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Virtual Currency Under Federal Anti-Money Laundering Laws: FinCEN Provides Guidance

By David L. Beam

A lot of companies transact in credits that might be called "virtual currency." Most of these companies probably do not consider themselves financial institutions. Many have never considered the possibility that they need to register with the Financial Crimes Enforcement Network ("FinCEN"), an agency in the U.S. Treasury. And probably only a few have considered the possibility that they should be reporting suspicious virtual currency transactions to the authorities.

Some of these companies might need to rethink their assumptions in light of a guidance document recently issued by FinCEN, entitled *Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies*[1] (the "Guidance").

Virtual currency is an amorphous term, and FinCEN defines it broadly to potentially capture more than just Bitcoin-like systems.

If your company is involved with anything that might be considered "virtual currency," you should review the Guidance carefully to evaluate its potential applicability to your business.

I. Background: Federal Regulations Governing Money Service Businesses

The Bank Secrecy Act and FinCEN regulations impose various obligations on financial institutions. These obligations include maintaining anti-money laundering programs and complying with suspicious activity reporting requirements, among other obligations.

Financial institution includes a money service business, as defined in FinCEN rules.[2] FinCEN rules define *money service business* as a "person wherever located doing business . . . wholly or in substantial part within the United States," in one of seven capacities. These capacities are:

- Dealer in foreign exchange;
- Check casher;
- Issuer or seller of traveler's checks or money orders;
- Provider of prepaid access;
- Money transmitter;
- U.S. Postal Service; and
- Seller of prepaid access.

The Guidance focuses on whether parties that engage in various activities related to virtual currency could qualify as dealers in foreign exchange, providers or sellers of prepaid access, or money transmitters.[3]

FinCEN rules define a *dealer in foreign exchange* as a person who:

(1) "accepts the currency, or other monetary instruments, funds, or other instruments denominated in the currency of one or more countries";

(2) "in exchange for the currency, or other monetary instruments, funds or other instruments denominated in the currency, of one or more other countries";

(3) "in an amount greater than $1,000 for any other person on any day in one or more transactions."[4]

FinCEN rules define *provider of prepaid access* as "the participant within a prepaid program that agrees to serve as the principal conduit for access to information from its fellow program participants."[5] A seller of prepaid access is a "person that receives funds or the value of funds in exchange for an initial loading or subsequent loading of prepaid access if that person:

(i) Sells prepaid access offered under a prepaid program that can be used before verification of customer identification under" a customer identification program; "or

(ii) Sells prepaid access (including closed-loop prepaid access) to funds that exceed $10,000 to any person during any one day, and has not implemented policies and procedures reasonably adapted to prevent such a sale."[6]

Prepaid access is defined as "[a]ccess to funds or the value of funds that have been paid in advance and can be retrieved or transferred at some point in the future through an electronic device or vehicle, such as a card, code, electronic serial number, mobile identification number, or personal identification number."[7]

Finally, FinCEN rules define money transmitter as, subject to certain exceptions,[8] a person "that provides money transmission services"[9] or that is "engaged in the transfer of funds."[10] *Money transmission services* are "the acceptance of currency, funds, or other value that substitutes for currency from one person *and* the transmission of currency, funds or other value that substitutes for currency to another location or person by any means."[11]

II. Summary of the Guidance

A. Coverage of the Guidance

The Guidance addresses the application of FinCEN rules to parties involved with "convertible" virtual currency systems. The Guidance defines convertible virtual currency as virtual currency that "either has an equivalent value in real currency, or acts as a substitute for real currency."[12] The Guidance defines virtual currency as "a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency. In particular, virtual currency does not have legal tender status in any jurisdiction."[13] Virtual currency contrasts with "real" currency. FinCEN rules define *currency* as "the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance."[14]

The Guidance addresses the application of FinCEN's rules to three different types of participants in virtual currency arrangements: "users," "exchangers," and "administrators." The Guidance defines each type of participant as follows:

- A user, the Guidance says, "is a person that obtains virtual currency to purchase goods or services."[15]
- An exchanger is "a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency."
- An administrator is "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency."

B. Virtual Currency Activities Do Not Qualify as Providing/Selling Prepaid Access or Exchanging Currency

FinCEN quickly dismissed summarily that any of the participants in virtual currency arrangements could be considered providers or sellers of prepaid access, or dealers in foreign exchange. The acceptance or transmission of convertible virtual currency constitutes neither providing nor selling prepaid access, the Guidance says, "because prepaid access is limited to real currencies."[16] For the same reason, "a person who accepts real currency in exchange for virtual currency, or *vice versa*, is not a dealer in foreign exchange under FinCEN's regulations."[17]

C. Some Virtual Currency Activities Can Make One a Money Transmitter

Although parties that deal in virtual currency are neither *providers or sellers of prepaid access* nor *dealers in foreign exchange*, the Guidance concludes that some might be money transmitters. Unlike the definitions of the former terms (which capture only parties transacting in "real" currency), the definition of money transmitter encompasses parties that engage in transactions involving "currency, funds, or *other value that substitutes for currency*."

