

New York July 2014 “BitLicense” Proposal: Visual Memorandum

July 31, 2014



Davis Polk

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Outline

- I. Introduction
- II. What Is Covered Under NYDFS's Proposal?
- III. Application Process, Suspension and Revocation
- IV. Consumer Protections
- V. Safeguarding Assets
- VI. Cyber Security Program
- VII. Anti-Money Laundering
- VIII. Exams, Reports and Oversight

Introduction

We have sought to strike an appropriate balance that helps protect consumers and root out illegal activity – without stifling beneficial innovation.

– NYDFS Superintendent Benjamin Lawsky, [BitLicense Press Release](#)

- On July 17, 2014, the New York Department of Financial Services (“NYDFS”) published proposed “[BitLicense](#)” regulations
- Most virtual currency (e.g., Bitcoin) businesses would have to be licensed to engage in business with New York customers (retail or institutional) or otherwise operate in New York
- BitLicense is the first comprehensive virtual currency regulatory regime proposed in the United States and would have a profound impact on the industry
- Costly compliance likely to cause high barriers to entry, inconsistent with New York becoming a virtual currency hub that promotes innovation
- BitLicense-regulated companies would likely find it easier to establish banking relationships. Final regulations would begin to lift the cloud of regulatory uncertainty, facilitating the flow of institutional money into the virtual currency space.

Reasons for Action

- Increase in popularity of Bitcoin and other virtual currencies
- Volatility and consumer losses
- Increased acceptance by merchants
- Increased venture capital investment in virtual currency startups
- Lack of comprehensive regulation of virtual currency businesses
- Failures of Bitcoin exchanges (e.g., \$450 million failure of Mt. Gox) allegedly caused by poor security practices, poor compliance programs, negligence, malfeasance or fraud
 - See Davis Polk blog post: [The Failure of Mt. Gox](#)
- Concerns regarding potential money laundering and facilitation of crime
 - E.g., FBI’s seizure of Silk Road, an anonymous Internet marketplace for narcotics transactions, money laundering, and murder for hire using Bitcoin
- Consumer fraud (e.g., allegations that BitInstant and Mt. Gox failed to timely deliver purchased Bitcoins or dollars for sold Bitcoin)



Comments due by September 6, 2014 – NYDFS may extend deadline – final regulations likely to change

Introduction

Summary of Requirements for BitLicense Proposal

Covered Activities	<ul style="list-style-type: none">• Most business activities, excluding mere merchant/consumer activities;• involving centralized or decentralized virtual currencies (excluding in-game / rewards points); and• involving New York or New York customers.	Cyber Security Program	<ul style="list-style-type: none">• Board-approved cyber security policy & program to protect electronic systems and sensitive data.• Qualified Chief Information Security Officer.• Annual reports to NYDFS.• Annual penetration testing/audits.• Maintain business continuity and disaster recovery plan, to be independently tested annually.
BitLicense Application / Revocation	<ul style="list-style-type: none">• Must submit detailed applications to NYDFS & become licensed <i>before</i> undertaking covered activities.<ul style="list-style-type: none">• Existing businesses will have transition period to apply; if denied, must cease activities.• NYDFS has broad discretion to approve/deny, revoke/suspend licenses.• Material change of activities or change of control requires an application to NYDFS.	Anti-Money Laundering	<ul style="list-style-type: none">• Largely consistent with federal AML requirements.• Initial & annual risk assessments to inform AML program. Board-approved policy.• 10-year records of all transactions.• Report within 24 hours to NYDFS \geq \$10,000 one-day transactions by one person.• Suspicious Activity Reports required.• Customer Identification Program.• OFAC checks and compliance.• Annual internal or external audit. No structuring to evade reporting, or obfuscating identity.
Consumer Protections	<ul style="list-style-type: none">• Initial and per-transaction disclosures of risks, terms and conditions.• Complaint policies & disclosures.• Advertising and marketing requirements (e.g., no false, misleading or deceptive representations or omissions).	Exams, Reports and Oversight	<ul style="list-style-type: none">• NYDFS examines at least every two years, and may examine affiliate of licensee in its discretion (not limited to virtual currency activity).• Submit quarterly financials within 45 days, audited annual GAAP financials within 120 days of fiscal year end (including management certifications).• Have overall compliance program and officer(s).
Safeguarding Assets	<ul style="list-style-type: none">• Capital requirements at NYDFS's discretion. Licensed entity must invest "earnings and retained profits" in enumerated high-quality assets (e.g., CDs, not Bitcoin), but dividends not prohibited.• Bond/trust account at NYDFS's discretion.• Full reserves for custodial assets — selling / encumbering prohibited.• Books and records requirements (generally 10 years).		

Introduction

First Comprehensive Virtual Currency Regulatory Regime

- BitLicense would be the first comprehensive regulatory regime aimed squarely at Bitcoin and other virtual currencies, spanning multiple areas of regulatory concern

No Comprehensive U.S. Federal Regulation	Limited and Focused State Action
<ul style="list-style-type: none">Federal regulators— including FinCEN, the IRS, SEC, CFTC and CFPB – have put out guidance but taken limited action.<ul style="list-style-type: none">Financial Crimes Enforcement Network (“FinCEN,” a division within the U.S. Department of the Treasury) guidance and administrative rulings, along with IRS guidance have been the most significant federal regulatory actions to date.Narrow areas of focus: AML and tax compliance.The CFTC, SEC, CFPB and FTC are apparently looking at Bitcoin, but no comprehensive regulation.<ul style="list-style-type: none">Bitcoin unlikely to be a “security” for SEC-regulatory purposes, but interests in Bitcoin businesses or Bitcoin Ponzi schemes likely are. See Securities and Exchange Commission v. Trendon T. Shavers. The SEC has also issued an investor warning on the topic of Bitcoin and virtual currency-related investments.The CFTC likely has jurisdiction over Bitcoin derivatives activity.A GAO report recommended that the CFPB become involved in virtual currency working groups, the CFPB concurred.	<ul style="list-style-type: none">State money transmitter regulations generally focus on AML and consumer protection, but are not well-suited for virtual currency business regulation.Only a few states (e.g., TX, KS, WA) have indicated whether and how their regulations apply to virtual currencies.CA recently passed legislation amending a statute that previously prohibited issuing or putting into circulation anything but lawful money of the United States to allow Bitcoin and other digital currencies.Emerging Payments Task Force of the Conference of State Bank Supervisors has been studying virtual currency regulation, and has issued model consumer guidance.Some state financial regulators have delayed approving or denying money transmission licensing applications from Bitcoin-related businesses.

