



October 14, 2015

Ms. Margaret C. Liu
Senior Vice President and Deputy General Counsel
Conference of State Bank Supervisors
1129 20th Street, NW, Suite 900
Washington DC 20036

Dear Ms. Liu:

Thank you for taking the time to meet with me and my colleagues about the Conference of State Bank Supervisors's Model Regulatory Framework for Virtual Currency Activities. As we mentioned, we appreciate immensely the great effort that the Emerging Payments Task Force has devoted to developing this important framework. We are also concerned, however, that while the policy goals outlined are absolutely correct, the the list of covered activities in the framework does not match those smart policy goals. What follows is an explanation of our concern. We sincerely appreciate your offer to forward these thoughts to regulators in the states.

In its policy statement on state virtual currency regulation, CSBS has clearly set out the normative case for consumer protection regulation of digital currencies, as well as an intuitive standard for determining which virtual currency businesses should need to be licensed:

[M]any virtual currency services are clearly focused on consumer financial services. Such virtual currency service providers are in a position of trust with the consumer, which creates a public interest to ensure activities are performed as advertised with appropriate minimum standards to minimize risk to consumers.

It is CSBS policy that entities performing activities involving third party control of virtual currency should be subject to state licensure and supervision like an entity performing such activities with fiat currencies.¹

¹ Conference of State Bank Supervisors, *State Regulatory Requirements for Virtual Currency Activities CSBS Model Regulatory Framework 10*, (Sep. 2015) available at [https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework\(September%2015%202015\).pdf](https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework(September%2015%202015).pdf)

We firmly support this policy. However, we believe that statutory language used to enact this policy should have greater specificity than is found in the language provided in CSBS's Model Framework.

Whether a particular business is a digital currency transmitter, and should be required to seek a license to operate, will always be a question of facts and circumstances. That inquiry, however, can be standardized and focused in the realm of digital currencies, simplifying the work of regulators and offering clearer guardrails for innovators building new products.

As CSBS suggests, "third-party control of virtual currency" is the act that gives rise to a position of trust and concomitant licensing obligations. The essential question facing a regulator should therefore be: *Can this business transact with the customer's digital currency, or is it merely providing tools or infrastructure that allow the user to more easily or safely transact on her own?* This is a simple question of capability and it can be easily asked by a regulator and easily answered by a business. Bitcoin and similar cryptocurrencies have been developed so that only users with knowledge of a cryptographic secret, or "key," are capable of moving some corresponding balance on the digital currency network. If a business doesn't have knowledge of a consumer's secret key, then it simply cannot transact on the user's behalf, and it therefore can't be said to have "third-party control of virtual currency."

Broadly worded definitions for covered activities create uncertainty. Even many activities-based standards may fail to offer guidance or clarity. What, for example, does it mean to "issue," "control," "hold," or "store" bitcoins, or to "facilitate" a Bitcoin transaction? Bitcoins have no physical embodiment and are not computer files as one would find on a hard drive or attached to an email. They are amounts listed on a peer-to-peer ledger. How does one hold that? Do Internet service providers (e.g. Comcast or Time Warner) "facilitate" a transaction by relaying messages to and from participants on the currency's peer-to-peer network? Yes, but are they then digital currency transmitters? Surely not, but statutes with such wording would not clearly foreclose that interpretation, and the result is complexity and uncertainty in both compliance and enforcement.

Rather than list activities, such as "exchanging" or "transmitting," a standard should specify the capabilities that would allow a business to have "third-party control of virtual currency." Only companies with the *capability* to transact on the user's behalf should be subjected to licensing. Coin Center's Framework for State Regulation, which you will find attached to this letter, proposes the following language to clearly define this category:

Qualifying activities. A person or entity shall be found to be engaged in Digital Currency Transmission if and only if it regularly and in the course of business has the ability to unilaterally execute² or prevent³ a Digital Currency transaction on behalf of others,⁴ except in cases where the ability to prevent transactions is reasonably time-limited and integral to a service such as escrow or transaction management.⁵

In our Framework, we carefully explain several uses of digital currency technology that would not fit into this definition. We provide examples of multi-signature technology where control is divided,⁶ microtransaction channels where control is time-limited,⁷ and cases where the non-unilateral power to prevent transactions enables various new uses, such as low-risk escrow services.⁸ Throughout, the Framework explains how these *non-custodial* technologies do not pose solvency risks to consumers and, therefore, should not be regulated at the level of state licensing in accordance with CSBS's stated policy.

Our Framework may appear to exclude all "exchange" activities from regulation, yet this is not the case. Any exchange posing consumer risk will have full control of consumer funds and, therefore, will be covered by our proposed definition. Using the term "exchange" or "convert" within legislation, however, risks expanding the definition to cover several nascent innovations, like sidechains or colored coins.⁹ These services could be technically described as "exchangers" or "converters" even though they are automated and non-custodial or non-financial services that do not pose a solvency risk to consumers. These technologies are also still very nascent, and related developers or businesses should not be regulated via licensing, at least not at the moment. Given the uncertainty surrounding the future development of these tools, this approach is essential to future-proofing any statute.

Moreover, clearly exempting such non-custodial technologies from licensing would not leave these businesses "unregulated." Rather, these services would be better regulated under contract law and under the state and federal consumer protection standards that

² See *Attached*, Peter Van Valkenburgh and Jerry Brito, *State Digital Currency Principles and Framework v1.3*, *Coin Center Report*, Oct 2015, Part 1.C "unilaterally execute" at p. 6, available at <https://coincenter.org/2015/04/state-principles-and-framework/>.

³ See *Id.* Part 1.D "unilaterally prevent" at p. 8.

⁴ See *Id.* Part 1.E "on behalf of others" at p. 13.

⁵ See *Id.* Part 1.D "unilaterally prevent" at p. 8.

⁶ See *Id.* Part 1.C "unilaterally execute" at p. 6.

⁷ See *Id.* Part 1.D "Reasonably Time Limited" at p. 11.

⁸ See *Id.* Part 1.D "Low Trust Escrow and Transaction Management Services." at p. 9.

⁹ See Brock Cusick, *What are Colored Coins? A Backgrounder for Policymakers*, Coin Center (Nov. 2014) available at <https://coincenter.org/2014/11/colored-coins/>.

already apply to any web-based service, such as Unfair and Deceptive Acts or Practices Law. These service providers would also be subject to Unfair, Deceptive, and Abusive Acts or Practices regulation under Dodd Frank and the federal Consumer Financial Protection Bureau. All told, these safety nets should be sufficient to guard the users of non-custodial services—who already are in a far less vulnerable position than users of custodial services—while also enabling healthy permissionless innovation.

The Framework developed by Coin Center presents simple explanations of various uses, and makes the case why some deserve clear legislative exemptions. We hope you find it a useful guide while navigating a regulatory course that can both protect consumers and enable innovators.

Please do not hesitate to reach out to us with any questions or comments. Coin Center exists to be a resource to policymakers as they navigate this complex new area of exciting innovation and necessary regulation. The goal is to ensure consumers are protected while avoiding inadvertently and unnecessarily hampering innovation. We look forward to working with you.

Sincerely,

A handwritten signature in black ink, appearing to be the initials 'JB' or a similar stylized monogram.

Jerry Brito
Executive Director