the third-party doctrine, which undercuts Americans' financial privacy.

> This approach is ill suited to the digital age, in which people reveal a great deal of information about themselves to third parties in the course of carrying out mundane tasks. People disclose the phone numbers that they dial or text to their cellular providers; the URLs that they visit and the e-mail addresses with which they correspond to their Internet service providers; and the books, groceries, and medications they purchase to online retailers. … I would not assume that all information voluntarily disclosed to some member of the public for a limited purpose is, for that reason alone, disentitled to Fourth Amendment protection.

Justice Sotomayor would likely strike down regulation that makes Americans' private financial transactions transparent to law enforcement absent the requisite level of suspicion shown to a magistrate. A case recently argued in the Supreme Court, *City of Los Angeles v. Patel*, may be the vehicle the full Court uses to reverse the mistaken premise that people's private information loses constitutional protection when shared with a third party.

Financial services regulators tasked with consumer protection may be bystanders to these issues, or they may seek balance, but taking the side of law enforcement against the privacy interests of New York consumers is not appropriate. The vast majority of New Yorkers are law-abiding, and the New York Department of Financial Services should recognize that its role is not alliance with criminal law enforcers against New Yorkers' privacy or obedience to law enforcement's demands. Rather, the department should work to ensure that information about consumers' use of financial services should be available to law enforcement only if suspicion rises to appropriate legal standards, such as probable cause evidenced by a warrant.

Conclusion

Given their variety and complexity, the department must articulate the rationales for the many proposals found in the current draft "BitLicense." This is essential if there is to be the public examination of them that New York's administrative procedure law requires.

After more than half a year and the first two rounds of comments, the time is long past for the department to produce the "[e]xtensive research and analysis" that it cited when it introduced the "BitLicense" proposal. The department should also conduct the legally required "jobs impact statement" before introducing any further drafts.

Any further proposal should use the terms "virtual" and "digital" more appropriately for this field. Technology-specific regulation should be avoided. And you should jettison the unwarranted financial surveillance from the proposal.

These are not the only area where the "BitLicense" proposal needs improvement. Other comments will certainly detail other important issues the current draft raises.

Thank you for the opportunity to offer these comments.

Sincerely,

/s/Jim Harper
Senior Fellow
The Cato Institute