



August 16, 2016

RE: Virtual currency legislative draft

Catherine Mele-Hetter
Washington Department of Financial Institutions
PO Box 41200
Olympia WA 98504-1200

Dear Ms. Mele-Hetter:

Thank you for taking the the time to talk on the telephone today about the draft legislation that the Department of Financial Institutions is helping develop that would add virtual currency to Washington's money transmission law. As we promised, here are our written comments on the legislative draft you have shared with us.

Coin Center has two primary suggestions. First, the term "constructive control" is undefined, leaving the legislation's scope of application vague and potentially overbroad. Second, virtual currency firms are required to hold additional reserves to ensure liquidity and solvency than are non-virtual currency money transmitters.

"Constructive Control" and the Definition of Money Transmission

As a matter of general policy, only businesses who assume a position of trust with respect to their customer's virtual currency should be required to undergo a licensing process. This policy is in line with the approach promoted by the Conference of State Bank Supervisors in their Model Regulatory Framework.¹

As we read the definition of Money Transmission in the legislative draft, the term "constructive control" is intended to specify the set of activities that generate this trust relationship and therefore give rise to a licensing obligation. We agree with this approach. However, the term "constructive control" lacks a plain language interpretation and therefore should be defined in the legislation. We have two suggestions.

¹ Conference of State Bank Supervisors, State Regulatory Requirements for Virtual Currency Activities: CSBS Model Regulatory Framework
<https://www.csbs.org/regulatory/ep/pages/framework.aspx>.

First, the term “constructive possession” would be preferable to “constructive control” because there is case law that interprets “constructive possession” in other, similar contexts, and there is little to no pre-existing law defining or interpreting the term “constructive control.”²

Second, the term “constructive possession” is defined in various other Washington state statutes. A good match for the purpose here is the definition given in Washington’s Code with respect to firearms:

“Constructive possession” means the power and intent to control the firearm, ammunition, or explosives.³

In the context of this draft legislation the definition would be as follows:

“Constructive possession” means the power and intent to control the virtual currency.

“Power” limits the set of money transmitters to those businesses who can actually misplace, lose, or fail to secure a customer’s virtual currency, and avoids the creation of a licensing obligation for parties who lack that ability and therefore do not pose a risk to consumers.

“Intent” limits the set of money transmitters to those who are aware of their power over other people’s virtual currency and have manifested an intent to assume that trusted relationship. This avoids the creation of a licensing obligation for parties who accidentally assume power over another’s virtual currency, as would happen if, for example, the user of a cloud-storage provider (*e.g.* Microsoft’s OneDrive) uploaded virtual currency credentials to her cloud storage account. In that example, the cloud storage provider would have the power to move the customer’s virtual currency (it has access to the credentials necessary to validly sign a virtual currency transaction), but never had the intent to assume that position of financial trust.

Additional Permissible Investments Requirement

The draft legislation also requires licensees transmitting virtual currencies to hold “an amount of permissible investments with a value equal to at least ten and one half percent of the value of the virtual currency obligated to Washington consumers.” Presumably this disparate treatment of virtual currency transmitters relative to other licensees is predicated on a perception that virtual currency transmission poses greater risks to consumers. We would be curious to understand what analysis has been done to arrive at that conclusion. However, even assuming that virtual currencies are inherently subject to

² See, *e.g.*, United States v. Derose, 74 F.3d 1177 (11th Cir., 1996).

³ RCW 9.94A.706(a) <http://app.leg.wa.gov/rcw/default.aspx?cite=9.94A.706>.

greater security risk than legacy financial systems, a requirement to hold additional permissible investments would not be the appropriate way to mitigate that risk.

Licensees transmitting virtual currencies are required to hold sufficient virtual currencies to meet all their outstanding obligations to customers. This requirement addresses the liquidity risk a licensee would pose if licensees did not hold one-to-one reserves. The risk that the additional permissible investment requirement seems to be addressing is, therefore, not a liquidity risk, but a cybersecurity risk. An additional permissible investment requirement, however, is not a good tool to address cybersecurity risks since there is no reason to believe that it will lead to adequate cybersecurity on the part of the licensee.

Rather than imposing an additional permissible investment requirement, a better approach to address cybersecurity risks is to require that licensees establish and maintain an adequate cybersecurity program as a condition of licensing. While the New York BitLicense is a deficient regulatory model in many respects, Section 200.16 requiring a cybersecurity program is reasonable and may be instructive as you consider such an approach.⁴ Indeed, a cybersecurity requirement may be appropriate for all licensees, not only those that transmit virtual currency.

A permissible investments requirement that discriminates between virtual currency and non-virtual-currency licensees discourages innovative business models. As a result, it would not be surprising if firms subjected to such requirement would exit Washington state.

If we can ever help answer any questions about the technology or its implications for public policy and law, or if we can ever help connect you to members of the digital currency ecosystem, please do not hesitate to ask.

Sincerely,

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

Jerry Brito
Executive Director

⁴ New York Department of Financial Services, BitLicense,
<http://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf>