Alternative Currencies
Developing Trends
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What is Bitcoin?

• Bitcoin is a “peer-to-peer” (“P2P”) system
  – In a P2P system, there is no central administrator
  – The ledger (“block chain”) is publicly available and distributed nodes (“miners”) verify transactions

• Bitcoin is a “convertible” virtual currency
  – Bitcoin can be used to purchase real and virtual goods and services and is readily exchangeable for government-issued currency

• Bitcoin is a “cryptocurrency”
  – Transactions are signed using public and private keys
How Should Virtual Currency Be Regulated?

• As currency?
• As property?
• As a commodity?
• As a prepaid account?
Is Virtual Currency “Currency”? 

- Under the Bank Secrecy Act ("BSA"), “currency” means
  - “The coin and paper money of the United States or of any other country that is designated as legal tender and that circulates and is customarily used and accepted as a medium of exchange in the country of issuance”
  31 C.F.R. § 1010.100(m)
- In contrast to real currency, “virtual currency” is a medium of exchange that operates like real currency in some environments, but does not have all the attributes of real currency
  - Specifically, virtual currency does not have legal tender status in any jurisdiction
Is Virtual Currency “Currency”?

- The BSA regulates, among other things, money transmitters
  - Any person that provides money transmission services—i.e., “the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another”
    31 CFR § 1010.100(ff)(5)(i)(A)
- The BSA imposes obligations on financial institutions to assist U.S. government agencies in detecting and preventing money laundering
- Under the BSA, money services businesses (“MSBs”), including money transmitters, must
  - Register with the Financial Crimes Enforcement Network (“FinCEN”)
  - Report suspicious activity and certain currency transactions
  - Establish an anti-money laundering (“AML”) program
  - Retain specified records
Is Virtual Currency “Currency”?  

• FinCEN has issued interpretive guidance and administrative rulings on administering, exchanging and using virtual currency  

• Generally, an administrator or exchanger that accepts and transmits or buys or sells convertible virtual currency is a money transmitter subject to the BSA  

• However, based on FinCEN guidance:  
  – A miner who creates virtual currency and uses it to purchase real or virtual goods and services is not a money transmitter (FIN-2013-G001)  
  – A miner who creates virtual currency and uses it to pay investors in his mining operation is not a money transmitter (FIN-2014-R001)  
  – A person who rents computer systems for mining virtual currency is not a money transmitter (FIN-2014-R007)
Is Virtual Currency “Currency”? 

• Money transmission is also regulated under state law
  – 47 states and the District of Columbia have money transmission laws
• The core purposes of the federal and state money transmission laws are very different
  – Federal law focuses on AML and anti-terrorism financing
  – State laws focus on the integrity and financial health of those running the money transmission—i.e., consumer protection and safety and soundness
• The key issues are whether a third party or intermediary is “holding” money and whether that third party is exempt from state money transmission laws (e.g., bank or broker-dealer)
• State regulators have expressed varying degrees of interest in virtual currency
Is Virtual Currency “Property”? 

• The Internal Revenue Service (“IRS”) had been pressed by the Government Accountability Office (“GAO”) and others to publish guidance on the tax treatment of virtual currency.

• The U.S. tax code contains special rules for dealings in foreign currency, but does not define “currency,” and absent guidance the treatment of bitcoin was unclear.

• In Notice 2014-21 (Mar. 2014), the IRS confirmed that under existing tax law:
  – Bitcoin and other “convertible” virtual currencies are not subject to the special tax rules that apply to foreign currency.
  – Instead, convertible virtual currency is simply treated as “property” (not defined; a residual category) for U.S. tax purposes.
  – The notice only applies to “convertible” virtual currencies.
Is Virtual Currency “Property”? 

• The usual tax rules that apply to any other “property,” therefore, also apply to bitcoin
  – Gain or loss is recognized on the sale or exchange of bitcoin
    ▪ No de minimis exception; valuation and recordkeeping issues
    ▪ Gain/loss may be capital or ordinary, depending on holder’s tax status as investor, trader or dealer
  – Bitcoin miners realize gross income upon receipt of bitcoin
  – Usual third-party tax reporting and withholding tax obligations can apply
• The IRS invites comments on other virtual currency tax issues to be addressed in future guidance
Is Virtual Currency a “Commodity”? 

