NEWLY RELEASED VIRTUAL-CURRENCY BUSINESSES ACT AUGURS INCREASED STATE REGULATION OF BITCOIN, ETHER, AND OTHER DIGITAL AND CRYPTO CURRENCIES

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U.S. Consumer Financial Services/FinTech Alert

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I. INTRODUCTION

The Uniform Law Commission ("ULC") is an organization focused on developing and preparing "non-partisan, well-conceived, and well-drafted" state legislation in areas of state law where there is a perceived need for uniformity. In practice, once the ULC releases proposed state legislation in any particular area (such as abandoned property or arbitration), it is not unusual for multiple states to adopt the ULC legislation. That is why we must pay attention when the ULC releases a proposed law regulating virtual, digital, or crypto currencies. [1]

On October 9, 2017, the ULC released the final version of its Uniform Regulation of Virtual-Currency Businesses Act ("VCBA" or "Act"), which can be found here. The Act repeatedly references both state money transmission laws and Financial Crimes Enforcement Network ("FinCEN") money services business regulations, noting that the VCBA is intended to provide protections and obligations that are generally similar to those legal regimes.

In this alert, we summarize key VCBA provisions and analyze the potential impact the Act may have on current virtual currency activity in the industry. For example, the ULC notes it attempted to achieve "a balanced and reasonable regulatory structure that should validate good business practice and thus enhance trust for users of virtual currency, and may lead to [U.S. Securities and Exchange Commission] approval of virtual-currency offerings." [2]

Of course, no state has yet adopted the VCBA, but we expect some states will do so, even if partially. Thus, it's important to understand how the Act could affect your business.

II. SUMMARY & ANALYSIS OF KEY PROVISIONS

a. Licensing

I. General Provisions

Subject to certain exemptions and alternatives discussed below, the Act requires a license "to engage in virtual-currency business activity" or to hold one's self out as being able to do so. [3] Various activities qualify as "virtual-currency business activity," including "exchanging, transferring, or storing virtual currency or engaging in virtual-currency administration, whether directly or through an agreement with a virtual-currency control-services vendor." [4] The ULC notes that this list of licensable activities was "designed to capture those activities with

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sufficient similarity to money transmission or other regulated money services activities as to become proper subjects for regulation under [the Act]." [5] We explore each of these activities in turn.

There are two threshold terms that are key to understanding what activities require a license: virtual currency and control. Licensing is required only if a transaction involves "virtual-currency." The Act defines *virtual currency* as "a digital representation of value that (i) is used as a medium of exchange, unit of account, or store of value; and (ii) is not legal tender, whether or not denominated in legal tender." [6] It does not include, among other things, "a transaction in which a merchant grants, as part of an affinity or rewards program, value that cannot be taken from or exchanged with the merchant for legal tender, bank credit, or virtual currency." [7] If a merchant reward can be converted to cash, bank credit, or other virtual currency, however, it qualifies as "virtual-currency." The commentary notes that the ULC made this noncash-out/cash-out distinction to be consistent with treatment of merchant rewards programs under FinCEN guidance and the Revised Uniform Unclaimed Property Act. Moreover, the commentary states that the definition of virtual currency is intended to track FinCEN guidance concerning what virtual currency transactions qualify as "prepaid access." [8]

As noted below, each of the licensable activities — exchanging, transferring, storing — requires a party to assume or maintain "control" of virtual currency on behalf of someone else. The Act defines *control* in relevant part as the "power to execute unilaterally or prevent indefinitely a virtual-currency transaction." [9] The control requirement is intended to serve several purposes. First, it must be "control" of virtual currency *on behalf of someone else*. As the commentary makes clear, the Act is "focused on intermediary providers of virtual-currency products and services – not on the virtual currency itself or on the 'owner' of virtual currency" that can effect transactions on its own behalf. [10] Second, a person meets the "control" definition only if the person can act *unilaterally* to execute or prevent a virtual-currency transaction. This means a "multi-sig" arrangement is not covered because under such an arrangement, more than one-credential-equivalent must be used to effect a transaction. For example, a party would not trigger the licensing requirement if the party held one key to virtual currency and the only way to exchange or transfer the virtual currency was using a key in combination with one or more other keys.

II. Specific Licensable Activities

The first listed activity is *exchanging* virtual currency. Under the Act, *exchange* means "to assume control of virtual currency from or on behalf of a resident, at least momentarily, to sell, trade, or convert (A) virtual currency for legal tender, bank credit, or one or more forms of virtual currency; or (B) legal tender or bank credit from one or more forms of virtual currency." [11] The term covers "any sale or barter of virtual currency for other virtual currency or 'real world' goods or services" but specifically excludes such activities when undertaken by miners. [12]

A license is also required for *transferring* virtual currency. The term *transfer* means "to assume control of virtual currency from or on behalf of a resident and to (A) credit the virtual currency to the account of another person; (B) move the virtual currency from one account of a resident to another account of the same resident; or (C) relinquish control of virtual currency to another person." [13] This activity is limited to transactions that involve only virtual currency. If the movement of virtual currency involves both virtual currency and fiat currency, the transaction is an "exchange" rather than a "transfer." [14]

Storing virtual currency is licensable activity. The term *store* means "to maintain control of virtual currency on behalf of a resident by a person other than the resident." [15]

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Finally, a license is required to engage in *virtual-currency administration*. The Act defines *virtual-currency administration* as "issuing virtual currency with the authority to redeem the currency for legal tender, bank credit, or other virtual currency." [16] This definition is intended to follow FinCEN guidance on virtual-currency and money transmission.

