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Re: Comments on Proposed Rulemaking regarding Regulation of the Conduct of Virtual Currency Businesses - DFS-29-14-00015-P

Ladies and gentlemen:

SecondMarket Holdings, Inc. ("SecondMarket") is pleased to respond to the New York State Department of Financial Services' (the "Department") request for comments on the proposed rulemaking regarding regulation of the conduct of virtual currency businesses (the "BitLicense Proposal"). This letter uses the commonly-used term "digital currency" interchangeably with the term "Virtual Currency" as defined under Section 200.2(m) of the BitLicense Proposal.

Who We Are

SecondMarket is a Delaware corporation founded and headquartered in New York City. Our subsidiaries include SecondMarket, Inc., a registered broker dealer, and Alternative Currency Asset Management LLC ("ACAM"), an asset management company focused on the digital currency space. On September 25, 2013, ACAM launched the first U.S.-based investment vehicle for investing in bitcoin, the Bitcoin Investment Trust (the "BIT"), to which ACAM serves as Sponsor.

The BIT is a statutory Delaware grantor trust that passively holds bitcoins – it has no other operations. Investors acquire shares in the BIT via SecondMarket, Inc., the BIT's approved Authorized Participant ("AP"), through a process replicating that of an Exchange Traded Fund ("ETF") invested in a single commodity, currency or similar asset. However, unlike an ETF, the BIT is not currently listed on an exchange or otherwise publicly traded.

We created the BIT to provide investors with a professional solution to gain exposure to bitcoin in a structure that solved for many of the problems of direct bitcoin investment, such as having to wire funds to unregulated exchanges in foreign jurisdictions as well as concerns around bitcoin safekeeping and ownership. In addition, by transacting through SecondMarket, a registered broker dealer, investors gain the protection of regulatory oversight, compliance procedures and a FINRA-registered team.

In the year since its launch, the BIT's assets under management have grown to over 105,000 bitcoin (approximately $40.6 million at today's price) with over 180 investors. The majority of these investors are entities, including family offices and private trusts, and high net worth individuals willing to invest at least $25,000 in the BIT.

It is important to note that the BIT is not registered with the Securities and Exchange Commission, and the securities being sold in the BIT are issued pursuant to the private placement exemption provided in Rule 506(c) under the Securities Act of 1933, as amended. As such, the BIT is only open to suitable, sophisticated investors.

In addition to acting as the BIT's AP, SecondMarket, Inc. is an active buyer in the bitcoin market, sourcing bitcoin from a number of types of sellers in the market, including merchants that accept bitcoin as payment, merchant processors, early adopters and bitcoin mining companies. SecondMarket, Inc. requires every seller from whom SecondMarket, Inc. purchases bitcoin to complete a new account profile that requires full legal name, address, social security number and employment information (for natural persons), or taxpayer ID and formation documents (for entities), along with a copy of a government-issued photo ID. Once it obtains that information, SecondMarket, Inc. carries out industry standard Anti-Money Laundering procedures on each seller, including background checks through LexisNexis and Google and an OFAC search.

These same procedures also apply to buyers in the market in the event SecondMarket, Inc. is selling, as when SecondMarket, Inc. has an excess position in bitcoin. SecondMarket, Inc. will generally sell the bitcoin through an exchange that has implemented its own Anti-Money Laundering procedures for exchange participants, ensuring that these participants are appropriately vetted. To the extent that SecondMarket, Inc. finds a potential buyer in an off-exchange transaction, we run the buyer through the same process described for sellers of bitcoin.

The BitLicense Proposal

We applaud the NYDFS for its efforts in formulating the BitLicense Proposal and taking a proactive role with respect to digital currencies. As a high level of uncertainty remains at the state level regarding the regulatory status of digital currencies, we believe there is a tremendous opportunity for the Department to create a framework that can be replicated nationwide. The Department's challenge lies in striking a balance that provides clarity to digital currency entrepreneurs, safeguards investors and consumers, and promotes economic growth in New York State, without being overly burdensome or broad in scope, as the Department has itself pointed out.

We expect the BitLicense regime to have a significant effect on the bitcoin ecosystem and therefore the willingness of individuals to invest in bitcoin and in the BIT. Because we have a vested interest in the health of the bitcoin ecosystem, we highlight below particular areas of the BitLicense Proposal that could be enhanced to ensure the BitLicense framework strikes the right balance.

1. The BitLicense Proposal imposes a number of requirements that are more onerous than the requirements applicable to New York Money Transmitters.

We support the Department's efforts to provide a clear regulatory framework around digital currency-related businesses that operate in a manner similar to more traditional financial services businesses, but believe that careful consideration needs to be given to the basis for each BitLicense proposal that imposes obligations greater than the requirements currently applicable to NY money transmitters.

To this point, we note Superintendent Lawsky's recent comments on the Department's intentions to extend the additional requirements to registered NY money transmitters, as well, but remain concerned that the fledgling BitLicensees, rather than existing money transmitters, will be the ones to bear the initial brunt of additional regulation under this very rigorous new regime.

2. The BitLicense regime should not impose requirements that are more onerous than the Federal Anti-Money Laundering requirements applicable to money servicing businesses.

The BitLicense Proposal imposes several new obligations on digital currency businesses that are more onerous than the corresponding federal guidelines. Some examples of heightened obligations under the BitLicense Proposal include: no minimum dollar threshold for suspicious activity report ("SAR") filing obligations, additional SAR filing obligations for BitLicensees not already required to file under federal law, and the omission of confidentiality and safe harbor protections with regards to SAR reporting.

An asymmetrical compliance regime favoring traditional financial entities will stymie rather than spur innovation in the digital currency industry. To the extent that the Department finds it necessary to extend SAR reporting obligations on BitLicensees beyond those that are required under Federal law, such requirements should at a minimum be consistent with the flexibility provided by the Federal requirements.

3. **The BitLicense regime should not impose significant barriers to entry that may have the unintended effect of dissuading digital currency-related startups from operating in New York State.**

As a private company, founded and headquartered in New York City, we are extremely proud of the efforts that New York City and New York State have taken to attract startups to New York City, particularly in the technology and financial services space. Our offices, in fact, are located in a part of Manhattan commonly referred to as Silicon Alley. And we know from experience the costs and burdens associated with getting a regulated entity off the ground and operating in New York State. As a result, we are concerned that the BitLicense Proposal includes none of the regulatory flexibly generally provided to the startup industry by regulators such as the Securities and Exchange Commission and FINRA in the context of the broker dealer industry. For

example, we believe that the Department should consider allowing a transitional "on-ramp" approach that allows startup entities to operate in New York State in partnership with a registered BitLicensee, registered broker dealer, or registered money transmitter, similar to FINRA's allowance of an unregistered entity to "piggy back" off of a registered broker dealer's license while completing its own registration process. We also believe that the Department should implement a minimum threshold of activity that would trigger registration. Without these types of accommodations, innovative startups will look less favorably on New York State as a place to set up business, contrary to Superintendent Lawsky's goal "to make certain that New York remains a hub for innovation and a magnet for new technology firms."[1]

We also note that Section 200.8(a) of the BitLicense Proposal provides no clear range for the proposed minimum capital requirements. We believe that the Department should provide specific examples of indicative minimum capital requirements based on the enumerated factors so that potential BitLicensees have a clear idea of what the requirements will be prior to applying for a BitLicense.

4. The Department should confirm that the BitLicense regime does not extend beyond custodians, intermediaries and exchangers to cover non-financial businesses and software developers.

The Department should clarify that under Section 200.2(n) of the BitLicense Proposal, "Virtual Currency Business Activity" does not include the release of any open-source software that merely facilitates the transfer or personal storage of digital currency, such as software that powers several leading bitcoin wallet services, mixing services that enhance consumer protections, and multi-signature wallet services that improve wallet security and help safeguard user assets. For example, under Section 200.2(n)(1) of the BitLicense Proposal, Virtual Currency Business Activity includes "receiving Virtual Currency for transmission or transmitting the same." We believe this provision may be misinterpreted, especially as the provision is inconsistent with its description in the Department's press release announcing the BitLicense Proposal[2] and because the scope of "transmitting the same" is vague. To provide clarity, we propose that the working definition of "Virtual Currency Business Activity" be more clearly limited to those businesses that take custody of user assets or serve as intermediaries or currency exchangers. We have been encouraged by Superintendent Lawsky's recent public suggestion that this definition would, in fact, be narrowed and exclude software and software development.[3]

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[1] Bitcoin Firms Will Get 'Regulatory Framework' in 2014, NY's Lawsky Says, Wall Street Journal Money Beat (Jan. 28, 2014), http://blogs.wsj.com/moneybeat/2014/01/28/bitcoin-firms-will-get-regulatory-framework-in-2014-nys-lawsky-says/.

[2] NY Dfs Releases Proposed Bitlicense Regulatory Framework for Virtual Currency Firms, Press Release (Jul. 17, 2014), http://www.dfs.ny.gov/about/press2014/pr1407171.html ("Receiving or transmitting virtual currency on behalf of consumers").

[3] See, e.g., BitBeat: Lawsky Outlines Changes to BitLicense, Wall Street Journal Money Beat (Oct. 14, 2014), http://blogs.wsj.com/moneybeat/2014/10/14/bitbeat-lawsky-outlines-changes-to-bitlicense/.

5. **The Department should clarify that the BitLicense Proposal does not require licensure for the creation, release and development of new alternative digital currencies.**

Under Section 200.2(n)(5) of the BitLicense Proposal, any party "controlling, administering or issuing a virtual currency" will require a BitLicense. Because this language is similar to language used by FinCEN in its digital currency guidance, we interpret the language to be consistent with FinCEN's guidance and clarifying letters – i.e., it does not include any party related to a decentralized digital currency like bitcoin, including developers or miners. Nevertheless, the department should provide more clarity that mere creators and/or software developers of existing or new digital currencies would not be engaged in Virtual Currency Business Activity, and therefore would not need to be licensed. We note that in certain cases a creator or software developer of a digital currency may also be engaged in holding digital currencies for others or facilitating the transfer of digital currencies on behalf of others (e.g., Liberty Reserve), and its activities may fall within the definition of Virtual Currency Business Activities on this basis.

Requiring new digital currency issuers and administrators to apply for BitLicenses would prove difficult to enforce in practice and would have the unintended consequence of curbing innovations that help fortify the security and usability of digital currencies. In particular, confusion regarding whether developers of existing or new digital currencies would have to be licensed under the BitLicense regime would discourage the continued improvement of the protocol and software of bitcoin and other digital currencies and thereby make consumers and other users of digital currencies less safe.

6. **The Department should reconsider the BitLicense Proposal's provision requiring innovators to first ask permission before offering any new service.**

In most cases, digital currency businesses should be allowed to experiment and develop new tools and services for their customers without the potentially lengthy delays and high costs associated with the need to obtain prior approval of the Department. Given the speed at which the Bitcoin technology is evolving, the current BitLicense Proposal requirement to submit all new product features and changes for review is onerous and may make it more difficult for entrepreneurs and enterprises alike to create innovative new products. We also note that given the exponential growth of the digital currency industry, and the frequency with which early-stage technology companies offer and alter their product suites, it might be difficult for the Department to carefully study all of these requests and provide timely responses. These delays, coupled with the cost and time involved in preparing a request for prior approval would likely have the effect of ossifying the state of the art at a time when there is still so much potential; as the Department Superintendent Benjamin Lawsky indicated in his October 14, 2014 speech on the BitLicense Proposal, the most successful uses probably haven't been imagined yet.