• Generally, a “commodity” is defined as an article of trade or commerce, or a tangible good  
  – Bitcoins can be viewed as tangible goods, because individuals have constructive possession of bitcoins  
  – Constructive possession is control of property without actual possession  

• However, key characteristics of commodities are price stability and non-substitutability  
  – Bitcoin is subject to severe price volatility  
  – There are emerging virtual currency competitors (e.g., Peercoin and Litecoin)
Is Virtual Currency a “Commodity”?

• If bitcoins were commodities, how would they be regulated?
  – The Commodity Exchange Act defines “commodity” to mean “wheat, cotton, rice, corn, oats, barley, [etc.] . . . and all services, rights, and interests . . . in which contracts for future delivery are presently or in the future dealt in” 7 U.S.C. § 1a(9)

• The Commodity Futures Trading Commission (“CFTC”) has authority to regulate commodity futures and certain foreign-exchange instruments
  – Would bitcoin transactions be regulated as commodity futures?
  – Would bitcoin be regulated as a foreign-exchange instrument?
Is Virtual Currency a “Commodity”?  

- On September 17, 2015, the CFTC took its first action against an unregistered bitcoin options trading platform  
- The CFTC ordered the platform operator and its CEO to:  
  - Cease illegally offering bitcoin options  
  - Cease operating a facility for trading or processing of swaps without registering  
- In taking the action, the CFTC held that bitcoin and other virtual currencies are commodities covered by the Commodity Exchange Act
Is Virtual Currency a “Prepaid Account”? 

• In December 2014, the Consumer Financial Protection Bureau (“CFPB”) issued a proposed rule that would regulate “prepaid accounts”

• The proposed rule would cover stored value, not otherwise regulated under the Electronic Fund Transfer Act and Regulation E, that enables P2P transfers
  – The CFPB acknowledged that the proposed rule might apply to virtual currencies and related products and services
  – The CFPB also acknowledged that its analysis of the application of existing regulation and of the proposed rule to virtual currency products and services is ongoing and that the proposed rule does not resolve virtual currency-related issues

• A final rule is anticipated in early 2016; likely another proposal on virtual currencies
Key Virtual Currency Legal Issues

- Anonymity
- Licensing and registration requirements
- Consumer protection
- Banking relationships
- Potential for distributed ledger technology
Key Issue—Anonymity

• Virtual currency is appealing to illicit actors because it enables use to remain relatively anonymous

• Notwithstanding the presumption of anonymity, law enforcement may be able to adapt to new technology
  – The public key is a user’s pseudonym, which is tied to every transaction recorded in the public ledger
  – It may be possible to tie a public key to an individual, or at least individually identifiable information, such as an IP address; however, anonymizing software (e.g., Tor) can be used to increase pseudonymity
Key Issue—Licensing/Registration

- State licensing authorities, led by the New York Department of Financial Services ("NYDFS"), have been adapting their money transmission licensing statutes to virtual currency activities
  - In June 2015, the NYDFS issued its final rule creating a comprehensive "BitLicense" scheme, which requires a license to engage in "virtual currency activities" in New York or with New York residents
  - Other states are considering regulating virtual currency activities via their legacy money transmission statutes
  - In September 2015, the NYDFS issued its first BitLicense to Circle Internet Financial
- Separately, in May 2015, the NYDFS granted a charter under the New York Banking Law to itBit Trust Company, LLC ("itBit"), a commercial Bitcoin exchange
Key Issue—Licensing/Registration

- On September 15, 2015, the Conference of State Bank Supervisors (“CSBS”) issued its final Model Regulatory Framework on virtual currency activities (“Final Framework”)
  - The CSBS issued the Final Framework “to assist those states seeking to develop and implement state regulatory regimes for virtual currency activities”
- The Final Framework includes a definition of “Virtual Currency,” a general policy statement, a statement of covered and excluded activities, and a set of nine regulatory requirements
- The CSBS takes the position that “activities involving third party control of virtual currency, including for the purposes of transmitting, exchanging, holding, or otherwise controlling virtual currency, should be subject to state licensure and supervision”
- Because the Final Framework is drafted at a high level, state-by-state implementations will undoubtedly create inconsistency
Key Issue—Consumer Protection

• Federal, state and foreign consumer protection agencies have issued consumer warnings regarding the risks deriving from buying, holding or trading virtual currencies, such as bitcoins.

