

Virtual Currencies: New York State Department of Financial Services Releases Proposed Regulations

As the first of their kind, the proposed regulations may add legitimacy to virtual currencies, but the new regulatory regime could stifle innovation and development.

On July 23, 2014, the New York State Department of Financial Services (NYSDFS), the governmental agency that regulates the financial services and insurance industries in New York, released proposed regulations governing the use of virtual currencies in New York State (Proposed Rule).¹ The Proposed Rule is open to a 45-day public comment period that will end on September 5, 2014, after which the NYSDFS will consider the comments and possibly amend before deciding on the final form of the regulations. This Client Alert discusses the history of virtual currencies, provides an overview and summary of the key requirements of the Proposed Rule, highlights some of the similarities between the Proposed Rule and other NYSDFS rules that regulate aspects of the financial services industry in New York, and discusses the potential impact of the Proposed Rule on the virtual currency industry.

Virtual Currencies: A Brief History

Virtual currencies and other cryptocurrencies, such as Bitcoin, are financial and technological instruments that incorporate characteristics of money, accounting, networks and remittances into one concept. Bitcoin has been gaining traction as a decentralized, digital currency since it was officially launched in 2009. Although virtual currencies are not considered “lawful money” in the United States, the number of virtual currency users is growing rapidly beyond the scope of the banking industry. As such, the need to implement regulations to reduce the operational and systemic risks associated with the virtual currency industry and to protect consumers from financial harm is paramount to ensure the survival of a multibillion-dollar system with more than one million users.

To date, federal and state banking regulators have failed to reach a consensus as to how to both classify Bitcoin and regulate such an industry. Various federal regulatory agencies have acknowledged the existence of the virtual currencies industry, but only a few have addressed how such an industry might be regulated. Federal Reserve Chair Janet Yellen has called Bitcoin “a payment innovation that is taking place outside of the banking industry,” but the Federal Reserve has not indicated whether the supervision and regulation of the virtual currencies industry should fall under its purview. Other federal regulators, such as the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) and the Consumer Financial Protection Bureau (CFPB), have made some clarifying remarks as to how virtual currencies might fit into their respective regimes, but neither FinCEN nor the CFPB has issued any corresponding regulatory proposals.² At the state level, while most states regulate money transmission in some form, prior to the NYSDFS’s issuance of the Proposed Rule no state had issued proposals relating specifically to establishing a regulatory framework for virtual currencies.³

Overview and Summary of the Proposed Rule

With the introduction of the Proposed Rule, the NYSDFS has established itself as the first regulatory agency, at either the state or federal level, to develop a framework for oversight of the virtual currency industry. Drawing heavily from New York's banking industry regulations, the Proposed Rule establishes a strict regulatory regime that will require companies currently operating under the virtual currency model to drastically change their business practices.

Definition of "Virtual Currency"

"Virtual Currency," as defined under the Proposed Rule, means any type of digital unit that is (i) used as a medium of exchange or a form of digitally stored value or (ii) incorporated into payment system technology. In addition, Virtual Currency includes digital units of exchange that may:

- Have a centralized repository or administrator
- Be decentralized and have no centralized repository or administrator
- Be created or obtained by computing or manufacturing effort

Carve-outs from the definition of Virtual Currency include digital units that are (i) used solely within online gaming platforms with no market or application outside those gaming platforms or (ii) used exclusively as part of a customer affinity or rewards program and can be applied solely as payment for purchases with an issuer and/or other designated merchants, but cannot be converted into or redeemed for any government-issued currency that is designated as legal tender in its country or issuance through government decree, regulation or law (Fiat Currency).

Licensing Requirement to Engage in a "Virtual Currency Business Activity"

Perhaps the most significant aspect of the proposed new regulatory regime for Virtual Currencies in New York is the requirement that a "Person" (defined below) would only be permitted to engage in a "Virtual Currency Business Activity" (defined below) if such Person is granted a license by the Superintendent of Financial Services (Superintendent). Person, as defined under the Proposed Rule, includes an individual, partnership, corporation, association, joint stock association, trust or other business combination or entity, however organized. Virtual Currency Business Activity means any of the following activities involving New York or any Person that resides, is located, has a place of business or is conducting business in New York:

- Receiving Virtual Currency for transmission or transmitting Virtual Currency
- Securing, storing, holding or maintaining custody or control of Virtual Currency on behalf of others
- Buying and selling Virtual Currency as a customer business
- Performing retail conversion services, including the conversion or exchange of Fiat Currency or other value into Virtual Currency, the conversion or exchange of Virtual Currency into Fiat Currency or other value, or the conversion or exchange of one form of Virtual Currency into another form of Virtual Currency
- Controlling, administering or issuing a Virtual Currency

Notwithstanding the above licensing requirement, Persons that fall under the following two categories are exempt under the Proposed Rule from the requirement to obtain a license to engage in any Virtual Currency Business Activity:

- Persons chartered under the New York Banking Law to conduct exchange services and who are approved by the Superintendent to engage in a Virtual Currency Business Activity

- Merchants and other consumers who use Virtual Currency only for the purchase or sale of goods or services

