EXPERT ANALYSIS

Virtual Currencies & the Current State of the Law

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In recent years, virtual currencies have garnered a staggering amount of media, investor and government attention. The advent and rapid popularization of virtual currency technology, such as bitcoin, has caused a sea change in the financial technology industry.

Recent advancements to virtual currency technology — the so-called block-chain protocol or architecture — have further exacerbated this disruption. However, the uncertain legal and regulatory environment in which it exists often tempers the increasing interest in the technology.

This commentary is intended as an overview of important or potentially overlooked applications of legislation aimed at virtual currency. Before undertaking any type of virtual currency-related activity, companies and individuals should review all applicable state and federal laws.

VIRTUAL CURRENCY AND HOW IT WORKS

Virtual currencies go by many names, including cryptocurrencies. Regardless of the label used, a true virtual currency is comprised of one significant element: the block chain. A block chain is a cryptographically secured, distributed ledger. The block chain is significant because it allows users of the currency to initiate and settle transactions without the use of a centralized, third-party intermediary such as a bank.

Because the block chain is cryptographically secured and distributed, no single party can alter it without reaching a consensus with a certain percentage of the others. The block chain's ability to facilitate a near-instantaneous, distributed consensus among multiple users is often lauded as virtual currency's true technological innovation.

Each user of a virtual currency is typically assigned one or more private and public encryption keys. The public key serves as an address to which other users can send payment. The private key serves as a type of signature, enabling the user to authorize transactions originating from his or her virtual currency account, which is typically referred to as a wallet.

A distributed network of participants must cryptographically verify every transaction initiated and settled on the block chain through an analysis of the corresponding public and private encryption keys. Because the block chain is public and decentralized, no single party can manipulate the ledger without the other parties verifying and approving any proposed changes. The process of performing the mathematically complex cryptographic verification is colloquially referred to as "mining." The popular virtual currency known as bitcoin operates in this fashion.

A movement of sorts has begun to adapt the technology for other uses. For example, Overstock. com intends to use a block-chain-based system to conduct an offering of virtual securities. Banks

and stock markets are investing in and researching "block chain 2.0" technology. Other entities have developed applications to administer secure and cryptographically verifiable escrow transactions. More advanced applications allow for the creation and execution of "smart contracts," or computer code that facilitates, verifies or enforces the performance of a contract.

Companies dealing in virtual currency or using block-chain technologies should be cognizant of whether and how new or proposed legislation may affect their operations.

LEGAL AND REGULATORY LANDSCAPE

Texas

Texas was the first state to issue regulatory guidance on using virtual currency. On April 3, 2014, the Texas Department of Banking issued a supervisory memorandum, clarifying the circumstances under which businesses dealing in decentralized virtual currencies will be required to comply with the Texas Money Services Act.[1]

Any virtual currency business conducting a transaction within the TMSA's scope must comply with the applicable licensure rules, including restrictions on the types of cryptocurrency-based investments used to calculate the company's net worth, consumer protection and cybersecurity requirements, the memorandum noted.

According to the Texas Banking Department, however, an exchange of virtual currency for sovereign-issued currency between two parties is not considered a money transmission under the TMSA. As such, no Texas money services license is required.

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This is based on the department's contention that virtual currency is not considered "money" as the TMSA defines that term. Under the TMSA, "'money' or 'monetary value' means currency or a claim that can be converted into currency through a financial institution, electronic payments network or other formal or informal payment system."

Given the decentralized nature of virtual currency, or cryptocurrency, the Banking Department concluded that virtual currency "does not entitle its owner to anything and creates no duties or obligations in a person who gives, sells or transfers it." Because a virtual currency cannot be converted to sovereign currency without a "willing buyer," the department concluded it falls beyond the boundaries of the TMSA.

However, the memorandum contained an important caveat.

Although a direct exchange of virtual currency does not fall within the TMSA's reach, an exchange facilitated through a third-party intermediary might.

For example, an exchange of virtual currency for sovereign currency through a third-party exchange is an "escrow-like" transaction, which necessarily creates "duties or obligations" to the person or entity giving, selling or exchanging the virtual currency, the memorandum said.

Further, if virtual currency and sovereign currency are exchanged through an ATM, then that transaction may require licensure under the TMSA if the ATM transaction uses a third-party intermediary. If, however, the ATM facilitates the exchange directly between the machine's operator and the customer, it does not implicate the TMSA's licensure requirements.

