COIN CENTER

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**To: Sarah Jane Hughes, Members, and Observers; ULC Regulation of Virtual Currency Businesses Act Committee.**

Writing on behalf of Coin Center, a Washington, D.C.-based non-profit cryptocurrency policy research and advocacy center, I'd like to offer a response to comments previously submitted[1] by the Office of Strategic Policy, Office of Terrorist Financing and Financial Crimes of the U.S. Department of the Treasury (TFFC) regarding definitions proposed by Coin Center for the Uniform Regulation of Virtual Currency Businesses Act (URVCBA).

The comments of the TFFC (1) are focused on anti-money laundering and terrorist financing concerns best addressed at the federal level, and immaterial to a determination regarding state consumer protection and solvency regulation for virtual currency businesses, (2) propose an unworkable totality of the circumstances test for the definition of VCBA that would chill innovation and unnecessarily and unpredictably expose innovators to felony criminal liability, and (3) express unfounded concerns that definitions in language proposed by Coin Center would create loopholes as contrasted with federal Bank Secrecy Act compliance obligations (in fact, existing FinCEN administrative rulings exempt a significantly larger group of companies from BSA regulation than the proposed Coin Center exclusions to the definition of VCBA would exempt from the URVCBA). Each point will be addressed in turn.

### (1) The policy focus of the URVCBA is consumer protection and solvency, not anti-money-laundering (AML) or terrorist financing control (TF).

It appears that the concerns expressed in the TFFC's March letter are motivated by AML and TF policy rather than consumer protection or solvency concerns.

Companies performing money services using bitcoin or other virtual currencies should be placed on an even regulatory footing with legacy industry. Traditionally, state-level regulation of money services business has been limited to guaranteeing that the consumers of these services are protected from fraud and that the institutions providing these services

[1] *See* Anne Shere Wallwork's February 29, 2016 comment filed on behalf of Treasury's Office of Terrorist Financing and Financial Crimes.

are solvent. The policy goals of virtual currency business regulation should be no different: limited to protecting consumers and ensuring institutional solvency.

AML and TF concerns are not to be taken lightly and controls are essential to a peaceful society. However, the responsibility for setting these standards and leading enforcement efforts should remain with the federal government and not be imported into state law by way of a uniform bill focused on the unrelated problem of consumer protection. These standards are found in the Bank Secrecy Act and its implementing regulations. If AML and TF loopholes exist in these regulatory regimes then it is these federal rules that need to be amended or reinterpreted through the normal process of notice and comment rather than through an extraordinary process suggested by the TFFC's letter: federal commandeering of state legislatures or legislative efforts.[2]

**(2) The severity of federal criminal penalties for unlicensed money transmission and the chilling effect of vague standards on innovation make it essential that covered activities (VCBA) be defined using bright line rules rather than facts and circumstances determinations.**

The TFFC has proposed that the set of regulated businesses (VCBA) in the URVCBA be defined loosely to accommodate a process of case-by-case administrative determinations based on an unspecified list[3] of "facts and circumstances" related to each particular business. [4] Coin Center prefers a bright line rule test for VCBA.[5]

A "facts and circumstances" test would endanger the managers, investors, and—by extension— users of virtual currency businesses by subjecting them to an unnavigable

[2] For a discussion of the constitutionality of commandeering within our federalist system and the anti-commandeering doctrine established by the Supreme Court in *New York v. United States* and later *Printz v. United States* , see Neil S. Siegel, "Commandeering and Its Alternatives: A Federalism Perspective" ("'Commandeering' refers to a federal requirement that state officials enact, administer, or enforce a federal regulatory program."). *See also* New York v. United States, 505 U.S. 144, 156-57 (1992) (reasoning that "where the Federal Government compels States to regulate, the accountability of both state and federal officials is diminished. If the citizens of New York, for example, do not consider that making provision for the disposal of radioactive waste is in their best interest, they may elect state officials who share their view. That view can always be pre-empted under the Supremacy Clause if it is contrary to the national view, but in such a case it is the Federal Government that makes the decision in full view of the public, and it will be federal officials that suffer the consequences if the decision turns out to be detrimental or unpopular. But where the Federal Government directs the States to regulate, it may be state officials who will bear the brunt of public disapproval, while the federal officials who devised the regulatory program may remain insulated from the electoral ramifications of their decision. Accountability is thus diminished....").