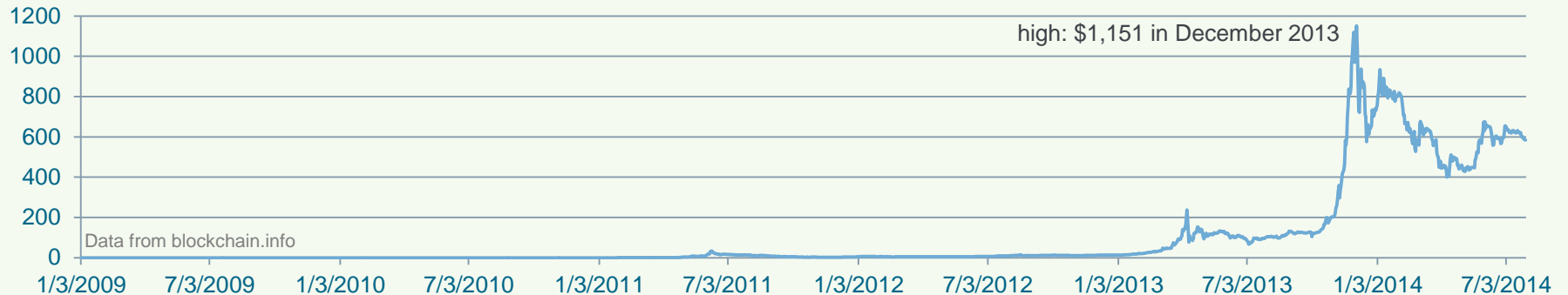
- BitLicense regime is likely to serve as a model for federal agencies, other states and foreign governments.

Introduction

Timeline of BitLicense Proposal



Bitcoin Market Price (USD)



Introduction

Key Points

- **High barriers to entry.** BitLicense regime has no onramp or *de minimis* exception but its impact is great: (1) detailed, time-consuming and likely costly application process, (2) requirement for audited financials, (3) requirements for hiring or designating qualified compliance personnel, and (4) AML requirements for certain businesses not covered by federal AML requirements.
 - Creates high barriers to entry for new or financially unsupported players.
 - Startups may need to exclude New York customers and otherwise avoid New York jurisdiction to focus on developing their products before subjecting themselves to BitLicense until they receive significant funding.
 - Problematic from standpoint of NYDFS's goals of establishing New York as an important virtual currency hub and promoting beneficial innovation.
- **Business benefits.** Banks and other traditional financial services companies may be more willing to open accounts for and provide services to businesses licensed under the BitLicense regime. Additionally, proposal begins to lift the cloud of regulatory uncertainty, making it more likely that more institutional money will become involved in virtual currency.

“Mr. Lawsky said ... that he was willing to address concerns that the regulations as they stand would squeeze smaller companies. He said he would also consider extending the comment period.

“This is certainly a unique situation where we’re trying to regulate in an evolving, high-tech, innovative environment, and we want to make sure we get it right,” Mr. Lawsky said. “We will certainly think through very carefully the very obvious comment that, when it’s a small start-up, they’re going to have less resources in terms of compliance.”

- [New York Times Dealbook](#) (July 29, 2014)

- **Regulations Likely to Change.** Superintendent Lawsky and the NYDFS have closely engaged with the virtual currency community, including by holding [hearings](#) in January 2014, participating in a [Reddit Ask Me Anything](#), and submitting the proposed regulations [on Reddit](#). Lawsky has indicated openness to comments, and the New York Times Dealbook [has reported](#) that the NYDFS plans to repropose the rules after the close of the initial comment period.

Introduction

Key Points (*cont.*)

- **May force subsidiarization.** Requirement that “retained earnings and profits” may only be invested in certain liquid, investment grade instruments denominated in dollars (i.e., cannot include virtual currencies or foreign currency-denominated instruments), among other requirements, may force Bitcoin businesses to operate in New York only out of special purpose licensed subsidiaries. May introduce possible capital inefficiency, managerial inefficiency or tax issues.
 - Challenges for New York-located companies as the whole company would be “involved” in New York, and subject to BitLicense regime.
- **NYDFS discretion.** NYDFS has broad discretion to allow or disallow a license, prohibit new activities, or restrict or shut down existing and licensed virtual currency businesses.
 - NYDFS has limited discretion to exempt different kinds of businesses from provisions. It has discretion to set capital requirements and bond/trust account requirements. Most other requirements (e.g., AML program), are mandatory, including for businesses for which the requirements make no sense.
- **Largely consistent with current federal AML laws, but more businesses captured.** For businesses that are already required to register with FinCEN, the BitLicense AML requirements are largely consistent with requirements of the Bank Secrecy Act, as amended by the Patriot Act, and implemented by FinCEN regulations, guidance and administrative rulings. See [Appendix](#). However, the proposal would require AML compliance for many types of businesses that are not currently required to register with FinCEN under its guidance. See [Slide 14](#).

Introduction

Key Points (*cont.*)

- **Compliance with other virtual currency laws.** Businesses would also have to comply with federal, other states' and other countries' virtual currency laws.
 - Congress could preempt BitLicense.
 - No clarity on interaction with future virtual currency regulations of other states, federal agencies or countries.
 - Potential for multiple yearly examinations in each state as well as by federal agencies.
 - No explicit exemption from New York money transmitter regime.
- **Non-Compliance.** No explicit indication of penalties for improperly failing to obtain a BitLicense or violating BitLicense requirements, other than (1) ability of NYDFS to apply for an injunction and (2) suspension or revocation of license.
 - NYDFS preserves right to impose penalties under any other applicable law, such as New York Banking Law or Financial Services Law.
- **Most virtual currency non-merchant businesses, including foreign businesses, would be covered**, potentially including foreign businesses with minimal New York connections, including exchanges, payment processors, ATMs, among others: substantially all businesses who do business with or solicit New York customers must be licensed. (See Slides [12](#) and [13](#))
 - However, consumers that use Bitcoin to purchase goods, and merchants that merely sell goods or services for Bitcoin, do not have to be licensed.

[BitLicense] is a comprehensive framework, it covers basically anyone operating in a significant commercial way in the Bitcoin space.

