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

Coin Center generally supports the current draft of the Uniform Regulation of Virtual Currency Businesses Act. We welcome the opportunity to submit a brief written comment to the committee outlining our residual concerns with this important model legislation.

Definitions

Coin Center greatly appreciates the care that the ULC has taken in drafting a **definition of virtual currency business activity** and a definition of **control** that would not inadvertently require non-custodial virtual currency infrastructure technology providers to become licensed in the several states. **The precision of this definition remains Coin Center's top concern as the the ULC continues to draft this important model law.**

In previous comment letters and a presentation to the committee, Coin Center has described how these non-custodial entities function, explained why the nature of their activities does not pose a solvency risk to users of the network,[1] and shown how—for federal anti-money laundering purposes—the policies of FinCEN would also generally exclude these entities from their registration requirement.[2]

In this letter we would like to reinforce that analysis by looking at international standards, specifically the work of the Financial Action Task Force on this subject. The FATF has already

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[1] Peter Van Valkenburgh, "When does a company actually control customer bitcoins?" *Coin Center* (March, 2016) https://coincenter.org/entry/when-does-a-company-actually-control-customer-bitcoins

[2] FinCEN has not required these non-custodial entities to register, and would likely not require them to do so in the future based on a plain language interpretation of the Bank Secrecy Act implementing regulations, as well as a close reading of FinCEN guidance on the subject. *See* Peter Van Valkenburgh, "Second Letter to ULC" *Coin Center* (March, 2016) https://coincenter.org/entry/second-letter-to-the-uniform-law-commission

suggested that the subcategory of financial institution most relevant to many virtual currency businesses is "money or value transfer services." It has stated:

> "The FATF defines a "financial institution" as any natural or legal person who conducts as a business one or more of several specified activities for or on behalf of a customer. The categories potentially most relevant to currently available VCPPS [VC payment products and services] include persons that conduct as a business: Money or value transfer services (MVTS); acceptance of deposits and other repayable funds from the public; issuing and managing means of payment; and trading in foreign exchange, or transferable securities."[3]

We note that generally virtual currency is not treated as "funds" and virtual currency held for others is not treated as a "deposit" (which can be lent out in a fractional reserve banking system) and therefore "deposit acceptance" may also not be a wise choice. We also note that "issuing and managing a means of payment" is more relevant to centralized virtual currencies (as defined by the FATF) given that decentralized virtual currencies like Bitcoin do not have an issuer or administrator. Finally, we note that "trading in foreign exchange" is a sensible subcategory for classifying virtual currency exchanges but may not accurately describe custodial wallet providers that do not also offer a virtual currency exchange service. "Money or value transfer services" as a subcategory of financial institution articulated by the FATF, however, is a very reasonable superset that would include custodial virtual currency firms.

Note that "money or value transfer services" does not, according to the FATF recommendations, include businesses that provide messaging or support to financial institutions:

> "[Money or value transfer services] does not apply to any natural or legal person that provides financial institutions solely with message or other support systems for transmitting funds."[4]

Note that the definition of money or value transfer services uses *acceptance* and *payment* of value as its determining criteria:

> Money or value transfer services (MVTS) refers to financial services that involve the acceptance of cash, cheques, other monetary instruments or other stores of value and the payment of a corresponding sum in cash or other form to a beneficiary by means of a communication, message, transfer, or through a clearing network to which the MVTS provider belongs. Transactions performed by such services can involve one or more intermediaries and a final payment to a third party, and may include any new payment methods. Sometimes these services have ties to particular geographic

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[3] FATF Virtual Currency Guidance (2015) p. 6
http://www.fatf-gafi.org/media/fatf/documents/reports/Guidance-RBA-Virtual-Currencies.pdf

[4] The FATF Recommendations (2012) p. 119 fn. 60.
http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf

> regions and are described using a variety of specific terms, including hawala, hundi, and fei-chen.[5]

Again, the key determining factor in these definitions is that a money or value transfer service business "accepts" and "pays… a corresponding sum," and that "messag[ing]" or "support systems" are clearly excluded. This focus on "acceptance" and "paying" indicates that the FATF is chiefly interested in regulating those who actually take possession of funds, and define their categories of regulated entities accordingly.

As we have previously discussed, defining the act of taking custody of virtual currency is complicated by virtue of multi-sig and n-lock technologies. We believe that the current ULC definition of "control" properly identifies the moment when a business becomes a custodian of other people's virtual currency and avoids overbreadth and is therefore in line with the FATF's approach to these issues:

> (3) "Control" means possession of sufficient virtual currency credentials or authority on a virtual currency network to execute unilaterally or prevent indefinitely virtual currency business transactions.