[3] Though it is never mentioned, presumably the TFFC would like the list of facts and circumstances to be the list found in the bank secrecy act implementing regulations. 31 CFR 1010.10(ff)(5)(ii). However, no mention is made of adding that list to the definition of VCBA in this bill.

[4] *See* Anne Shere Wallwork's February 29, 2016, comment (suggesting the committee "leave the minutia of whether particular business models and technologies fit under the regulatory definitions to normal processes involved in applying regulation to specific activity, based on all the relevant facts and circumstances of the particular case.").

[5] Coin Center's recommended definitions are defined and explained at 1-2 of the February 26, 2016 memorandum to the Drafting Committee.

minefield of severe criminal penalties. Under provisions from the Patriot Act found in 18 USC 1960, managing, owning, or investing in a company found to be transmitting money without a license in a state where a license was required is a felony punishable by up to five years in prison.[6] This criminal statute has no knowledge requirement; even managers or investors unaware of state laws on the subject, unaware that their business had failed to get a license, or unaware that their business is—under some or other of the 50-some state standards—a money transmitter, can be found guilty of a federal felony.[7] The severity of this federal criminal law underscores the importance for states to draft ***clear bright line tests for who must be and who need not be licensed***. Failing to do so unreasonably endangers the innovative men and women who build these businesses.

A "facts and circumstances" test affords regulators too much discretion, effectively enabling them to retroactively criminalize any activity that resembles money transmission on a case by case basis. Presumably the TFFC is advocating for a process that resembles FinCEN's requests for interpretive rulings on the implementing regulations of the Bank Secrecy Act.[8] Even if such discretion is used wisely and efficiently, as FinCEN has done, when applied by the states it will create a massive literature of individual determinations for each prospective applicant in each state. If even five different companies with five subtly different business models must seek individual judgements from regulators based on their individual facts and circumstances there will be some 250 different interpretive rulings once the fifty-state licensing process is complete. A sixth company looking for regulatory clarity would need to hire an impressive compliance staff to review, at minimum, these 250 different rulings, and then make complicated inferences regarding the need to apply for a license within each state based on the unique circumstances of that sixth company.

Even with this Kafkaesque literature under careful review, the company cannot be guaranteed safety. These rulings apply only to the company that sought them; the sixth company—even if it is effectively identical to the five before it—cannot rely on these 250 rulings as binding precedent for their own case.

Fear and legal uncertainty generated by a discretion-based "facts and circumstances" standard would chill the activities of innovators in this space, hastening the migration of these businesses to overseas jurisdictions with simpler or more transparent regulatory regimes[9] (leaving the US uncompetitive in the future of financial technology) or to regions where regulation is corrupt or absent (leaving customers unprotected).

[6] *See* 18 U.S. C § 1960 - Prohibition of unlicensed money transmitting businesses, *available at* https://www.law.cornell.edu/uscode/text/18/1960.

[7] *See id. See also* Brian Klein, "Does 18 U.S.C. § 1960 create felony liability for bitcoin businesses?
A Backgrounder for Policymakers" *Coin Center* (Jul. 2015)
*https://coincenter.org/2015/07/does-18-u-s-c-%C2%A7-1960-create-felony-liability-for-bitcoin-businesses/.*

[8] *See* https://www.fincen.gov/statutes_regs/rulings/ for a listing of FinCEN's administrative rulings to date.

[9] *See e.g.*, the UK's plan for regulating virtual currency businesses described at https://coincenter.org/2015/03/the-uk-plan-for-bitcoin-is-a-step-in-the-right-direction/.

Again, if the TFFC and Treasury are concerned with the definition of money transmission for AML or TF purposes, and would prefer a more flexible standard, then they should address those concerns at the federal level through a process of notice and comment rulemaking rather than shoehorning that unrelated policy agenda into state level consumer protection bill.