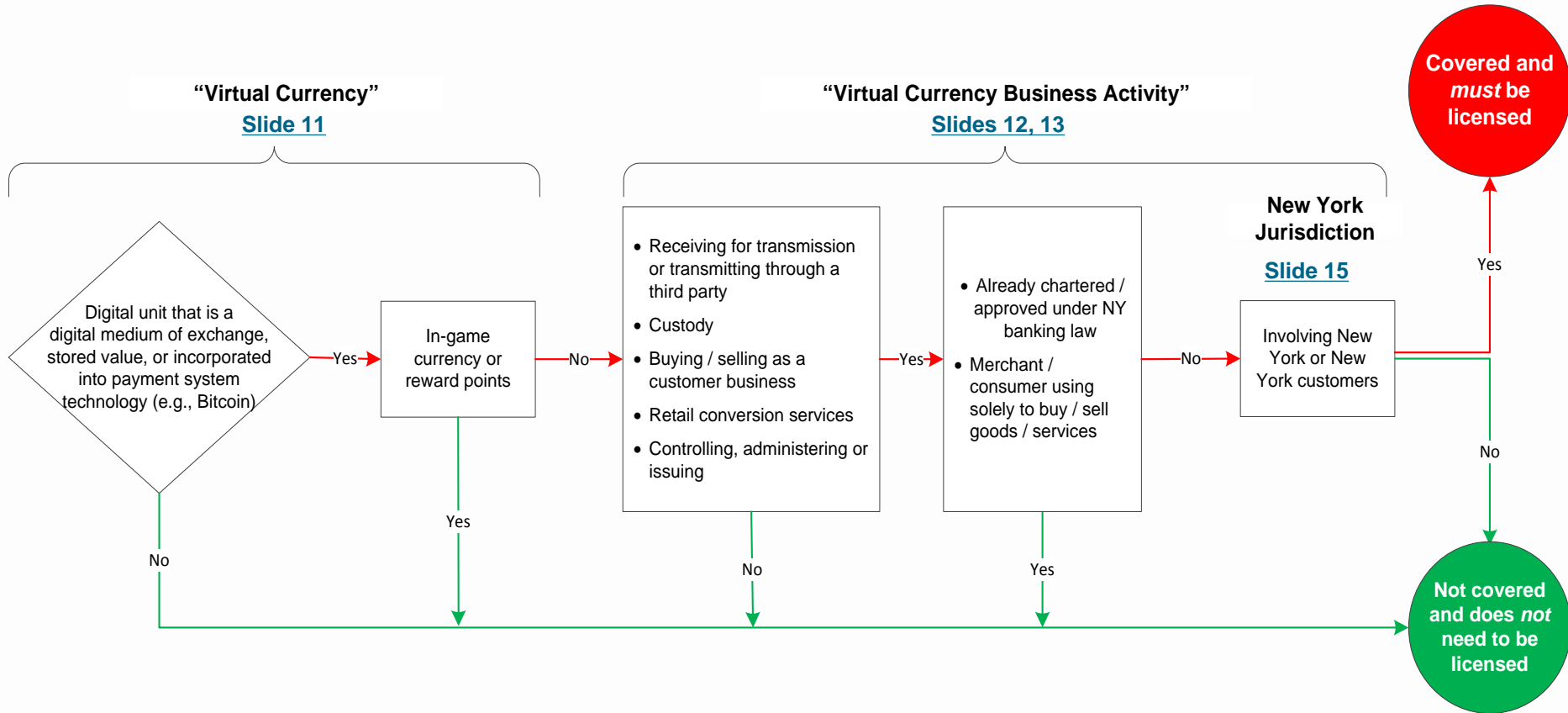
- **Superintendent Lawsky, [CNBC](#)**
(July 17, 2014)

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What Is Covered Under NYDFS's Proposal?

Summary Flowchart
§ 200.2



What Is Covered Under NYDFS's Proposal?

Covered Virtual Currencies § 200.2(m)

The BitLicense proposal applies to business activities (see [next slide](#)) involving a “**virtual currency**,” which is defined as:

- Any type of digital unit that is used as a medium of exchange or form of digitally stored value or that is incorporated into payment system technology.
- Broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository or administrator; or (iii) may be created or obtained by computing or manufacturing effort.
- Excludes most in-game currencies / reward points not convertible to fiat currency

Likely Examples of Virtual Currencies	Likely Examples of Non-Virtual Currencies
<p>Decentralized</p> <ul style="list-style-type: none"> Has no centralized repository or administrator. Instead, networks of computers – in some cases known as “miners” - maintain the currency. Largely consistent with FinCEN definition: (1) no central repository or administrator, and (2) persons may obtain the currency by their own computing or manufacturing effort. Mostly “cryptocurrencies” based on cryptography (like Bitcoin). 	<p>Does not include digital units</p> <ul style="list-style-type: none"> “used solely within online gaming platforms with no market* or application outside of those gaming platforms” “used exclusively as part of a customer affinity or rewards program, and can be applied solely as payment for purchases with the issuer and/or other designated merchants, but cannot be converted into, or redeemed for, Fiat Currency”
<p>Centralized</p> <ul style="list-style-type: none"> Relies on a central administrator. 	<ul style="list-style-type: none"> World of Warcraft Gold Nintendo Wii Points Airline miles

- Bitcoin, Dogecoin, Litecoin and the hundreds of other “[alt-coins](#)” based on Bitcoin



- Perfect Money (does not do business in United States)
- Liberty Reserve (shut down by U.S. government for money laundering)

*Linden Dollars – SecondLife game currency likely not meant to be captured – **but there is an active market for exchanging with fiat currency (e.g., [VirWox](#))**. Status of digital currencies used as property markets/smart property unclear (e.g., [Colored Coins](#)). Local community currencies (e.g., [LETS](#)) may fall within definition.

What Is Covered Under NYDFS's Proposal?

Types of Business Activities Subject to NYDFS Regulation
 § 200.2(n), (l), 200.3(c)

“Virtual Currency Business Activity” is defined as any of the following involving New York (as discussed on [Slide 15](#)):

<p style="text-align: center;">Receiving virtual currency for transmission or transmitting it</p> <ul style="list-style-type: none"> Transmission is defined as “the transfer, by or through a third party, of virtual currency” from “the account or storage repository” of one person/entity to that of another person/entity “Receiving virtual currency for transmission” – e.g., Jill transfers Bitcoins to Business X in order to have X send it on to Bob. “Transmitting” virtual currency – problematic and vague. Business that merely transfers Bitcoins among internal proprietary accounts likely is not captured because there is no “third party.” <ul style="list-style-type: none"> What about a business that has Bitcoins and transfers them to a third party other than to pay for goods (e.g., a company that buys Bitcoin and pays salaries in Bitcoin)? Is a business that mines Bitcoins and sells them on the market captured? In both cases, NYDFS probably did not intend for these activities to be captured, but unclear under the language of the proposal. <p style="text-align: right;">Press release language is different: “Receiving or transmitting virtual currency <u>on behalf of consumers</u>”</p>		<p style="text-align: center;">Holding virtual currency for others</p> <p>“Securing, storing, holding or maintaining custody or control of virtual currency on behalf of others”</p> <ul style="list-style-type: none"> Any e-wallet provider <i>Applies to all multi-signature applications (multiple people must agree on a transaction)?</i> 	
<p style="text-align: center;">Buying and selling virtual currency as a customer business</p> <ul style="list-style-type: none"> Broad & problematic language “Customer business” probably means buying/selling on a principal or agency basis to/from customers. Incidental sales to customers or ongoing sales to third parties that are not part of a customer-facing business likely not included. Press release distinguishes “customer business” from “personal use” “Customer” undefined – includes non-consumer customers? 	<p style="text-align: center;">Retail conversion services</p> <p>Converting or exchanging:</p> <ul style="list-style-type: none"> Fiat into virtual currency Virtual currency into fiat Virtual currency into another form of virtual currency <p><i>Retail undefined– includes online only?</i></p>	<p style="text-align: center;">Controlling, administering, or issuing a virtual currency</p> <ul style="list-style-type: none"> Overlap with definition of administrator under FinCEN regulations (“person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency”) <ul style="list-style-type: none"> Under FinCEN administrative ruling action, Bitcoin miners are not “administrators” NYDFS press release indicates that this category does not include miners <i>Creators of Bitcoin alt-coins? Probably not.</i> <i>Bitcoin Foundation? Probably not.</i> 	<p style="text-align: center;">Exempt</p> <ul style="list-style-type: none"> Entities chartered under NY Banking Law to conduct exchange services, if approved by the NYDFS to engage in virtual currency business activity Merchants or consumers that utilize virtual currency solely for the purchase or sale of goods or services