New York

In June the New York State Department of Financial Services released its final BitLicense rules, which establish the minimum standards for all businesses that conduct virtual currency business activities in the state or with a state resident. The state requires any entity that is engaged in a "virtual currency business activity" to apply for and obtain a BitLicense.[2]

The term "virtual currency" is broadly defined to include digital units of exchange that:

- Have a centralized repository or administrator.

- Are decentralized and have no centralized repository or administrator.

- May be created or obtained by computing or manufacturing effort.

The definition was narrowed from earlier drafts to explicitly exclude prepaid cards, digital units used solely in online games and customer rewards programs.

A business in New York is considered to be conducting "virtual currency business activity" if it falls within one of five categories:

- Receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency.

- Storing, holding, or maintaining custody or control of virtual currency on behalf of others.

- Buying and selling virtual currency as a customer business.

- Performing exchange services as a customer business.

- Controlling, administering or issuing a virtual currency.

The licensure process mandates a broad, detailed disclosure of the applicant's background and intended business activities. This includes providing a set of fingerprints; two portrait-style photographs; and current financial statements for each principal officer, stockholder and beneficiary of the applicant and for all employed individuals who have access to customer funds.

Additionally, the applicant must provide a background report prepared by an approved, independent investigatory agency; an organizational chart of the applicant's management structure; current financial statements of the applicant and each principal officer, stockholder, and beneficiary; and all banking arrangement details.

The compliance requirements for applicants who obtain a BitLicense are similarly onerous. Licensees must maintain and enforce written policies pertaining to fraud, money laundering, cybersecurity, privacy and information security.

Each licensee must also maintain capital reserves in an amount and form determined by the superintendent of financial services.

Further, licensees must permit the superintendent to examine the licensees' financial condition, policies and regulatory compliance efforts.

They must also maintain and keep records in their original format for seven years and implement robust anti-money-laundering, consumer and cybersecurity protections.

To comply with anti-money-laundering obligations, each licensee must maintain a customer identification program, which requires it to verify a customer's identity, keep identification records and check customers' names against the "specially designated nationals" list maintained by the U.S. Office of Foreign Assets Control.

Licensees must also design a cybersecurity program to address five core functions:

- Identify internal and external cyberrisks.

- Protect the licensee's electronic systems.

- Detect system intrusions, data breaches, unauthorized access to systems or information, malware, and other cybersecurity issues.

- Respond to detected cybersecurity events and mitigate the consequences.

- Recover from a cybersecurity event and restore normal operations.

Additionally, each licensee must submit an annual report to the Department of Financial Services evaluating the availability, functionality and integrity of the licensee's electronic systems;

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identifying relevant cyberrisks; assessing the current cybersecurity programs; and proposing steps to redress any identified inadequacies.

Connecticut

In June Connecticut enacted legislation regulating virtual currencies. The law enables the state banking commissioner to determine whether a business dealing in virtual currencies must obtain a money transmitter license.[3]

The law defines "virtual currency" as:

> Any type of digital unit that is used as a medium of exchange or a form of digitally stored value or that is incorporated into payment system technology. Virtual currency shall be construed to include digital units of exchange that (A) have a centralized repository or administrator; (B) are decentralized and have no centralized repository or administrator; or (C) may be created or obtained by computing or manufacturing effort. Virtual currency shall not be construed to include digital units that are used (i) solely within online gaming platforms with no market or application outside such gaming platforms, or (ii) exclusively as part of a consumer affinity or rewards program, and can be applied solely as payment for purchases with the issuer or other designated merchants, but cannot be converted into or redeemed for fiat currency.

Interestingly, beyond defining virtual currency, the law offers little guidance.

A direct exchange of virtual currency does not fall within the Texas Money Service Act's reach, but an exchange facilitated through a third-party intermediary might.

It seemingly allows the banking commissioner to impose conditions on the licensure of a business "transmitting monetary value in the form of virtual currency" at his or her discretion. The law offers no guidance as to what those conditions might be, or when they would be appropriate.

Moreover, the law allows the banking commissioner to deny any application if, given the applicant's proposed business model, the commissioner determines that the license may present an undue risk of financial loss to consumers. However, the law does not provide detailed criteria by which the commissioner should make such a judgement.