Application for Licensing Submission Process

In order to be considered for a Virtual Currency Business Activity license under the Proposed Rule, an applicant would be required to provide the Superintendent with a variety of information designed to remove the anonymity previously associated with parties engaged in virtual currency transactions and to introduce a level of transparency to provide consumers with an idea of the type of person with whom the consumer is conducting business. To this end, applicants would be required to provide the Superintendent with extensive information, including, but not limited to, the following:

- The exact name of the applicant
- The jurisdiction where such applicant is organized or incorporated
- Biographical information for each individual applicant, each director and certain specified officers and/or beneficiaries and/or stockholders, as applicable
- State Division of Criminal Justice Services and Federal Bureau of Investigation background checks for each individual applicant, for all employees of such applicant and for certain specified officers and/or beneficiaries and/or stockholders, as applicable
- An organizational chart and management structure of the applicant
- A current financial statement for the applicant and certain specified officers and/or beneficiaries and/or stockholders, as applicable
- A projected pro forma balance sheet and income expense statement for the next year of the applicant's operation
- Details of all banking arrangements
- An explanation of the methodologies used to calculate the value of Virtual Currency in Fiat Currency

The Proposed Rule's list of licensing requirements is not exhaustive, and the Superintendent would have discretionary authority to require applicants to provide additional information as needed.

Superintendent's Consideration of Application for Licensing

Upon the filing of an application for licensing, the Superintendent would have a period of 90 days, which may be extended on a discretionary basis, to approve or deny an application. During this period, the Superintendent would evaluate an applicant's ability to engage in a Virtual Currency Business Activity by investigating such applicant's financial condition and responsibility, financial and business experience, and character and general fitness.

Compliance Regime for Persons Engaged in a Virtual Currency Business Activity

In addition to requiring any Person duly licensed by the Superintendent to engage in a Virtual Currency Business Activity (Licensee) to comply with all federal and state laws, rules and regulations applicable to Virtual Currencies, each Licensee would also be subject to an extensive enforcement regime under the Proposed Rule. Such a regime would involve compliance with anti-fraud, anti-money laundering, cyber security, privacy and information security, and other such policies. The Proposed Rule sets forth the various requirements for maintaining and documenting compliance with the various policies listed above. In addition to requiring the Licensee's board of directors or equivalent governing body to review and approve each such documented compliance policy, the Proposed Rule provides that the Superintendent would also conduct periodic examinations at least once every two calendar years. During such examinations, the Superintendent would review and evaluate the Licensee's compliance policies, among other practices.

Comparison to New York State Financial Services Industry Regulations

The proposed virtual currency regulatory framework and compliance regime includes many notable parallels with the current regulatory framework for participants in the financial services industry in New York, including banks and non-banking financial services entities, such as money transmitters. With the exception of cyber security, the parallels include requirements to maintain minimum capital standards, place in custody and safeguard customer assets, maintain books and records, submit to periodic examinations by the Superintendent, and comply with ongoing reporting and disclosure obligations as well as consumer protection disclosures.

Potential Impact on the Virtual Currency Industry in New York

The Proposed Rule would require any potential Licensee, regardless of size, to invest substantially in compliance resources to ensure that all current and future Virtual Currency Business Activities are compliant with the new regulatory regime. The costs associated with such compliance requirements may have the unintended consequence of stifling innovation and development on the virtual currency front by preventing individuals or small start-ups with limited budgets from establishing a presence in New York. The NYDFS has acknowledged this possible consequence and has assured the industry it intends to balance innovation, economic development and safety and soundness in the final rule.

Conclusion

As the first state to propose an established framework for the virtual currency industry, the dialogue surrounding the Proposed Rule and the final form of the rule likely will significantly impact the ways in which other state and federal regulators adopt virtual currency standards. While New York's proposed virtual currency regulations are the first of their kind in the United States, the similarities to the regulatory regimes for both banks and non-bank financial services providers will require potential virtual currency licensees to understand both the virtual currency industry and the financial services regulatory regimes. In navigating this new regulatory landscape, potential licensees should enlist the assistance of experts with expertise in both the virtual currency and bank regulatory worlds.

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Endnotes

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- ¹ 23 NYCRR Part 200 (proposed), available at <http://www.dfs.ny.gov/about/press2014/pr1407171-vc.pdf>.
 - ² FinCEN issued guidance on March 18, 2013, clarifying that Bitcoin operates similarly to real currency and therefore should be treated like currency for purposes of US anti-money laundering regulations and should be subject to FinCEN's registration, reporting and record-keeping requirements, including Know Your Customer rules. In addition, the CFPB recently indicated that it is working in conjunction with other federal regulators to develop consumer protection regulations relating to the virtual currency industry.
 - ³ A few states, including California, Kansas and Texas, have addressed the topic of virtual currencies without proposing any such regulations. California's state legislature approved a bill on June 30, 2014, that lifted a ban on the use of Bitcoin and other alternative currencies to make such currency legal in purchasing goods and transmitting payments. In Kansas, the Office of the State Bank Commissioner issued guidance on June 6, 2014, regarding the regulatory treatment of virtual currencies pursuant to the statutory definitions under the Kansas Money Transmitter Act. On April 3, 2014, the Texas Department of Banking issued a supervisory memorandum outlining its policy with respect to virtual currencies.