What Is Covered Under NYDFS's Proposal?

Types of Business Activities Subject to NYDFS Regulation (*cont.*)

§ 200.2, 200.3(c)

What qualifies as a Virtual Currency Business Activity likely calls for a facts and circumstances analysis. However:

Likely Includes	Unclear if Includes	Likely Does Not Include
<ul style="list-style-type: none"> ▪ E-Wallets ▪ Exchanges ▪ Merchant / Payment Processors* ▪ Dealers ▪ Virtual currency ATMs ▪ Tumblers† ▪ Administrators of any centralized virtual currencies 	<ul style="list-style-type: none"> ▪ Mining pools (without wallets) ▪ Mining companies (without wallets) that rent or sell mining contracts/services to others ▪ Investment vehicles that hold virtual currencies and issue securities ▪ Developers that program and release software for non-open source decentralized currencies ▪ Market makers 	<ul style="list-style-type: none"> ▪ Companies that merely provide non-virtual currency financial or other services to virtual currency-associated businesses ▪ Consumers that mine, buy or earn as salary virtual currencies, and (i) hold those virtual currencies for investment, (ii) use them to purchase goods or services, or (iii) remit them to friends or family not on behalf of others ▪ Merchants that merely accept virtual currencies directly or via payment processors and buy goods and services via Bitcoin ▪ Programmers / supporters of most open source decentralized virtual currencies ▪ Non-profits/lobbying groups (e.g., Bitcoin Foundation, DATA) that support decentralized virtual currencies, including by paying programmer salaries** ▪ Investors in virtual currency businesses, including virtual currency-focused venture capital funds ▪ Manufacturers and sellers of dedicated virtual currency mining hardware ▪ Proprietary trading companies ▪ Miners

* Certain Bitcoin payment processors have taken the position that FinCEN guidance, by contrast, has a narrow exception for certain payment processors.

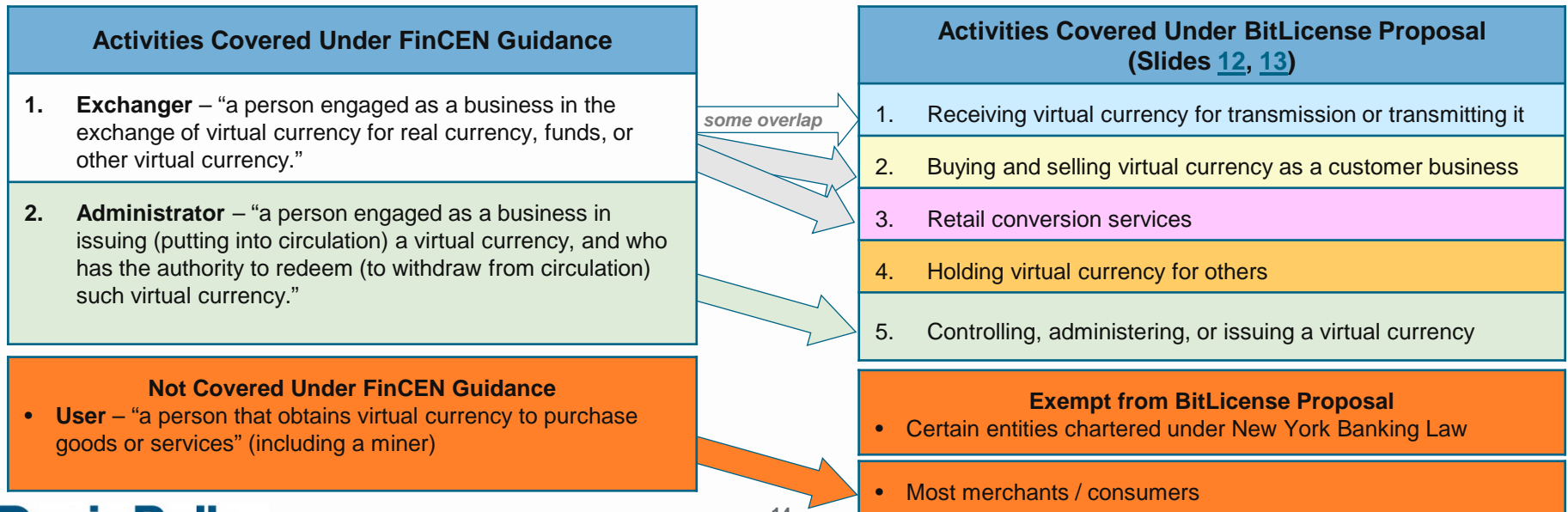
† Tumblers (or Mixers) obscure the origin of virtual currencies, which can hinder the ability to trace virtual currencies to illicit sources. They are likely prohibited under § 200.15(f).

** Related - see [Bitcoin Foundation's May 2013 letter](#) to the California Department of Financial Institutions arguing that the Foundation need not register as a money transmitter under California law

What Is Covered Under NYDFS's Proposal?

Comparison to FinCEN Guidance

- FinCEN issued [Virtual Currency Guidance](#) in March 2013 that addresses “convertible” virtual currencies, including decentralized currencies like Bitcoin.
 - Virtual currency is not legal tender, and therefore is subject to money services business (MSB) rules rather than rules for providers of prepaid access or rules for dealers in foreign exchange
- FinCEN issued two administrative [rulings](#) in January 2014 specifically related to Bitcoin.
 - [Mining](#)
 - “What is material to the conclusion that a person is not an MSB is not the mechanism by which a person obtains the convertible virtual currency, but what the person uses the convertible virtual currency for, and for whose benefit.”
 - Generally, the result is that individual miners, *and mining businesses* (including those that convert Bitcoins to dollars and make dividends to shareholders) are not MSBs
 - Implicitly confirms that there are no “Administrators” in Bitcoin (see definition below)
 - [Investment Activities](#)
 - Generally, result is that *bona fide* investment companies engaged in investing in / trading in Bitcoin are not MSBs.