1. Application to Users of Virtual Currency

The Guidance says that a *user* of virtual currency is not a money service business under FinCEN's regulations. Simply using virtual currency to purchase goods or services, "in and of itself, does not fit within the definition of 'money transmission services.'"

No doubt the millions of American consumers who use virtual currencies will be relieved to know that they do not need to adopt personal anti-money laundering programs or file SARs.

2. Application to Administrators and Exchangers

Administrators and exchangers can, in some situations, be money transmitters under FinCEN's rules. Specifically, the Guidance says that an administrator or exchanger will be a money transmitter if the administrator or exchanger:

(1) accepts and transmits a convertible virtual currency; or

(2) buys or sells convertible virtual currency for any reason.

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The Guidance then considers the "appropriate regulatory treatment" of administrators and exchangers of three specific kinds of convertible virtual currency: (i) e-currencies and e-precious metals; (ii) centralized convertible virtual currencies; and (iii) de-centralized convertible virtual currencies.

a. E-Currencies and E-Precious Metals

In 2008, FinCEN issued guidance in which the agency concluded that a broker or dealer in currency or other commodities is not acting as a *money transmitter*, as defined in FinCEN regulations, when it "accepts and transmits funds solely for the purpose of effecting a bona fide purchase or sale of currency or other commodities for or with a customer."[18] In the recent Guidance, FinCEN clarifies that "if the broker or dealer transfers funds between a customer and a third party that is not part of the currency or commodity transaction, such transmission of funds is no longer a fundamental element of the actual transaction necessary to execute the contract for the purchase or sale of the currency or the other commodity." Further, because "the definition of a money transmitter does not differentiate between real currencies and convertible virtual currencies, the same rules apply to brokers and dealers of e-currency and e-precious metals."

b. Centralized Virtual Currencies

The second type of activity that the Guidance addresses "involves a convertible virtual currency that has a centralized repository." (The Guidance does not define or otherwise elaborate on what constitutes a "centralized repository.")

The administrator of a repository for convertible virtual currency will be a money transmitter under the FinCEN rules "to the extent that it allows transfers of value between persons or from one location to another." It does not matter "whether the value is denominated in a real currency or a convertible virtual currency."

An exchanger that "uses its access to the convertible virtual currency services provided by the administrator to accept and transmit the convertible virtual currency on behalf of others" is also a money transmitter. This includes making "transfers intended to pay a third party for virtual goods and services."

The Guidance further breaks down virtual currency into two forms. The first form involves an exchanger "that accepts real currency or its equivalent from a user . . . and transmits the value of that real currency to fund the user's convertible virtual currency account with the administrator." The Guidance likens the exchanger's role in this transaction to a seller of virtual currency, and the user's role to a purchaser of virtual currency. This qualifies as money transmission, the Guidance says, because the exchanger is transmitting from one location (such as the user's real currency account at a bank) to the user's convertible virtual currency account with the administrator.[19]

The second form of transaction "involves a *de facto* sale of convertible virtual currency that is not completely transparent." In this form, the exchanger "accepts currency or its equivalent from a user and privately credits the user with an appropriate portion of the exchanger's own convertible virtual currency held with the administrator of the repository." The exchanger will then transmit the internally credited value to third parties at the user's discretion. The exchanger's activities in this scenario constitute money transmission, the Guidance says, because the exchanger is transmitting value to another person (the third party) at the user's direction. "To the extent that the convertible virtual currency is generally understood as a substitute for real currencies, transmitting the convertible virtual currency at the direction and for the benefit of the user constitutes money transmission on the part of the exchanger."

c. De-Centralized Convertible Virtual Currencies

The Guidance defines a de-centralized convertible virtual currency as a virtual currency "(1) that has no central repository and no single administrator; and (2) that persons may obtain by their own computing or manufacturing effort."

A person that creates units of de-centralized convertible virtual currency and uses it to purchase real or virtual goods and services is a user of the virtual currency, says the Guidance, and therefore is not acting as a money transmitter. However, the Guidance says that a person that "creates units of convertible virtual currency and sells those units to another person for real currency or its equivalent is engaged in transmission to another location and is a money transmitter." A person also is acting as a money transmitter if "the person accepts such de-centralized convertible virtual currency from one person and transmits it to another person as part of the acceptance and transfer of currency, funds, or other value that substitutes for currency."

III. Analysis

A. "Currency" to Purchase Virtual Goods or Services

FinCEN does not explicitly distinguish between credits that can be used solely to purchase virtual goods or services (e.g., credits in a massively multiplayer online game) and credits that can be used to buy goods and services in the real world. Further, the Guidance suggests in several places that its definition of convertible virtual currency covers both types of credits. For example, in the discussion of de-centralized virtual currencies, FinCEN refers to a person who "creates units of . . . convertible virtual currency and uses it to purchase real *or virtual* goods and services."[20]

FinCEN's failure to distinguish between these two kinds of credits is unfortunate. Virtual currency does not have a universally-accepted definition. However, many—perhaps most—definitions of virtual currency limit it to credits that can be used to purchase goods and services in the real world. It is debatable whether many credits that can only be used for transactions in an online game world or other virtual universe really are properly characterized as "substitutes for currency." And even if they are in some instances, credits for virtual goods and services present materially different money laundering and financial crimes risks than credits that can be used in real world transactions. FinCEN might ultimately conclude that some credits in the former category still qualify as "substitutes for currency." However, the two kinds of credits are different enough that FinCEN should keep clear the distinction between the two, and analyze each separately.