**(3) Process aside, the substantive concerns of the TFFC regarding questions of the BSA's coverage are unfounded. No activities are being exempted from the URVCBA under Coin Center's proposed language that are not already exempted from BSA regulation in existing interpretive rulings from FinCEN.**

Coin Center's proposed language would exempt software developers, virtual currency miners, and escrow providers or other similarly empowered multi-sig keyholders.[10] Each of these groups have already been clearly excluded from FinCEN's interpretation of the definition of money transmission in successive interpretive rulings.

In FIN-2014-R002, FinCEN clearly specified that the design and distribution of software in and of itself is not money transmission:

> The production and distribution of software, in and of itself, does not constitute acceptance and transmission of value, even if the purpose of the software is to facilitate the sale of virtual currency.[11]

Therefore no company would be exempted under Coin Center's proposed language—"contributing… software… to a decentralized virtual currency network"—that isn't already exempted under FIN-2014-R002.

In FIN-2014-R001, FinCEN clearly specified that mining is not money transmission:

> To the extent that a user mines Bitcoin and uses the Bitcoin solely for the user's own purposes and not for the benefit of another, the user is not an MSB under FinCEN's regulations, because these activities involve neither "acceptance" nor "transmission" of the convertible virtual currency and are not the transmission of funds within the meaning of the Rule.[12]

A miner who uses bitcoin is, by more technical definition, contributing connectivity and computing power to the bitcoin network. It is for these contributions (and only upon verification of these contributions) that a bitcoin miner is rewarded by the network with new bitcoins (*i.e.* mines for bitcoins). Therefore, no company would be exempted under Coin

[10] Coin Center's recommended definitions are defined and explained at 1-2 of the February 26, 2016 memorandum to the Drafting Committee.

[11] FinCEN, *Application of FinCEN's Regulations to Virtual Currency Software Development and Certain Investment Activity*, FIN-2014-R002 (Jan. 2014) *available at* https://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R002.pdf.

[12] FinCEN, *Application of FinCEN's Regulations to Virtual Currency Mining Operations*, FIN-2014-R001 (Jan. 2014) *available at* https://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R001.pdf.

Center's proposed language—"contributing connectivity… or computing power to a decentralized virtual currency network"— that isn't already exempted under FIN-2014-R001.

In FIN-2014-R004, FinCEN clearly specified that online escrow is not money transmission:

> FinCEN finds that the Company's money transmission activities are only necessary and integral to its provision of escrow services. In order to provide assurances to both buyer and seller that the buyer has enough resources to pay for the goods and services, on the one hand, and that those resources will not be released until the transaction is completed according to the purchase agreement, on the other, the Company needs to take possession of the funds and hold them in escrow until the pre-established conditions for the funds to be paid to the seller or returned to the buyer are met, then release those funds appropriately. The acceptance and transmission of funds do not constitute a separate and discrete service provided in addition to the underlying service of transaction management. They are a necessary and integral part of the service itself. Therefore, the Company would not be a money transmitter as that term is defined in our regulations.[13]

A multi-sig company that retains insufficient keys to transact is bound by the network and mathematics to play a highly limited role in transactions that are either escrow transactions in name or something directly analogous: *only add your signature to the pending transaction if the sender and recipient of the transaction appear satisfied and have not been compromised by hacking*. In other words a multi-sig provider would necessarily fit in the FIN-2014-R004 exclusion.

Moreover, the exclusion found in FIN-2014-R004 is, in fact, significantly broader than the exclusion Coin Center has suggested for multi-sig in this model bill. Specifically, we suggest only two activities be exempted: (1) arrangements where the multi-sig company *cannot unilaterally* execute or prevent a transaction on behalf of the customer, and (2) arrangements where the company can prevent transactions only for a specifically time-limited period.

