

Client Alert

February 10, 2015

State Virtual Currency Regulatory Developments

By **Obrea O. Poindexter, Jeremy R. Mandell and James C.H. Nguyen**

On February 4, 2015, the New York Department of Financial Services (“NYDFS”) issued for public comment a revised proposed rule to implement a “BitLicense” regulatory regime (the “2015 Proposal”). As discussed below, the 2015 Proposal differs in material respects from the July 2014 proposal (the “2014 Proposal”), on which we previously reported.

In addition, the Conference of State Bank Supervisors (“CSBS”) has issued for comment a draft model regulatory framework on virtual currency activities. The summary below identifies certain key differences between the CSBS proposal and the NYDFS proposal.

NYDFS REVISED “BITLICENSE” PROPOSAL

As we covered in a previous communication, NYDFS Superintendent Benjamin Lawsky delivered remarks last November outlining changes to the proposed BitLicense regulatory regime to address the approximately 3,700 comments received in response to the 2014 Proposal.

The 2015 Proposal introduces changes to the scope of the BitLicense regulatory scheme, as the NYDFS seeks to clarify what types of “virtual currency activities” would be regulated. The 2015 Proposal also proposes a “conditional license” regime designed for startups and small businesses that are unable to satisfy all of the requirements of a full BitLicense and, instead, could take advantage of a two-year period afforded by the conditional license to develop operations. Finally, the 2015 Proposal would make several changes to certain licensing procedures and requirements from the 2014 Proposal.

Scope

The 2015 Proposal would clarify and limit the scope of the BitLicense regulatory scheme. As discussed further below, the revisions clarify that gift card programs and loyalty rewards programs would not be viewed as virtual currency, and that entities engaged in certain software development activities or merchant activities would not be required to obtain a BitLicense. In addition, the 2015 Proposal would exempt from the licensing requirements individuals who solely purchase and hold virtual currencies as a personal investment, as well as entities engaged in activities in connection with non-financial transactions that involve a nominal amount of virtual currency (i.e., transactions intended to accomplish “distributed timestamping” and not to exchange value). Moreover, the 2015 Proposal would also broaden the exemption for financial institutions chartered under New York’s Banking Law.

In remarks about the changes to the proposed BitLicense regulatory scheme on December 18, 2014, Superintendent Lawsky stated that “customer loyalty programs, rewards, and gift cards denominated in fiat currency will not fall under the BitLicense.” The 2015 Proposal appears to reflect this change. Specifically, the 2015 Proposal provides that “digital units used as part of Gift Cards,” as well as “digital units that can be redeemed for goods, services, discounts, or purchases with the issuer and/or other designated merchants or can be redeemed for digital units in another customer affinity or rewards program, but cannot be converted into, or

Client Alert

redeemed for, Fiat Currency or Virtual Currency” would not be considered “Virtual Currency” under the regulatory scheme.

Superintendent Lawsky also stated in his remarks that the “revised regulation” would not “regulate software development” and would not require “merchants who accept virtual currencies as payment for goods and services [and their customers] . . . to obtain a BitLicense, if that is the only virtual currency activity [in which merchants engage].” The exception for software development is explicitly addressed in the 2015 Proposal, which states that “[t]he development and dissemination of software in and of itself does not constitute Virtual Currency Business Activity.” In addition, the 2015 Proposal exempts certain providers of software security by amending the definition of Virtual Currency Business Activity such that activities “securing” Virtual Currency on behalf of others would no longer be considered a Virtual Currency Business Activity (i.e., software wallet providers and multisignature wallet providers would not be covered under the new definition).

Superintendent Lawsky indicated in his December remarks that the revised proposal would clarify the exemption for merchants. In the 2015 Proposal, the exemption for merchants was amended to clarify that merchants that use “Virtual Currency solely . . . for investment purposes” would not be covered under the BitLicense regime.

In addition, the 2015 Proposal contains amended language to exempt “[p]ersons that are chartered under the New York Banking Law.” This language broadens the exemption for New York chartered financial institutions from the 2014 Proposal, which only would have exempted persons that “conduct exchange services,” such as foreign-exchange entities. This amended language appears to broaden the scope of the exemption for New York state-chartered banks, but it is less clear what effect this would have on non-New York chartered banks and other financial institutions.