B. Impact on State Money Transmitter Laws

Any time FinCEN addresses whether an activity is money transmission under FinCEN's rules, the question arises whether state regulators should or will adopt FinCEN's analysis when interpreting the definition of money transmitter in their own laws. The answer to this question with respect to the Guidance will have an enormous practical impact on many companies. FinCEN defines convertible virtual currency so broadly that many companies that are not traditional financial institutions will be administrators or exchangers of convertible virtual currency. Registering with FinCEN and complying with FinCEN's regulations will be burdensome enough for these companies. Getting licensed as a money transmitter and complying with the money transmission regulatory regimes in the forty-eight states (plus the District of Columbia) that require money transmitters to be licensed would increase this burden exponentially. It could easily put some nascent virtual currency operators out of business.

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Fortunately, the Guidance will not automatically dictate whether an administrator or exchanger of virtual currency is a money transmitter (or equivalent term) under state law. When interpreting their own laws, state regulators are not bound to accept FinCEN's characterization of activities related to virtual currency. And, although not immediately obvious, the reasoning of the Guidance would, if applied to state money transmitter laws, in many instances support the conclusion that administrators and exchangers of virtual currency are *not* money transmitters under state law.

In most states, "receiving money for transmission" requires a license. If this is all the statute says, then a strong argument can be made that the Guidance's reasoning supports the conclusion that administrators and exchangers of virtual currency are not money transmitters under state law. The Guidance concludes that administrators and exchangers of virtual currency potentially can be money transmitters only because the definition of money transmission services in the FinCEN rules covers transaction in "other value that substitutes for currency." However, the Guidance concludes that administrators and exchangers of virtual currency are never providers or sellers of prepaid access, or dealers in foreign exchange, because the definitions of those two terms do not include parties' transactions in "other value that substitutes for currency." In other words, the Guidance supports the proposition that a party transacting in virtual currency is not engaged in actual currency transactions, even if the virtual currency is "convertible" into real currency. If this reasoning were extended to state money transmitter laws, then a party that receives virtual currency would not be "receiving money for transmission."

* * * * *

If you transact in virtual currency, you should review the Guidance to evaluate its potential applicability to your business. K&L Gates routinely advises companies that offer virtual currency and other kinds of payment products on the application of FinCEN regulations. Please contact us if you would like to discuss the application of these rules to your business, or would like assistance in developing a compliance program.

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[1] Financial Crimes Enforcement Network, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (Mar. 18, 2013) (available at http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf) (hereinafter "Guidance").
[2] 31 C.F.R. § 1010.100(t)(3).
[3] FinCEN does not address whether parties involved with virtual currency systems might be check cashers, issuers or sellers of traveler's checks or money orders, or the U.S. Postal Service. This is likely because their activities related to virtual currency would clearly not fall into any of these categories.
[4] 31 C.F.R. § 1010.100(t)(1).
[5] *Id.* § 1010.100(t)(4). The regulations require the participants in a prepaid access program to "determine a single participant within the prepaid program to serve as the provider of prepaid access." *Id.* If the parties

do not designate a provider, then the provider is the participant "with principal oversight and control over the prepaid program." *Id.* § 1010.100(t)(4)(ii). The regulations set forth various factors to consider when evaluating which participant has "principal oversight and control." *Id.*

[6] *Id.* § 1010.100(ff)(7).

[7] *Id.* § 1010.100(ww).

[8] *See id.* § 1010.100(ff)(5)(iii).

[9] *Id.* § 1010.100(ff)(5)(A).

[10] *Id.* § 1010.100(ff)(5)(B).

[11] *Id.* § 1010.100(ff)(5)(A) (emphasis in original).

[12] Guidance at 1.

[13] *Id.*

[14] 31 C.F.R. § 1010.100(m).

[15] Guidance at 2.

[16] *Id.* at 5.

[17] *Id.* at 6.

[18] Financial Crimes Enforcement Network, *Application of the Definition of Money Transmitter to Brokers and Dealers in Currency and Other Commodities*, FIN-2008-G008, at 2 (Sept. 10, 2008) (available at www.fincen.gov/statutes_regs/guidance/pdf/fin-2008-g008.pdf).

[19] The Guidance posits, but rejects, the argument that the exchanger is not a money transmitter because the exchanger is "merely providing the service of connecting the user to the administrator and that the transmission of value is integral to this service." Guidance at 4. The definition of money transmitter exempts a person that "[a]ccepts and transmits funds only integral to the sale of goods or the provision of services, by the person who is accepting and transmitting the funds." 31 C.F.R. § 1010.100(ff)(5)(ii)(F). However, the Guidance concludes that this exemption would not apply because the only services that the exchanger would be providing are money transmission services. Guidance at 4.

[20] *Id.* at 5 (emphasis added).

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