Note that FinCEN's exclusion covers *traditional* escrow providers; these providers *will necessarily have the full and technically unencumbered ability to transact unilaterally* with the funds they hold while engaged for an escrow. As FIN-2014-R004 describes, these companies "take possession" of the funds. Our exclusion does not cover such an arrangement because the solvency risk posed by this possession or custody presents a reasonable case for consumer protection regulation. Instead, our exclusion would only cover multi-sig escrow providers who can temporarily block virtual currency transfers (*i.e.* time-limited prevention), or participate as a minority party in a voting rule to determine when virtual currency should be sent (*i.e.* has keys but cannot unilaterally execute or prevent).

[13] FinCEN, *Application of Money Services Business Regulations to a Company that Offers Escrow Services to a Buyer and Seller in a Given Internet Sale of Goods or Services*, FIN-2014-R004 (Apr. 2014) *available at* https://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R004.pdf.

The analogy to traditional escrow is imperfect. Really, multi-sig escrowed funds are being held in a communal lock box on the decentralized virtual currency network (like a global safe deposit box) and the multi-sig company is merely an arbiter or mediator (rather than a full-on escrow provider) who has some power on that network to vote for when those funds should be unlocked. To be more specific, unlike an escrow provider who holds $100,000 cash in a company safe while the parties to a real estate transaction finalize a sales contract, a multi-sig provider holds no money.  Instead, the multi-sig provider is like an arbitrator who holds one key to a bank safe deposit box that is filled with $100,000 and whose lock requires two of three keys to open. The multi-sig provider has one key and the buyer and seller each have one other key. The buyer and the seller can together unlock the box to complete the transaction, or—if the parties fail to agree to the terms of the contract—their arbitrator the multi-sig provider can work with one or other of the parties to open the safe deposit box in order to either complete the transfer or refund the money to the sender.

In short, Coin Center's proposed language would actually *exempt fewer companies from licensure than the standards set by FinCEN in its interpretive rulings*. This should not come as a surprise. The goals of FinCEN and of state money transmission regulators are not the same. In cases where money laundering is a large risk but consumer harms are a small risk we should expect more lenient rules from the states, and in cases where consumer harms loom large and AML is a secondary concern we should expect more lenient rules from FinCEN (as in this case of FIN-2014-R004 as compared with our proposed exclusion for multi-sig escrow providers).

One could argue that the relative leniency or stringency of the rules are unimportant as compared with the ability of regulators to have discretion in crafting or revising those rules. Again, however, if every state regulator had the sort of discretion enjoyed by FinCEN, there would be a cacophony of incongruous standards, a patchwork of vague and varying legal regimes lying in wait for any company with customers in the several US states. If we value innovation in this sector we cannot afford a "facts and circumstances" test; we need bright line rules that ensure that those who are in a position of trust, to paraphrase the CSBS framework,[14] and *only* those in a position of trust need to be licensed and regulated. The standard proposed by Coin Center:

> possession of sufficient virtual currency credentials or authority on a virtual currency network to unilaterally execute or prevent virtual currency transactions on the virtual currency network.

[14] Conference of State Banking Supervisors, *State Regulatory Requirements For Virtual Currency Activities Csbs Model Regulatory Framework* (Sep. 2015) *available at* https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework(September%2015%202015).pdf ("While virtual currencies and virtual currency business activities continue to evolve, many 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.").

coupled with the escrow exclusion:

> [but not including] possessing, for a specifically time-limited period, virtual currency credentials sufficient to prevent virtual currency transactions in order to provide a service such as an escrow.

best identifies companies in a position of trust while providing a clear bright line rule sheltering innovators by clearly indicating when they need or need not worry about costly regulatory compliance and severe criminal liability. Hiring a million-dollar compliance team and reviewing a menacing torrent of incongruous state interpretive rulings should not be a necessary pre-condition to building a virtual currency company; particularly a virtual currency company that won't even hold people's funds in trust. The very purpose of this committee is to avoid such non-uniformity in state law. A bright line test fits the bill; it should be sufficient to simply answer the question: can your business unilaterally execute or indefinitely prevent a transaction on behalf of someone else? Can you lose people's money or not? If so, get licensed.

Thank you for your time and effort considering these important but complicated issues. As always, feel free to contact me at peter@coincenter.org or at 703-338-4456 if you have any further questions.