What Is Covered Under NYDFS's Proposal?

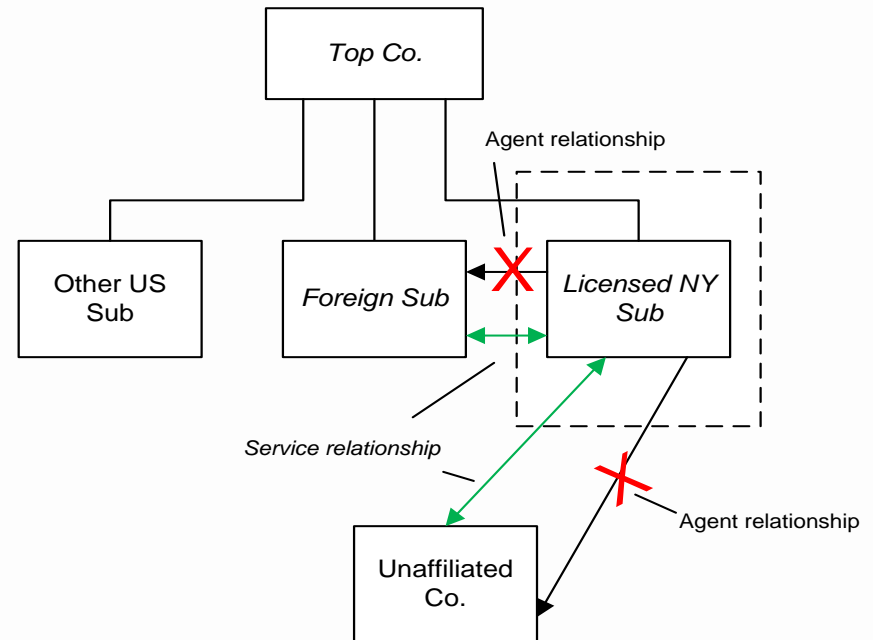
Types of Entities Subject to NYDFS Regulation
§ 200.2, 200.3(b)

Involving New York

The only entities subject to the BitLicense regime are those conducting Virtual Currency Business Activities

- “*involving*” New York or
 - “*involving*” any person that
 - resides,
 - is located,
 - has a place of business,
 - or is conducting business in New York
- Likely to include servicing or soliciting NY customers, including through web-based services that do not exclude New York persons
- Certain businesses may choose to limit New York-facing activity to limited purpose subsidiaries, especially given restrictions on investments of retained earnings and profits in liquid, high-quality, investment grade, U.S.-denominated instruments (see [Slide 25](#)).
 - No prohibition on dividends to parent/shareholders.
 - However, extent of New York jurisdiction under the proposal is very broad
 - Companies that are located in or operated from New York are unlikely to be able to subsidiarize

Relationships Between Licensees and Affiliates and Third Parties



- Using an unlicensed agent (affiliated or not) to undertake virtual currency business activity is prohibited.
- However, relationships with unlicensed service providers (affiliated or not) that do not themselves undertake Virtual Currency Business Activity are not explicitly prohibited.
 - Unclear where providing services crosses into agency requiring license

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Application Process, Suspension and Revocation

Obtaining a BitLicense

§ 200.2(i), 200.3(a), 200.4, 200.5, 200.21

Before engaging in any virtual currency business activity,* an entity must apply to NYDFS for a license and include in its application:

Information About Participants			Information About the Applicant
<p><u>Principal Officers, Principal Stockholders and Principal Beneficiaries:</u></p> <ul style="list-style-type: none"> Detailed biographical and historical information Independent background report (by agency acceptable to NYDFS) Current financial statement Fingerprints and photographs <p><u>All employees of the applicant:</u></p> <ul style="list-style-type: none"> Fingerprints and photographs 			<ul style="list-style-type: none"> Organizational chart of management structure Current and projected financials A description of the proposed, current, and historical business of the applicant Details of all banking arrangements All written policies and procedures Affidavit with description of all administrative, civil, or criminal actions, all litigation and all proceedings before any governmental agency Copies of insurance policies Explanation of methodologies used to calculate the value of virtual currency to fiat currency Demonstration of how applicant will comply with BitLicense regime
<p>Similar to information requested by Interagency Biographical and Financial Report and New York money transmitter "Individual Forms"</p>			
Principal Officer	Principal Stockholder	Principal Beneficiary	Other Requirements
<p>Defined as an "executive officer," including CEO, CFO, COO, etc.</p>	<p>Defined as a person "who, directly or indirectly, owns, controls, or holds, with power to vote ten percent or more of any class of outstanding capital stock..."</p> <ul style="list-style-type: none"> 10% threshold is low compared to other regulatory frameworks. Definition likely captures not just stockholders of the entity, but in certain cases stockholders of parent companies. Can make application onerous if there is a long string of attributed ownership based on 10% level since information is needed from all Principal Stockholders. 	<p>Defined as a person "entitled to ten percent or more of the benefits of a trust."</p>	<ul style="list-style-type: none"> Non-refundable application fee Any other information "as the superintendent may require"

* Existing businesses have 45 days from effective date of regulation (which will be listed in the final regulations) to apply. If denied, they must immediately cease virtual currency business activity involving New York or New York customers.

Application Process, Suspension and Revocation

Discretion in Approving or Denying Application, Suspending or Revoking BitLicense § 200.6

- NYDFS must approve/deny an application within 90 days **of when the NYDFS deems an application to be complete** (NYDFS has discretion to extend deadline)
 - Coupled with the NYDFS's discretion to ask for additional information from an applicant, there is a risk that applications may not be acted upon for long periods of time (however, existing businesses that apply within the 45-day transitional period would not need to cease activity unless and until the NYDFS denies an application)
 - As with other financial services applications, there will likely be additional information requests, increasing the time and cost to securing a BitLicense
 - The license will be granted if, after an investigation of the applicant's financial condition, experience, and "character and general fitness" the NYDFS finds that the applicant's business will be conducted honestly, fairly, equitably, carefully, and efficiently within the purposes and intent of the regulations, and in a manner commanding the confidence and trust of the community
 - NYDFS has discretion to attach conditions to approval of a license
- BitLicenses may be **suspended or revoked**:
 - for any of the grounds for which the NYDFS could originally deny the license application;
 - for good cause, including default and likely default on existing obligations and engaging in unlawful, dishonest, wrongful or inequitable conduct that may harm the public; and
 - for failure to pay a judgment arising from or relating to the licensee's virtual currency business activities
- No license may be revoked without a hearing
 - The licensee will be given at least 10 days notice in advance of a hearing of the location, time, and nature of the action against the licensee.
- The NYDFS may also obtain a preliminary injunction against any licensee for any violations of these regulations, the Financial Services Law, Banking Law, or Insurance Law

