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NEW YORK PROPOSES STATE LICENSING REQUIREMENTS FOR VIRTUAL CURRENCIES

The New York Department of Financial Services (NY-DFS) has issued a proposed regulatory framework for virtual currencies. The proposed regulations will require virtual currency companies to obtain licenses named "BitLicenses." By releasing the proposed "BitLicense" rules, New York became the first state to propose a regulatory structure specifically designed for virtual currencies. This Alert is first in a series on virtual currency regulation.

The NY-DFS describes the framework as the product of an almost year-long process which included public hearings in January 2014. NY-DFS has sought to engage the Bitcoin community in developing the regulations. For example, in conjunction with the release of the proposed rules, Benjamin Lawsky, Superintendent of the NY-DFS, issued a statement on internet website Reddit, a popular discussion place for Bitcoin aficionados. In the statement, Lawsky stressed that those developing the regulations are seeking to strike an appropriate balance that helps protect customers and root out illegal activity without stifling innovation.

The regulations require BitLicenses for the following types of virtual currency businesses:

- Receiving or transmitting virtual currency on behalf of consumers;
- Securing, storing or maintaining custody or control of such virtual currency on behalf of customers;
- Performing retail conversion services, including the conversion of fiat currency into virtual currency and vice versa, as well as the conversion from one form of virtual currency to another form;
- Buying and selling virtual currency as a customer business; and
- Controlling, administering or issuing a virtual currency.

See Section 200.2(n) of the Proposed Regulations.

The framework would not apply to Bitcoin miners creating the currency and specifically excludes merchants and consumers that utilize virtual currency solely for the purchase or sale of goods and services. *Id.* Section 200.3(a)(2).

Many retailers now utilize virtual currency. Dell, Inc. recently

announced it would accept Bitcoin as payment. Other major entities embracing Bitcoin include Overstock.com, Expedia, Wikipedia, Dish Network, and Square for online transactions. In 2013, Lamborghini Newport Beach sold a Tesla Model S electric car for 91.4 Bitcoins in a transaction handled by payment processor BitPay. New Silicon Valley startup "Beepi," an online used-car marketplace, is now accepting Bitcoin payments in a partnership with BitPay.

BitLicense holders will be required to conform to rules aimed at protecting consumers, preventing illegal activity and increasing cyber security (particularly as the nature of virtual currency arguably makes it more susceptible to attacks from hackers). In addition to meeting other requirements, companies holding BitLicenses must do the following:

- **Anti-Money Laundering Compliance:** Licensees must verify the identity of customers opening accounts. Licensees must also report suspected fraud and illegal activity and report transactions exceeding \$10,000 to the NY-DFS within 24 hours. Licensees must maintain the following information for all virtual currency transactions:
 - Identity and physical addresses of the parties involved;
 - The amount or value of the transaction, including method of payment and denomination used;
 - The date the transaction was initiated and completed; and
 - A description of the transaction (*Id.* Section 200.15);
- **Consumer Disclosures:** Licensees must provide disclosures to consumers about potential risks associated with virtual currencies, including warnings that virtual currency transactions are generally irreversible and the virtual currency market can be volatile (*Id.* Section 200.19);
- **Cyber Security Program:** Licensees must implement and maintain an effective cyber security program which includes annual penetration testing of its electronic systems (*Id.* Section 200.16);
- **Chief Information Security Officer:** Licensees must designate a qualified employee to serve as the Licensee's Chief Information Security Officer (*Id.* Section 200.16(c));

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- **Safeguarding Consumer Assets:** In addition to other requirements, Licensees must maintain a bond or trust account in U.S. dollars, in an amount approved by the superintendent, for the protection of customers (*Id.* Section 200.9);
- **Capital Requirements:** Licensees must maintain a minimum amount of capital, amount to be determined by the superintendent, to ensure the financial integrity of the company (*Id.* at 200.8);
- **Business Continuity and Disaster Recovery:** Licensees must establish and maintain a written business continuity and disaster recovery plan (*Id.* Section 200.17);
- **Books and Records:** Licensees must maintain certain books and records, including bank statements, minutes of governing bodies, documentation related to investigations of consumer complaints, etc. (*Id.* Section 200.12); and
- **Reports and Financial Disclosures, Audit Requirements:** Licensees must submit quarterly financial statements and annual audited financial statements, along with other financial documentation, to the NY-DFS (*Id.* Section 200.14).

The NY-DFS will begin accepting applications for BitLicenses the day the proposed regulations become effective. Those already engaged in regulated activity will have 45 days to apply for the license after the regulations become effective. BitLicense applications will be accepted or denied within 90 days of submission.

Unsurprisingly, those in the virtual currency community had varied reactions to the regulations. Proponents of the regulation recognize the need to create stability for virtual currency in order to protect consumers and prevent illegal activity. Though Bitcoin's current anonymity makes it attractive to some users, it also creates an environment arguably ripe for illegal activity. Consumer, merchant and investor confidence in Bitcoin may increase with regulations in place. New York's proposal is expected serve as a "blueprint" for other states and entities exploring the process of virtual currency regulation.

Some Bitcoin enthusiasts are skeptical. Specifically, virtual currency entrepreneurs and start-up companies may not have the resources necessary for regulatory compliance. Additionally, some are concerned that excessive regulation could drive virtual currency businesses overseas.

The regulations were formally published in the July 23, 2014 edition of the New York State Register, triggering the start of a 45 day public comment period. After the 45 day period, the rules will be subject to additional changes from NY-DFS and sent back out for review for another 30 days. Lawsky indicated to *The New York Times* on July 29 that he would consider extending the comment period. □

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