Although the Act often parallels existing definitions and concepts from FinCEN, it explicitly does *not* adopt a "facts and circumstances" approach to determining what constitutes a "virtual-currency business activity." The commentary explains that licensing triggers need to be "as bright as possible to provide certainty and uniformity" so entities can determine whether they need a license or whether they qualify for the exemptions or alternatives discussed below, in Section II.b. [17]

III. Security & Net Worth

The VCBA has application requirements that are too extensive for this alert. We highlight the security and net worth requirements, however, because of some unique characteristics they possess vis-à-vis most state money transmission laws.

Similar to state money transmission statues, the VCBA requires an applicant to deposit security with the state to secure performance of its duties. The types of security that can be used vary, however, and include funds or investment property, a letter of credit, a surety bond, or other security satisfactory to the state. [18] The state has discretion to determine the amount required. The commentary acknowledges that surety bonds and letters of credit are not readily available to virtual-currency start-up businesses and so the ULC sought to provide some flexibility for meeting the security requirement, including by allowing states to permit virtual currency to meet the requirement. [19] The Act also requires a minimum net worth and sufficient unencumbered reserves to wind down operations. [20] The applicant can use virtual-currency, other than the virtual-currency over which it has control for a resident, to meet the net worth requirement. [21]

b. Licensing Exemptions & Licensing Alternatives

I. Exemptions

The Act provides many exemptions that are similar to those in state money transmission statutes. For example, the Act exempts government agencies, banks (including the OCC's proposed special purpose national bank, but not Industrial Loan Companies), entities providing processing or clearing services, and persons using virtual-currency on their own behalf, for personal, family, or household purposes, or for academic purposes. [22] The Act also exempts any virtual-currency transaction that is subject to the Electronic Fund Transfer Act, the Securities Exchange Act of 1934, or the Commodities Exchange Act. [23]

Other exemptions are unique to the Act, however. For example, it exempts a person whose virtual-currency business activity in a state "is reasonably expected to be valued, in the aggregate [within that state], on an annual basis at $5,000 or less." [24]The Act also exempts entities that are, in essence, providing services to a virtual-currency business, such as a person that "contributes only connectivity software or computing power to a decentralized virtual currency, or to a protocol governing transfer of the digital representation of value" as well as a person that "provides only data storage or security services" for a virtual-currency business. [25] Entities that are licensed under the state's money transmission statute are also exempt so long as they obtain permission from the state to engage in virtual-currency business activity and comply with certain provisions of the Act. [26] (On a related note, the denial, suspension, or revocation of a person's license or registration under the Act may not be

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used to justify suspending or revoking such person's state money transmitter license (unless the Act provides an independent ground to do so)). [27]

II. Alternatives

The Act provides some limited alternatives to licensing for entities that would otherwise require a license. First, the Act permits reciprocal licensing, and how an entity seeks a reciprocal license depends on whether the state participates in the National Multistate Licensing System ("NMLS"). If the state does participate, an entity that is licensed to conduct virtual-currency business activity in one state may file through NMLS an application to engage in virtual-currency business activity in another state. [28]

If a state does not use NMLS, the applicant must notify the state that the applicant will rely on reciprocal licensing. [29] Under this procedure, a state can compare its licensing scheme with that of the state(s) in which the applicant is licensed and grant reciprocity on a discretionary basis. If the state does not deny the application within 15 days of receipt of all required materials, the applicant can begin engaging in virtual-currency business activities no earlier than 31 days after completing its application. [30] A state can alter these time periods for good cause.

Another licensing alternative is the "registration option," which is available to an entity whose volume of virtual-currency business activity in U.S. Dollar equivalent will not exceed $35,000 annually. [31] Such an entity may operate in a state by simply registering, rather than obtaining a license (although many registrant requirements are similar — if not identical — to licensee requirements). [32] For example, the registrant must provide evidence of and agree to maintain the minimum net worth requirements and reserves, and evidence that it has policies and procedures to comply with the Bank Secrecy Act, as well as the Act's examination and disclosure requirements. [33] An entity can use the registration provisions for only two years; after two years, the entity must cease its virtual-currency business activities or apply for a license, even if it will not surpass the $35,000 annual limit. [34]

The ULC touts this registration option as an "intermediate status" that offers advantages to both the public and the business entity. As for public good, it points to the Act's requirement that an applicant register with FinCEN "to the extent that FinCEN's regulations and guidance mandate registration." [35] The commentary also notes the registration provisions will give the states an opportunity to follow and learn from newcomers' activities with residents of the state.

As for the business entity, the ULC argues that the registration provisions provide the entity with an on-ramp for doing business in a state with clear requirements for what the business must do to retain its status as a registrant. As the commentary puts it, this allows some "'in the wild' testing of the products and services in the enacting state." [36] It also permits start-up businesses and those testing new products to engage state residents without obtaining a license and yet be protected from potential violations of 18 U.S.C. § 1960, which imposes criminal liability for engaging in unlicensed money transmission. [37]

c. Other Requirements

The Act imposes recordkeeping, reporting, and requirements that are similar to state money transmitter laws. Applicants are required to have satisfactory policies and procedures and to implement a compliance program. [38]

Licensees and registrants must make numerous specific disclosures to residents before establishing a "relationship" with them. These disclosures include, among others: a schedule of fees and charges that will be assessed; the manner in which those charges will be calculated if their amounts are not set and disclosed in

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advance, and when those fees will be charged; insurance-related disclosures; and a descriptions of the consumer's liability and error-resolution rights.

The Act provides for enforcement actions similar to those in state money transmitter laws, such as actions for material violations of the Act's provisions. [39] It also permits actions against people who "engage[] in unsafe or unsound practices," and "unfair or deceptive acts and practices," [40] provided these acts and practices are material. The Act provides only a very limited private right of action.

Finally, the Act attempts to avoid duplicative regulation by requiring state regulators to consider how cooperation with other states will maximize effectiveness and uniformity. It requires in certain circumstances that states enacting the VCBA establish and participate in a central depository for filings, cooperate to develop uniform forms, applications, and procedures, and formulate joint rules, policies, and guidance. [42]

* * * *

K&L Gates will be tracking the extent to which states decide to adopt the Act with respect to virtual, digital, or crypto currency companies doing business in their state. Reach out to members of the Fintech and Payments teams to discuss how the Act could possibly affect your business.

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[1] Although many prefer to use the term "crypto" or "digital" currencies, since the ULC's Act has adopted the term "virtual currency," we will use that term.

[2] VCBA, Prefatory Note.

[3] *Id*. § 201.

[4] *Id.* § 102(25). Other activities that qualify as "virtual-currency business activity" relate to interests in precious metal and exchanging digital representations of value within an online game or gaming platform. *Id*. Those activities are outside the scope of this alert.

[5] *Id*. § 102, Comment 2.

[6] *Id*. § 102(23)(A).

[7] *Id*. § 102(23)(B)(i).

[8] Although the ULC states the Act "may lead to [U.S. Securities and Exchange Commission] approval of virtual-currency offerings," the Act does not discuss Initial Coin Offerings ("ICO"), so there is no clear guidance on whether the Act applies to tokens offered in an ICO. The answer will likely depend on the particular facts. On the one hand, *virtual currency* is defined to include a "store of value." However, the specific characteristics of the token would have to be analyzed to determine, for example, if it could be converted to fiat currency or other virtual currency, whether it can only be used on the platform, and whether it can be sold in the secondary market.

[9] *Id*. § 102(3)(A).

[10] *Id*. Prefatory Note.

[11] *Id*. § 102(5).

[12] *Id*. § 102, Comment 5.

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[13] *Id*. § 102(21).

[14] *Id*. § 102, Comment 10.

[15] *Id*. § 102(20).

[16] *Id.* § 102(24).

[17] *Id*. § 102, Comment 2.

[18] *Id*. § 204.

[19] *Id*. § 204, Comments 1, 5.

[20] *Id*. § 204(b).

[21] *Id*. § 204(c).

[22] *Id*. §§ 103(1), (2), (4), (7).

[23] *Id*. § 103(b).

[24] *Id*. § 103(b)(8).

[25] *Id*. § 103(b)(6).

[26] *Id*. § 103(b)(3). Other exemptions exist for dealers in foreign exchange, attorneys, and title insurance companies providing escrow services, securities, or commodities intermediaries, secured creditors, virtual-currency control-services vendors, and persons that provide virtual-currency business activities free of charge.

[27] *Id*. § 703(b).

[28] *Id*. § 203, Alternative A.

[29] *Id*. § 203, Alternative B, (a)(2).

[30] *Id*. §§ 203, Alternative B, (a)(3), (4).

[31] The Act's $35,000 annual limit is per state; it is not an aggregate limit across all states. *Id*. § 207, Comment 4.

[32] *Id*. § 207(a).

[33] *Id*. §§ 207(a)(6)-(8).

[34] *Id*. § 207(d)(4).

[35] *Id*. § 207, Comment 2.

[36] *Id*. § 103, Comment 2.

[37] *Id*. § 207, Comment 3.

[38] *Id*. § § 601–602.

[39] *Id*. § 402(a)(1). According to Comment 1 to Section 402, the department determines what actions constitute a material violation of the act. Moreover, "patterns and practices of same minor violation" can be considered material. Id.

[40] *Id*. § 402(a)(3).

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[41] *Id*. § 402, Comment 1.

[42] *Id*. § 303(b).

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