Application Process, Suspension and Revocation

Approval of Material Change to Business

§ 200.10

Material Change Approval Requirement	Definition of a “Material Change”
<ul style="list-style-type: none">▪ Licensee must obtain NYDFS’s written approval to offer any new product, service, or activity, or to make a material change to an existing product, service, or activity, involving New York or New York residents	<ul style="list-style-type: none">▪ A change proposed to an existing product, service, or activity, that may cause that product, service, or activity to be materially different from that previously listed on the application▪ A proposed change which may raise a legal or regulatory issue about the permissibility of the product, service, or activity▪ A proposed change which may raise safety and soundness or operational concerns
Approval Process	
<ul style="list-style-type: none">▪ Licensee must submit a written plan describing the proposed material change, including its impact on the overall business of the licensee▪ Licensee must also submit “such other information as requested”	

Application Process, Suspension and Revocation

Change of Control; Mergers and Acquisitions

§ 200.11

Change of Control Approval Requirement	Definition of “Control”
<ul style="list-style-type: none">▪ A person seeking to acquire control of a licensee must submit an application to and receive the approval of the Superintendent▪ Similarly, applications must be submitted and approved for mergers / acquisitions of a substantial part of the assets of a licensee<ul style="list-style-type: none">▪ Note that internal corporate reorganizations are <u>not</u> exempted. This approach is consistent with legal-entity level regulation rather than regulation of the whole consolidated company.	<ul style="list-style-type: none">▪ Possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a licensee▪ $\geq 10\%$ voting power of stock of licensee = control
Approval Process	
<ul style="list-style-type: none">▪ NYDFS will approve or deny change of control applications within 120 days of the <u>completed</u> application▪ NYDFS will consider the public interest, needs, and convenience of the public when deciding whether to approve or deny	

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Consumer Protections

Mandatory Risk and Other Disclosures

§ 200.19

Initial Disclosures	Per-Transaction Disclosure
<p data-bbox="106 418 958 515"><i>Disclosures by licensee to new customers required as part of establishing a relationship/opening an account, and prior to initial transaction:</i></p> <ul data-bbox="106 568 977 1210" style="list-style-type: none">▪ Material risks of licensees' products, services, and activities and virtual currency generally:<ul data-bbox="202 644 938 746" style="list-style-type: none">▪ Prescribed list of risks in the regulation (e.g., not legal tender, no FDIC/SIPC protection, regulatory risks)▪ Any other material risks▪ General terms and conditions, including at a minimum:<ul data-bbox="202 839 958 1210" style="list-style-type: none">▪ Customer liability for unauthorized transactions▪ Customer stop-payment rights▪ Licensee liability to customer under applicable law▪ Licensee right to disclose information about customer's account▪ Customer right to periodic account statements and valuations▪ Customer right to receipt for transactions▪ Customer right to prior notice of change in licensee's policies	<ul data-bbox="1006 418 1798 753" style="list-style-type: none">▪ Prior to each transaction, written disclosure of specific terms of transaction including:<ul data-bbox="1103 494 1792 675" style="list-style-type: none">▪ Amount of transaction▪ Fees charged to customer for transaction▪ Type and nature of the transaction▪ Warning that transaction may not be undone once executed▪ After each transaction, receipt describing the transaction and detailing liability (NYDFS may request form of receipt)
	<h3 data-bbox="1147 822 1678 858">Acknowledgement Requirement</h3>
	<ul data-bbox="1006 889 1808 946" style="list-style-type: none">▪ Licensee must ensure that customers acknowledge receipt of all required disclosures
	<h3 data-bbox="1147 979 1682 1015">Writing / Language Requirement</h3>
	<ul data-bbox="1006 1046 1750 1146" style="list-style-type: none">▪ Disclosure must be in clear, conspicuous, and legible writing, in English <u>and</u> other predominant language(s) spoken by customers

Consumer Protections

Complaints, Anti-Fraud, and Advertising / Marketing
200.18, 200.19(g), 200.20

Complaints	Anti-Fraud Requirements
<ul style="list-style-type: none">▪ Must establish and maintain written policies and procedures for resolving complaints▪ Must disclose on websites and in physical locations (as appropriate):<ul style="list-style-type: none">▪ Licensee's contact information for complaints▪ Consumer's right to directly contact the NYDFS with complaints▪ NYDFS's contact information▪ Must report changes in complaint policies to NYDFS within 7 days	<ul style="list-style-type: none">▪ Reasonable steps to detect and prevent fraud▪ Must have written anti-fraud policy, including, at a minimum:<ul style="list-style-type: none">▪ Identification and assessment of fraud-related risk areas▪ Procedures and controls to protect against identified risks▪ Allocation of responsibility for risk monitoring▪ Procedures for periodic evaluation and revision of anti-fraud procedures, controls, and monitoring mechanisms▪ Defrauded customers shall be entitled to compensation from any trust account, bond or insurance policy maintained by licensee▪ Prohibition on fraudulent activity
Advertising / Marketing	
<ul style="list-style-type: none">▪ Must include licensee's name and provide notice that it is licensed by NYDFS in any advertising materials directed at New York or New York residents<ul style="list-style-type: none">▪ <i>What does this mean for web-based advertising that is seen by New York residents but isn't specifically geared towards them?</i>▪ Must maintain copies of all advertising materials for examination by the NYDFS▪ All advertising must comply with federal and state disclosure requirements▪ Prohibition on false, misleading, or deceptive representations or omissions	

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Safeguarding Assets

Capital Requirements and Investments

§ 200.8

Required Capital Levels

Setting Required Capital Levels. Capital requirements will be determined by the Superintendent for each licensee based on a variety of factors generally related to risks to customers and counterparties. Superintendent has discretion to set high capital levels if proposed business does not appear sound.

Factors Superintendent Must Consider

- Assets, liabilities, liquidity, risk exposure, actual and projected virtual currency business activity
- Whether licensee is already licensed and regulated under New York law
- Financial protection provided to customers through a trust or bond account

Ongoing Review of Capital Levels. Capital requirements may change as licensees' activities and financials change.

Permitted Investments of Retained Earnings and Profits

- Only these instruments:
 - Certificates of deposit issued by financial institutions regulated by a U.S. federal or state regulatory agency
 - Money market funds
 - State or municipal bonds
 - U.S. government or government agency securities
- Investment grade
- Maturity up to 1 year
- Denominated in USD

Assessment of Investment Requirements

- Dividends to parent/shareholders not prohibited
- These U.S.-centric requirements are not workable for foreign businesses and may effectively require use of special purpose NY-licensed subsidiaries
- Requirements are vague as drafted – unclear how this will affect a business's ability to invest in new businesses
- Certain virtual currency businesses have strategic investments in subsidiaries or other virtual currency businesses
 - *Regulations should be drafted to permit such investments.*

Safeguarding Assets

Custody and Protection of Customer Assets

§ 200.9

- **Bond or Trust Account.** Each licensee must maintain a bond or trust account in U.S. dollars for the benefit of customers in an amount and form decided by NYDFS.
- **Full Reserves.** Licensees who secure, store, hold, or maintain custody or control of virtual currency on behalf of a person must hold that same type and amount of currency owed or obligated to the person.
- **No Encumbrances.** Licensees are prohibited from selling, transferring, lending, or otherwise using virtual currency held on behalf of another person.
 - Effectively prohibits fractional reserve banking with virtual currency balances.
 - No provision for licensee to overcome this prohibition with disclosure or customer consent.



Image from <http://bit.ly/1nR5T0p>

Safeguarding Assets

Books and Records

§ 200.12

- Each licensee must keep the following books and records for NYDFS's review:
 - Amount, date, time, payment instructions and fees for each transaction
 - Names, account numbers, and physical addresses of the parties to each transaction
 - General ledger of all assets, liabilities, capital, income, expense accounts, and profit and loss accounts
 - Bank statements and bank reconciliation records
 - Any statements or valuations sent or provided to customers or counterparties
 - Records or minutes of board meetings
 - Records demonstrating AML compliance and records of all breaches
 - Records of all customer complaints and investigations thereof
 - All other records required by the BitLicense regulations or by NYDFS
- Records must be kept in their original form for *at least 10 years* from the date of creation.
- Records of non-completed, outstanding, or inactive transactions must be retained for *five years* from the date that the property is deemed abandoned

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Cyber Security Program

§ 200.16, 200.17

My hope is that if Mt. Gox had been under our jurisdiction under these rules ... we would have been able to prevent [its loss of \$450 million worth of Bitcoin to hacking]...We're going to go in and test the cybersecurity readiness of these firms in New York, to make sure they're doing everything they can to prevent that kind of hacking attack.

- Superintendent Lawsky, [CNBC](#) (July 17, 2014)

Cyber Security Program

Overview

§ 200.16

Each Licensee Must Establish and Maintain an Effective Cybersecurity Program

Must be designed to perform these core functions:

- Identify the information stored on the licensee's systems, the sensitivity of the information, and how and by whom it can be accessed
- Protect the licensee's electronic systems and information therein from unauthorized access or use
- Detect attempts at unauthorized access to licensee's electronic systems and data
- Respond to detected cyber attacks to mitigate negative effects
- Recover from cyber attacks and restore normal services

Audit functions must include:

- Penetration testing of electronic systems (at least) annually; vulnerability assessment (at least) quarterly
- Audit trail of all financial transactions and accounting secured by:
 - Safeguards to insure against tampering
 - Protection of hardware by limiting access and maintaining access logs
 - Maintain records of all alterations to the audit trail system
 - Maintain audit trail records for 10 years
- Independent, third-party review of any internally developed proprietary software (at least) annually

Possible Best Practices - Framework for Improving Critical Infrastructure Cybersecurity

- The National Institute of Standards and Technology (NIST) published a [Framework for Improving Critical Infrastructure Cybersecurity](#) on February 12, 2014. The framework was developed pursuant to a 2013 Presidential Executive Order on [cyber preparedness](#). Although the framework relates to critical infrastructure, the SEC has recently [indicated](#) that following the framework may be a best practice. The NYDFS may look to the framework as a guide when examining licensees' cyber security programs.

Cyber Security Program

Chief Information Security Officer and Annual Reports

§ 200.16

Effective Cybersecurity Program

Personnel / Annual Report	Written cyber security policy addressing:
<ul style="list-style-type: none">• Must designate a qualified employee as Chief Information Security Officer (“CISO”)• Must prepare a report to the board of directors assessing the cyber security program and any inadequacies at least annually• Must employ, train, and provide continuing training for cyber security personnel	<ul style="list-style-type: none">• Information security• Data governance and classification• Access controls• Business continuity and disaster recovery planning and resources• Capacity and performance planning• Systems operations and availability concerns• Systems and network security• Systems and application development and quality assurance• Physical security and environmental controls• Customer data privacy• Vendor and third-party service provider management• Monitoring and implementing changes to core protocols not directly controlled by licensee• Incident response

Cyber Security Program

Business Continuity and Disaster Recovery

§ 200.17

- Must establish and maintain a written business continuity and disaster recovery (“BCDR”) plan which must:
 - Identify documents, data, infrastructure, personnel, and competencies essential to the licensee’s business
 - Identify personnel responsible for implementing BCDR plan
 - Include a plan for communicating with necessary personnel during an emergency
 - Include back-up system maintenance procedures
 - Include data back-up procedures
 - Identify third parties necessary to continue operation
- Must distribute BCDR plan to employees, provide training, and maintain accessible copies.
- Must notify Superintendent of any emergency that may affect ability to fulfill regulatory obligations or which may have an adverse effect on licensee, counterparties, or the market.
- BCDR plan must be tested at least annually by independent internal personnel or a qualified third party.



Image from <http://bit.ly/1nL5eN6>

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Anti-Money Laundering

Money laundering is too nice a word. Money laundering is the facilitation of all kinds of horrific crimes that I think everyone in this room never wants to see happening. Narco-trafficking being one, but acts of terrorism, funding rogue nations, etc., all take place through massive money laundering ...

The choice for the regulators is: permit money laundering on the one hand, or permit innovation on the other, and we're always going to choose squelching the money laundering first. It's not worth it to society to allow money laundering and all of the things it facilitates to persist in order to permit 1000 flowers to bloom on the innovation side.