There is a small change to this definition that we would like to see. The full definition currently has a second sentence that elaborates on "prevent indefinitely" by giving the example of an escrow. We believe this second sentence is unnecessary and may create the wrong impression, given that traditional escrow is often regulated by the states in other contexts. We would propose the following:

> (3) "Control" means possession of sufficient virtual currency credentials or authority on a virtual currency network to execute unilaterally or prevent indefinitely virtual currency business transactions. ~~The term does not include possession, for a reasonably time-limited period, of virtual currency credentials sufficient to prevent virtual currency transactions to provide a service such as an escrow, if that the user is able to regain unilateral rights to execute transactions following the period in which the escrow was in effect.~~

We are grateful as well that the ULC has defined the regulated activities, "exchange," "transfer," and "storage" to only include actions that involve, at least at some point, control or custody of the customer's virtual currency.

We have some minor issues with the currency definition of Virtual Currency Business Activity that reads as follows:

> "Virtual currency business activity" means engaging as a business in:
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> (A) virtual currency exchange, transfer, storage, or virtual currency administration;

[5] *Id.* p. 122

> (B) the exchange, transfer or storage of credentials that are sufficient to transact or prevent the exchange, transfer or storage of virtual currency, whether by performing these activities alone or under an agreement with a virtual currency control services vendor;

The phrase in (B), "that are sufficient to transact or prevent the exchange, transfer or storage of virtual currency," is redundant given that the definitions of exchange, transfer, and storage already reference a definition of control that is limited to those having the ability to "execute unilaterally prevent indefinitely" transactions. Additionally, we believe that (A) and (B) can be combined to avoid needless redundancy as follows:

> "Virtual currency business activity" means engaging as a business in:
>
> (A) virtual currency exchange, transfer, storage, or virtual currency administration, whether by performing these activities alone or under an agreement with a virtual currency control services vendor;

Provisional registrations and On Ramps vs. Safe Harbors

The goal of the current provisional registration appears twofold:

1. Insulate hobbyists, academics, and extremely small experimental start-ups from the crushing federal and state criminal and civil liabilities that could result from prosecution as an unlicensed money transmitter or virtual currency business.

2. Provide small to medium start-ups with an easier path to becoming a fully licensed virtual currency business.

Coin Center is primarily concerned with the first of these goals. The first goal is not well achieved via the current provisional registration framework because registrants are still required to go through a fairly rigorous registration process, and, upon completion of that registration, their ability to pursue their hobbies or research can still be denied by the regulator (*e.g.* this is more accurately described as a license than a registration because you can't engage in the behavior without permission).

The need for a comprehensive registration process and the ability of the regulator to deny registration is necessitated by the gravity of the risks involved with holding other people's valuables. To that extent the amount of virtual currency that a provisional registrant is allowed to hold before triggering full licensing obligations should be inversely related to the complexity and completeness of the provisional registration (and the ability to deny that registration). In other words, if people can hold as much as $1 million worth of other people's virtual currency and still be a provisional registrant then we would want a strict registration requirement and the ability to deny provisional registrations for cause. On the other hand if people can only hold, say, $50,000 worth of other people's virtual currency and still qualify,

then we could stomach a more lax registration requirement with no ability to deny registrations.

This second hypothetical is more in line with Coin Center's goal. We want an academic who builds a tool that would otherwise qualify as engaging in VCBA to be safe from prosecution as an unlicensed money transmitter as long as she only ever holds or exchanges a very small amount of other people's virtual currency. Moreover, we want that protection from liability to apply regardless of her filling out a comprehensive registration. We would describe this as a safe harbor rather than an onramp.

Accordingly, we suggest that the threshold amount that limits this safe-harbor be small, and that the requirements for satisfying the safe harbor be less onerous than the current provisional registration. Specifically, the safe harbor requirements should match the language in the proposed Pennsylvania legislation mentioned by the committee's reporter in her notes. There should be no requirements; the safe harbor should apply by default to anyone whose activities are small in dollar value. We are willing to support a very small dollar value limit if it would make this safe harbor provision more palatable to the committee members.

Minimum Capital Controls

Coin Center does not support the 10% additional reserve requirements proposed in the section on permissible investments. We note that money transmitters are not generally required to hold excess reserves above a 1:1 requirement under existing state money transmission regulation. Presumably this disparate treatment of virtual currency businesses is predicated on a perception that virtual currency businesses pose a greater risks to consumers than traditional money services businesses like Paypal or Western Union. 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 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. A permissible investments requirement

that discriminates between virtual currency and non-virtual-currency licensees discourages innovative business models.

We note that Washington State was considering this exact permissible investment requirement, but that they dropped it after feedback from industry and advocacy groups.

Thank you for your time and please always feel free to email me at peter@coincenter.org if you've any questions.

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