The commissioner also may require the applicant to provide a bond as a condition to obtaining a license and leaves the bond amount to the commissioner's discretion. Other provisions of Connecticut law that do not pertain to virtual currencies, however, put hard limits upon the dollar amount of required bonds.

OBSERVATIONS

Texas, New York and Connecticut highlight the disparate legal schemes virtual currency businesses may need to navigate.

Given the stark differences among them, it is nearly impossible to fashion an across-the-board policy that would provide for operational compliance in every state where such a law or regulation exists. As such, virtual currency businesses should evaluate whether the cost of compliance in a given state is worth the risk and financial reward of doing business there.

Any number of factors may affect such an analysis, but some are likely to be more important than others.

Customer privacy

One trait is likely to be common among customers of any virtual currency business: a desire to maintain a high degree of personal privacy or anonymity. Accordingly, these businesses must consider customers' privacy when seeking to comply with state law.

New York's BitLicense requires a company to create a program that may require it to disclose its customers' identities to the government.

After the BitLicense took effect, many virtual currency businesses shuttered their New York operations to avoid having to disclose customer identities and thus risk betraying customers' trust.

Because privacy is pivotal for most virtual currency customers, the cost of doing business in a state must be weighed against potential backlash. Companies should evaluate the geographical scope of their operations, user base and corporate structure to determine whether they can design a creative legal solution to limit the potential impact of required identity verifications and disclosures.

Ambiguities and the 'one size fits all' approach

The differences between the various regulatory schemes are readily apparent, but the similarities are far more subtle, leading to potential legal pitfalls.

For example, an activity that is considered within the scope of one state's framework may not fall within the scope of another state's law. Even when terms are ascribed a certain meaning within the law, ambiguities may exist.

Connecticut's law, for example, looks to whether a business is "transmitting monetary value in the form of virtual currency." These terms become somewhat abstract when used outside the context of centralized currencies. Given the myriad of highly technical applications that use virtual currency, it not clear what "transmitting monetary value" means. Some advanced "block chain 2.0" applications require the transmission of nominal amounts of virtual currency to facilitate a non-monetary goal, such as the creation and enforcement of a smart contract. Given the vague wording of the law, companies may need to ensure they are in compliance despite the fact that they do not function as a traditional money services business.

Similarly, New York's BitLicense looks to whether a business is "controlling, administering and issuing" virtual currency to determine whether it falls within the regulations' scope. These terms necessarily imply centralization and cannot be neatly applied to distributed, decentralized currencies.

These ambiguities become a more serious issue when block chain 2.0 technologies are considered. Multi-signature, or multi-sig, transactions provide a good example.

A multi-sig transaction requires two or more people to ratify a transaction with their private encryption keys before the transaction is processed. Thus, any number of people might be considered to maintain "custody or control" of the virtual currency. In practice, however, when everyone has a small degree of custody or control over the currency, nobody does. Such is the nature of virtual currencies and the block chain.

Although regulatory schemes like the BitLicense provide an exemption for nominal and non-financial uses of virtual currencies, those exemptions suffer from similar uncertainties. As virtual currency businesses mature and the regulations that govern them develop, there is likely to be considerable controversy surrounding seemingly mundane terminology.

Moreover, the scope of any law's application and jurisdiction must be considered. Many virtual currency businesses are Web-based and can be accessed from all over the world. Thus, a business should consider whether merely making a product or service available in a given state subjects it to the full brunt of the state's virtual currency rules, or whether actual operation within the state is required, and what that means. The distributed, decentralized nature of virtual currencies further complicates these issues.

CONCLUSION

As the technology continues to develop, laws governing virtual currencies will begin to play a larger role in financial technology. This trend is likely to grow as mainstream financial institutions express increased interest in virtual currencies.

Given the laws, rules and regulations surrounding this advanced technology, it is shaping up to become the next frontier of finance, technology and law.

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NOTES

[1] Tex. Dep't of Banking, Supervisory Memorandum 1037: Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act (Apr. 3, 2014), available at http://bit.ly/1OcXUYF.

[2] 23 CRR-NY 200.3(a).

[3] 2015 Conn. Legis. Serv. P.A. 15-53 (H.B. 6800) (West). The bill states that it is "[a]n act concerning mortgage correspondent lenders, the Small Loan Act, virtual currencies and security freezes on consumer credit reports."

In New York, the BitLicense process mandates a broad, detailed disclosure of the applicant's background and intended business activities.

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