To the extent that the Department is concerned about new activities of existing BitLicensees, these concerns could be addressed in one or both of the following ways:

- Requiring after-the-fact notices from licensees of material new activities when those activities cross a threshold (which may be similar to any threshold or thresholds created as part of a BitLicense on-ramp for unlicensed businesses engaging in Virtual Currency Business Activities), after which the Department could object if it does not approve.
- Requiring certain additional disclosures to consumers or counterparties in connection with new services or activities.

7. **The Department should broaden the BitLicense Proposal's list of permissible investments to include digital currencies.**

While the Department's definition of "permissible investments" under Section 200.8(b) appears well-intentioned, restricting BitLicensees from investing profits and retained earnings in digital currencies would have several unintended negative consequences. For example, under the current BitLicense Proposal, digital currency custodians who self-insure their deposits or otherwise hedge their digital currency positions would find themselves unable to offer compelling deposit insurance coverage and unable to offer some products which "hedge out" digital currencies' price volatility. As both of these outcomes would be bad for consumers and investors, the Department should consider broadening or amending the definition of "permissible investments." Such restrictions on digital currency balance sheet investments may be more properly imposed by a given company's investors and board directors, on a case by case basis and according to the best interests of the particular company and its customers.

8. **The BitLicense Proposal should clarify the definition of "custody" to ensure that the BitLicense regime accounts for a new digital currency industry standard related to multi-signature transactions.**

In recent months, most of the digital currency industry's leading custodians and exchanges have begun to incorporate multi-signature transactions into their products. Multi-signature transactions are a variant of Bitcoin's public-private key cryptography, and require that two of three private keys (or 3/5, 5/7, etc.) are provided in order to access and transfer funds from a given Bitcoin wallet. By contrast, a non-multi-signature transfer from a wallet requires only a single private key associated with that wallet. Multi-signature transactions have many potential applications, but the most basic application has to do with securing funds from theft. Using "multi-sig," an end-user could store two private keys separately while relying on a third-party to keep the third private key secure. With access to just one private key, that third-party would not have access to or control over a given user's funds, and as such should not appropriately be treated as a "custodian" under the definition of Virtual Currency Business Activities. The third-party acts as a trusted partner that improves the security and usability of Bitcoin by helping a user access funds in the event that he loses one of his two private keys. We do not believe that the actions of such an actor implicate the concerns of the Department, and therefore request that the Department clarify that such actions do not fall within the definition of Virtual Currency Business Activity.

One way to provide such clarification would be to follow the recommendation of Jerry Brito, writing for the Mercatus Center at George Mason University, who suggested in an earlier public comment that Section 200.2(n)(2) of the BitLicense Proposal should be amended to read: "maintaining **full** custody or control of Virtual Currency on behalf of others."[4] Such an amendment would ensure that valuable security solutions are developed for and offered to end-users seeking to better manage their personal digital currency holdings and obviate the need for the developers of these solutions to worry about bonding requirements tied to assets they do not actually control.

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As the Department has noted, digital currencies have the potential to reduce costs within the financial system, empower underserved consumers, and spawn countless innovations in financial services and beyond. By providing a framework for digital currencies to become fully integrated in the broader legacy financial system, the BitLicense Proposal has the potential to facilitate these important innovations, while holding relevant digital currency ventures to the same high standard as other money transmitters.

We appreciate the opportunity to provide these comments. We look forward to working with the Department on future iterations of its BitLicense Proposal and are happy to discuss any questions that you might have on the views expressed. You can reach me at barry@DCG.co or (212) 473-2408.

Yours sincerely,

/s/ Barry E. Silbert

Barry E. Silbert
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[4] Jerry Brito and Eli Dourado, Mercatus Center of George Mason University, Comments to the New York Department of Financial Services on the Proposed Virtual Currency Regulatory Framework (Aug. 14, 2014), available at http://mercatus.org/sites/default/files/BritoDourado-NY-Virtual-Currency-comment-081414.pdf.