

Virtual Currencies: New York State Department of Financial Services Discusses Proposed Regulations

As the proposed BitLicense takes shape, New York regulators are engaging in discussions with industry players.

On October 14, 2014 Benjamin N. Cardozo School of Law organized a panel discussion as part of its Tech Talks series on the topic of virtual currencies and the proposed BitLicense regime in New York. The keynote speaker, Benjamin Lawsky, Superintendent of the New York State Department of Financial Services (NYSDFS), spoke generally on the virtual currency industry and answered specific questions from the audience. His comments are summarized here.

General Comments on the Virtual Currencies Industry

Superintendent Lawsky shared the NYSDFS's thoughts in response to the comments it has received thus far in connection with New York's proposed regulation of the virtual currencies industry. The following is a high level summary of some of the points made by Superintendent Lawsky:

- The NYSDFS is trying to strike the right balance between allowing innovation and implementing regulations that are crucial to ensuring the success of the banking and finance sector.
 - Virtual currencies are at the crossroads of a lightly regulated technology sector and a heavily regulated traditional banking sector, which makes striking the right balance that much more challenging.
- The main goal of the licensing and regulatory regime surrounding the virtual currency industry is to protect consumers — effective government oversight can reduce the risk of fraud and will foster a sense of confidence among customers and investors.
- The blockchain technology underlying virtual currencies is quite powerful and is developing at an extremely rapid rate — if regulated in the right way, such technology could lead to improvements in our financial system.
 - Most people still do not understand the power of the blockchain technology that underlies virtual currencies, and many uses and applications of virtual currencies have yet to be imagined.
- Several features make virtual currencies important:
 - Offer cheaper fees (especially compared to established money transfer services such as Western Union and MoneyGram).

- Allow users to send money all over the world instantaneously.
 - Do not require credit card information (for Bitcoin transactions) and therefore reduce the incidence of identity theft.
 - Are programmable to include conditions precedent for automatic release (*e.g.*, from escrow) or other actions.
 - Are having a positive competitive effect on the banking industry (*e.g.*, banks are trying to decrease the three days normally required to process payment of a credit card bill due to competition from virtual currency providers).
- The NYSDFS has historically regulated money transmitters, but the laws governing money transmitters have not kept pace with the technological changes.
 - The NYSDFS wants to establish institutional Bitcoin exchanges as limited purpose trusts in New York and is in the process of finding companies that might be interested in such an idea.

Comments on New York’s Proposed Virtual Currencies Regulation

Superintendent Lawsky also commented on New York’s proposed virtual currencies regulation:

- The comment period for the first proposal, which has already been extended once, will end on October 21, 2014.
- After the comment period ends, a new proposal will be released with another 45-day comment period.
- The second proposal will be changed in substantive ways to incorporate many of the points commenters made and to address many issues that require clarification, including:
 - The requirement as to who must obtain a BitLicense — the regulations do not regulate Bitcoin software/platforms, software developers or individual users.
 - To the extent a business must obtain a money transmitter license and a BitLicense, the process for obtaining such licenses will be streamlined.
 - Banks engaging in virtual currency business activities must comply with virtual currency regulations and receive prior approval from the NYSDFS to engage in such activities.
 - Mining of virtual currencies will not be regulated.
 - There will be a compliance cost associated with the BitLicense, but the NYSDFS is committed to achieving the right balance to ensure that start-ups can run their businesses without being overly burdened by cost concerns.
- The BitLicense is expected to go into effect in late 2014 or early 2015 and businesses subject to the regulation must be compliant within 45 days.

Q&A Session with Superintendent Lawsky

During the Q&A session, Superintendent Lawsky was asked, and responded to, the following:

1. Will the new regulations allow for the creation of subsidiaries that are isolated from each other such that some subsidiaries will be permitted to engage in virtual currency activities in New York while others can engage in such activities outside of New York?

Insurance companies that are regulated in New York are allowed to have separate subsidiaries, but the NYSDFS has jurisdiction over the holding company. The NYSDFS likes to be consistent with its regulations across the insurance and banking industries, so the virtual currencies industry will likely be regulated in a manner similar to the insurance and banking industries in this regard.

2. Will the NYSDFS release the virtual currencies research it has been relying on?

The NYSDFS intends to make all of the comments it has received available to the public at the time the second proposal is released in an effort to be as transparent as possible.

3. Has the NYSDFS considered using some type of automated system to assist with the regulation of virtual currencies, especially given the amount of coding that is involved?

There have not been any definitive proposals about how such an automated system might be achieved, but this is something that should be considered.

4. If someone is using virtual currencies in a way that results in a purely non-economic exchange, will such activity be regulated under New York State law?

If there is no economic exchange, then such activity would not be regulated. However, given how the technology works, a financial transaction of a de minimis amount is likely to take place. The NYSDFS needs to determine how to account for such an amount and whether to allow for some kind of carve-out to avoid regulating non-economic uses of the technology. The concern, however, is that a carve-out could be exploited to avoid regulation.

5. Will the BitLicense be adopted by other states?

The NYSDFS has been in communication with other state, federal and international regulators and is being overly cautious in writing its regulation given the high likelihood that other states will be looking at the New York regulations as a potential model since New York is at the forefront of virtual currency regulation.

6. How pervasive will Bitcoin become as a medium of exchange?

There will first have to be more stabilization in Bitcoin prices. The price is fluctuating because Bitcoin is not widely used at the moment. Various retailers are addressing this risk by immediately exchanging Bitcoin for fiat currency.

7. What do small start-ups do about burdensome compliance costs that would result from the proposed regulation?

This is the toughest question facing the NYSDFS in its quest to find the right balance between having enough regulation while not inhibiting growth and innovation. The NYSDFS is considering having some sort of tiered or safe harbor approach to accommodate smaller businesses.

8. Will the NYSDFS be partnering with any law enforcement agencies to punish bad actors?

The NYSDFS will determine which type of law enforcement agencies to reach out to based on the nature of the illicit activity. The NYSDFS understands that the imposition of “know your customer” and other similar requirements may be necessary to help identify bad actors, but also appreciates that having too many requirements of that nature may negatively impact the industry.

Comments from the Virtual Currency Industry Panel

After Superintendent Lawsky’s speech, a group of panelists, each of whom works in the virtual currencies industry in some capacity, shared their thoughts on the virtual currency industry as a whole and discussed various topics, including:

- How to account for an industry that is developing in a decentralized regulatory world.
- What small start-ups might want to consider when trying to make large financial institutions understand the virtual currencies industry.
- Whether the NYSDFS is acting too soon in regulating a rapidly developing industry and whether these regulations will push entrepreneurs to grow their companies in other markets (most notably London).
- Ways to legitimize the virtual currencies industry (e.g., adopt legislation, increase the involvement of institutions or industries that could benefit from virtual currencies, encourage cross-border dialogue among the various global regulators (prudential or otherwise)).
- How to punish bad actors in the virtual currency space.

Conclusion

The willingness of the NYSDFS to engage in public discussion about ways to improve the proposed virtual currencies regulation is encouraging. A well-informed structure of regulation would likely help Bitcoin and other virtual currencies gain credibility and wider adoption in the financial markets. As the NYSDFS prepares to release its revised proposal, industry players are hoping that the NYSDFS will accomplish its implicit goal of setting a model for a virtual currency legal framework that does not have the unintended effect of stunting the growth of virtual currency and driving entrepreneurs away from New York.

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