-[Superintendent Lawsky](#), NYDFS BitLicense Hearings, January 2014

Anti-Money Laundering

Summary of AML Program Requirements § 200.15, 200.12(a)

<p>Risk Assessment</p> <ul style="list-style-type: none"> Initial and annual (or more often “as risks change”) risk assessment considering legal, compliance, financial, and reputational risks AML program should reflect risk assessment 	<p>Compliance Function</p> <ul style="list-style-type: none"> System of internal controls, policies and procedures to ensure ongoing compliance with all AML laws, rules and regulations Designated AML compliance officer(s) An overall AML policy must be reviewed/approved by board of directors 	<p>Audit Function</p> <ul style="list-style-type: none"> Annual (or more often) independent testing for compliance with and effectiveness of AML program by qualified internal or external personnel/party Audit report must be submitted to NYDFS 	
<p>Records + Reports</p> <ul style="list-style-type: none"> Records of all transactions <i>for 10 years</i> Notify NYDFS within 24 hours of transactions/series of transactions by a person exceeding \$10,000 in value in one day (a.k.a., Currency Transaction Reports or CTRs) Suspicious Activity Reports (SARs) to be filed in accordance with federal law; if not required to file under federal law, file with NYDFS within 30 days 	<p>Prohibitions</p> <ul style="list-style-type: none"> No structuring/assisting in structuring transactions to evade reporting requirements No allowing/facilitating obfuscation of identity of individual customer or counterparty <ul style="list-style-type: none"> E.g., tumblers/mixers Virtual currencies built to obfuscate identify may be prohibited (e.g., Zerocoin), although there is no explicit prohibition on virtual currencies without a public ledger No relationships with shell companies that are not physically present in any country 	<p>OFAC Compliance</p> <ul style="list-style-type: none"> Customers must be checked against the Specially Designated Nationals (“SDN”) list maintained by the Office of Foreign Asset Control (“OFAC”) Risk-based policies, procedures and practices to ensure compliance with OFAC regulations “to the maximum extent possible” 	<p>Customer Identification Program</p> <ul style="list-style-type: none"> Reasonably identify/verify customer’s identity, including name, physical address, etc. Enhanced due diligence policies, procedures and controls for non-U.S. licensees and for accounts of non-U.S. Persons Verify accountholders initiating transactions with a value > \$3,000

Anti-Money Laundering

Anti-Money Laundering Program
§ 200.12(a), 200.15, (d)(1)

Commentary

- To the extent that a business must register with FinCEN and is subject to federal AML requirements, the BitLicense AML requirements are largely consistent (see [Appendix](#) for a comparison of BitLicense AML requirements with those of FinCEN)
 - But many more types of businesses must obtain a BitLicense than are required to register with FinCEN. (See [Slide 14](#))
- Money laundering capabilities of virtual currencies have long been a concern of authorities
- Notable case of money laundering charges involving virtual currency: Silk Road
 - Silk Road was an online market place where virtual currency was allegedly used to facilitate money laundering, in addition to other criminal activity.
- Additionally, Charlie Shrem — a well-known entrepreneur in the Bitcoin space — was indicted on charges of conspiracy to commit money laundering on April 10, 2014 in the United States District Court in the Southern District of New York

“[As alleged](#), Robert Faiella and Charlie Shrem schemed to sell over \$1 million in Bitcoins to criminals bent on trafficking narcotics on the dark web drug site, Silk Road. Truly innovative business models don’t need to resort to old-fashioned law-breaking, and when Bitcoins, like any traditional currency, are laundered and used to fuel criminal activity, law enforcement has no choice but to act. We will aggressively pursue those who would coopt new forms of currency for illicit purposes.”

- Manhattan U.S. Attorney Preet Bharara



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Exams, Reports and Oversight

NYDFS Examinations

§ 200.13

- **Examination Authority.** NYDFS can examine the licensee, as necessary or advisable.
- **Frequency of Examination.** Not less than once every two years.
- **Scope of Review.**
 - Financial condition of the licensee.
 - Safety and soundness of the conduct of its business.
 - Policies of its management.
 - Whether licensee is complying with laws, rules, and regulations.
- **Additional Subjects of Examination.** In addition to the licensed entity, the NYDFS has the authority to review:
 - Any of licensee's **outside of New York** activities that the NYDFS determines **may affect licensee's business involving New York** or New York Residents.
 - **Affiliates** of the licensee as necessary.

Exams, Reports and Oversight

Reports and Financial Disclosures

§ 200.14

Financial Statement Requirements	
Quarterly (to be submitted within 45 days of end of quarter)	Annual (to be submitted within 120 days of fiscal year end)
<ul style="list-style-type: none">• Balance sheet• Income statement• Profit and loss statement• Statement of retained earnings• Statement of net liquid assets• Statement of cash flows• Statement of change in ownership equity• Statement demonstrating compliance with the regulation requirements of these regulations• Financial projections and strategic business plans• List of all off-balance sheet items• Chart of accounts including descriptions• Report of permissible investments by the licensee pursuant to these Regulations	<ul style="list-style-type: none">• Audited GAAP financial statements• Audit opinion of an independent certified public accountant• Evaluation by the auditor of the accounting procedures and internal controls of licensee• Statement of management's responsibilities for:<ul style="list-style-type: none">• Preparing the annual financial statements;• Establishing and maintaining adequate internal controls and procedures for financial reporting; and• Complying with all applicable laws, rules, and regulations.• Assessment by management of licensee's compliance with applicable laws, rules, and regulations• Officer or director certification of the financial statements attesting to their truth and correctness

Exams, Reports and Oversight

Ongoing Compliance
§ 200.7

Notice Requirements

- Licensee must notify NYDFS in writing of any criminal action or insolvency (at the commencement of any such proceeding) against the licensee or any of its directors, or Principal Stockholders, Officers, or Beneficiaries.
- Licensee must notify NYDFS in writing of any proposed change to the methodology for calculating the value of virtual currency in fiat currency.
- Licensee must submit a report to the Superintendent immediately if it discovers a violation of law, rule, or regulation, related to virtual currency activity.

Internal Oversight

- Each licensee must designate qualified individuals to coordinate and monitor the licensee's compliance with all applicable federal and state laws, rules and regulations.

Required Compliance Programs

- Anti-fraud
- Anti-money laundering
- Cyber security
- Privacy and information security
- Any other policy required under these regulations

Appendix

Comparison of AML Requirements: FinCEN Regulations and BitLicense Regime

	FinCEN Requirements for Money Transmitters	NYDFS BitLicense Proposal
Maintain a formal AML/KYC compliance program to monitor transactions (consisting of procedures and internal controls)	✓ (formal risk assessment not required)	✓ (must be based on a written risk assessment)
Collect and verify customer information (i.e., maintain a “CIP”)	✓ (to extent customer opens an account)	✓
Check customer identities against government sanction lists	✓ (to extent customer opens an account)	✓
Report suspicious activity to FinCEN (i.e., file SARs)	✓ (\$2,000+)	✓ (report to FinCEN; if Licensee not required to file SARs under Federal Law, then to NYDFS within 30 days. No threshold amount)
Report transactions over \$10,000 to FinCEN (i.e., file CTRs)	✓	✓ (report to FinCEN and to NYDFS)
Provide on-going training to Compliance employees	✓	✓
Designate Compliance Officer	✓	✓
Ensure periodic independent audits of compliance program	✓	✓

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