Cullen | Dykman

The NYS Department of Financial Services Throws in Its "Two Bits" on Bitcoins

August 13, 2014

On July 17, 2014, New York State's Department of Financial Services ("DFS") announced proposed regulations for virtual currency companies operating in New York. Because the leading virtual currency is known as "Bitcoin," the proposed set of regulations is commonly known as the "BitLicense" plan. The word "bitcoin" (with a lower case "b"), as used in this article, is intended to cover all forms of virtual currency. The plan is intended to address issues such as consumer protection, the prevention of money laundering, and cybersecurity. With the announcement, New York became the first state to propose regulations specifically concerning virtual currency. The public has until September 5, 2014 to provide the DFS with comments on the proposal.

Before discussing the proposed regulations and the reaction to them, we address the question: "What is a bitcoin?" Bitcoin is a software-based online payment system that began in 2009. Transfers are recorded in a public ledger using units called "bitcoins." There is no central repository of bitcoins nor is there one administrator. While bitcoin users are anonymous, a public record or "block chain" is public and shared between users. The success of Bitcoin is dependent on the acceptance of bitcoins. If people have confidence that the bitcoins they accept for goods or services they provided can be exchanged for goods and services they want with an equivalent value, they will be more likely to accept bitcoins. In this way it is similar to accepting a $20 bill because you know you will be able to exchange that bill for goods and services with a value of $20. In fact, the U.S. Treasury has called bitcoins a decentralized virtual currency.

On August 11, 2014, the Consumer Financial Protection Bureau, a federal regulatory agency responsible for consumer protection in the financial sector, published a consumer advisory concerning virtual currencies on its website. Many see this as the first step towards federal regulation of bitcoins. Unless and until the federal government addresses the issue, any regulation of bitcoins in the United States will take place at the state level, which brings us back to the regulations proposed by New York's DFS.

The regulations proposed by the DFS would require to bitcoin exchanges and companies that secure, store or maintain custody or control of the virtual currency on behalf of customers to have a "BitLicense." Those seeking a license would have to go through extensive background checks. Merchants that accept bitcoin for payment and entities that are chartered under the New York Banking Law to conduct exchange services and are approved by the DFS to engage in virtual currency business activities would not have to have a license.

Among the proposed rules, bitcoin companies would be required to have very strong cybersecurity programs to prevent hackers from stealing customers' bitcoins. The companies would also have to maintain sufficient capital, in a combination of real and/or virtual currency, to cover the amount on deposit by their customers. The companies would also have to maintain detailed records including, for each transaction, the amount, date, and precise time of the transaction, any payment instructions, the total amount of fees and charges received and paid to, by, or on behalf of the company, and the names, account numbers, and physical addresses of the parties to the transaction.

In an attempt to counter money laundering and the use of virtual currency in illegal transactions, the rules provide that the bitcoin company shall, with 24 hours, report to the DFS any transactions or series of transactions for the receipt, exchange, conversion, purchase, sale, transfer, or transmission of virtual currency, in an aggregate of more than $10,000 in one day and by one entity. The proposed rules also require the licensee to report any suspicious activities that might involve money laundering, tax evasion, or other illegal or criminal activity to the DFS.

The proposed regulations have raised concerns from many bitcoin proponents. Among the concerns are that some rules concerning the identity of users are virtually impossible to comply with because of the anonymity of the transactions. Others note that many bitcoin companies are small start-ups with limited budgets and without access to extensive legal resources sufficient to comply with the regulations. Opponents also argue that the proposed rules would have a chilling effect on those considering creating new types of virtually currency. Others have raised an issue as to New York's jurisdiction over transactions that do not have a direct nexus to New York, and some have speculated that some bitcoin companies will not transact business with users in New York in an attempt to avoid the requirements of the proposed regulations.

While some bitcoin enthusiasts oppose any form of government regulation, others see it as important to giving the public more confidence in virtual currencies; thus, increasing their acceptance. Proponents of regulation argue that the lack of regulation has contributed to bitcoin's dramatic price fluctuations as measured against currencies such as the U.S. Dollar.

Supporters of regulation also point to Mt. Gox as a reason regulation is needed. Mt. Gox was a Bitcoin exchange based in Tokyo, Japan, which, by 2013, handled approximately seventy (70%) all Bitcoin transactions. In February 2014, the Mt. Gox company suspended trading, closed its website and exchange service, and filed for bankruptcy protection. During the liquidation of the company, it was discovered that approximately 850,000 bitcoins, valued at more than $450 Million, were missing and likely stolen. While 200,000 of the bitcoins were later found, the loss is still staggering. Whether the loss was caused by theft, fraud, mismanagement or hackers, proponents of regulation point to Mt. Gox as something that cannot be allowed to happen again if virtual currency is to become widely accepted.

Some opponents of the DFS proposal have asked the DFS to extend the comment period beyond the original 45 days to give them sufficient time to present their position and alternatives. As of August 12, 2014, the DFS was considering the request.

If you have any questions regarding the DFS proposal or bitcoins in general, please feel free to contact Thomas Baylis at 516-357-3748 or via email at Tbaylis@cullenanddykman.com.

Practices

- Banking and Financial Services
- Regulatory and Compliance

Industries

- Financial Institutions

Attorneys

- Thomas Baylis