Conditional License

Introducing a significant change to the BitLicense regulatory scheme, the 2015 Proposal would permit the Superintendent to grant a “conditional license” for an entity that does not satisfy all licensing requirements. According to Superintendent Lawsky, the conditional license is designed for “startups and small businesses,” and will allow an entity to engage in Virtual Currency Business Activity for a period of two years, unless the superintendent removes the licensee’s conditional status or renews a conditional license. Under the 2015 Proposal, conditional licensees would be subject to “heightened review” by the NYDFS and also could be subject to “any reasonable condition or conditions” imposed by the Superintendent at his or her sole discretion.

Other Changes

The 2015 Proposal differs in a number of other important respects from the 2014 Proposal. Such differences include:

- A broader range of financial assets would be permitted to satisfy a licensee’s capital requirements;
- A licensee would need to maintain any trust account with a Qualified Custodian, defined to include “a bank, trust company, national bank, savings bank, savings and loan association, federal savings association, credit union, or federal credit union in the State of New York, subject to the prior approval of the superintendent”;

Client Alert

- A licensee would be permitted to submit a request for a determination on whether any proposed action would result in a change in control, which would relieve the applicant from any obligation or liability imposed under the change-in-control requirements until a determination is made by the superintendent;
- A licensee would only need to obtain the required transaction information on a non-customer counterparty “to the extent practicable”;
- Rather than obtaining an independent review of “source code,” as would have been required in the 2014 Proposal, a licensee would be required to maintain a “cyber security program” with written procedures, guidelines and standards;
- The record retention period for advertising and marketing materials would be lowered to seven years from the date of creation from the ten years previously required;
- A licensee would no longer be required to disclose its “liability to the customer under any applicable federal or state laws;” and
- A customer of a licensee would no longer be “entitled to claim compensation from any trust account, bond, or insurance policy maintained by the Licensee.”

In addition, the 2015 Proposal introduces a severability clause that would preserve the validity of any provision of the BitLicense regulatory scheme in the event that a court invalidates any other provision of the regulation.

Comments are due to the NYDFS within 30 days of publication of the revised proposed rule in the *New York State Register*.

CSBS POLICY STATEMENT AND DRAFT MODEL STATE REGULATORY FRAMEWORK

As the NYDFS was revising its BitLicense proposal, on December 16, 2014, the CSBS issued a [Policy Statement on State Virtual Currency Regulation](#) (“Policy Statement”) and a [Draft Model Regulatory Framework](#) and request for public comment (“Model Framework”). The Model Framework would entail licensing, BSA/AML and recordkeeping requirements, as well as certain consumer protections. The Model Framework takes an approach that is similar to, but in some instances less restrictive than, that of the NYDFS’s BitLicense proposal.

The Model Framework for virtual currency activities:

- Would create a licensing regime for companies that transfer, manage and hold virtual currencies on behalf of consumers;
- Would let states decide whether to create a virtual currency license or to regulate virtual currencies under existing state banking and money transmission laws; and
- Would not require state-level suspicious activity reporting.

Generally, the Model Framework outlines the broad components of a model licensing regime, but does not provide significant detail about what specific licensing procedures and requirements would be required in a model regulatory scheme. In this regard, the CSBS identifies nineteen specific areas where it is soliciting comments that address outstanding issues relating to the establishment, implementation and evolution of a state

Client Alert

regulatory scheme. The lack of specific details in the model framework, and the comparatively extensive set of questions posed in the document, may signal that the CSBS remains in the early stages of developing its Model Framework.

Comments on the Model Framework are due by February 16, 2015.

Contact:

Obrea O. Poindexter
(202) 887-8741
opoindexter@mofocom

Jeremy R. Mandell
(202) 887-1505
jmandell@mofocom

James C.H. Nguyen
(202) 778-1656
jamesnguyen@mofocom

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for 11 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofocom.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.