• Frequently, such agencies cite the following risks:
  – The value of virtual currencies can fluctuate significantly; as such, virtual currencies are not a “store of value”.
  – The value “held” in bitcoin wallets is not insured, as a deposit account is insured, although private insurance schemes are increasingly popular.
  – Bitcoins and other virtual currencies have been the subject of theft.
  – Bitcoin holders do not have the same dispute resolution rights as they may have with other forms of payment.
  – Bitcoin may not be subject to conventional counterfeiting, but risk of fraud remains.
Key Issue—Consumer Protection

- The GAO has released a report on virtual currencies
- The GAO found that federal interagency working groups on virtual currencies had not emphasized consumer protection issues due to the CFPB’s lack of participation in efforts to inform consumers about the potential risks associated with virtual currencies
- The GAO recommended that the CFPB identify interagency working groups that would benefit from the CFPB’s participation
- In a letter responding to the GAO, the CFPB identified its involvement in numerous informal discussions and its participation in various interagency working groups on virtual currencies, but nevertheless concurred with the GAO’s recommendation
Key Issue—Consumer Protection

• The CFPB also released a consumer advisory outlining risks associated with virtual currencies (“Advisory”)
• The Advisory also offers recommendations for consumers who are buying, storing or using virtual currencies, and encourages consumers to:
  – Know with whom they are doing business when engaging in virtual currency transactions
  – Be aware that virtual currencies can experience dramatic price fluctuations
  – Understand fraud risks when using or investing in virtual currencies
  – Protect their private keys from theft or loss
  – Understand that there is no government insurance for virtual currency accounts
Key Issue—Consumer Protection

• In conjunction with issuance of the Advisory, the CFPB announced that it would begin accepting complaints through its consumer complaint database from consumers who may encounter a problem with virtual currency products and services, such as exchanges or digital wallet providers

• According to the CFPB, it “will use all complaints to better understand the virtual currency market and its effect on consumers,” and “will also use the complaints to help enforce federal consumer financial laws and, if appropriate, take consumer protection policy steps”
  – No further detail was provided regarding what such “policy steps” might be

• To date, there are no complaints regarding virtual currencies in the CFPB’s public complaint database
Key Issue—Banking Relationships

• Many exchangers and other Bitcoin-related startups have had difficulty establishing banking relationships
  – Many banks are wary of banking MSB customers, which require enhanced monitoring
  – Moreover, there is substantial uncertainty around the regulatory treatment of Bitcoin and other virtual currencies, including whether exchanges need to obtain a money transmission license in every state

• Without bank accounts, exchangers cannot hold U.S. dollars or enable users to buy and sell bitcoins
Key Issue—Banking Relationships

• With respect to MSBs, like all other customers, banks must
  – Apply the banking organization’s Customer Identification Program
  – Conduct a basic BSA/AML risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary

• With respect to MSBs, unlike other customers, banks must
  – Confirm FinCEN registration, if required
  – Confirm compliance with state or local licensing requirements, if applicable
  – Confirm agent status, if applicable

• If the bank’s risk assessment indicates potential for a heightened risk of money laundering or terrorist financing, the bank is expected to conduct further due diligence in a manner commensurate with the heightened risk
Key Issue—Distributed Ledger Technology

• Perhaps the most significant development with respect to virtual currencies is related to the “blockchain,” or distributed ledger technology.

• Distributed ledger technology offers significant opportunity for entities in various industries to improve operational efficiencies:
  – Fundamentally, distributed ledger technology enables untrusted parties to transact over the Internet in real time.
  – Industry efforts, including R3, are engaged in extensive research/proof of concepts.