

To: President Ramasastry, Uniform Law Commissioners, and Executive Director Karsai

From: Fred Miller, Chair of the Drafting Committee, and Sarah Jane Hughes, Reporter, Uniform Supplemental Commercial Law for the Uniform Regulation of Virtual-Currency Businesses Act

Date: May 18, 2018

Re: Issues to be Decided at the Annual Meeting

This act – the Uniform Supplemental Commercial Law for the Uniform Regulation of Virtual-Currency Businesses Act (the "companion act") – is up for its first, and final, reading, as approved by the Executive Committee. A version of the act was presented with the Uniform Regulation of Virtual-Currency Businesses Act ("URVCBA") at the Annual Meeting last year but was not actually read.

Because the URVCBA gives significant regulation-writing authority to the state agency charged with its administration, something not common in commercial law due to the need for certainty, the companion act was separated from the URVCBA and is being considered independently this year even though it is intended to be enacted only simultaneously with the URVCBA or after the URVCBA is enacted.

The companion act has two purposes: (1) by imposing on licensees and registrants a mandatory "opt-in" to Uniform Commercial Code (UCC) Article 8 by agreement with its customers ("users" under the terms of the companion act) in Section 4 of the companion act, it provides tested and clear rules to facilitate virtual currency being controlled by a third party used as an asset; and (2) by setting rules to preserve customers' ownership of virtual currency in the control of licensees and providers and affording other Article 8 protections to customers of virtual-currency businesses, it decreases the risk to them of insolvency of the business or fraud by it and thus simplifies the determination of what is the proper amount of capital a virtual currency business must have to lessen those risks and to successfully operate the business. The first also makes it easier for virtual currency to serve as collateral in secured transactions and affords protection for transferees of virtual currency from a licensee or registrant under the URVCBA.

Executive accepted our request for waivers of a line-by-line reading for some provisions or sections of the companion act. This is because many parts of the act have been considered in other acts of the ULC, or are ULC "boilerplate," and need no comment at this time.

The scope of the companion act, set forth in its Section 3, is somewhat different from the scope the URVCBA provided. In the URVCBA, the focus was on "residents" of states that enact that act. In this act, the Drafting Committee debated the scope issue and determined that it should cover "users" of third-party providers' services that resulted in the providers' having "control" as defined in the URVCBA so that "a person for which a licensee or registrant [subject to the URVCBA] has control of virtual currency" is included. Companion Act, § 2(a)(6). As the draft Official Comment to Section 2 explains, the broader scope is needed so that the same protections afforded to a "resident" of the enacting state are afforded to non-resident "users" for whom the licensee or registrant controls virtual currency.

The heart of the companion act is Section 4. It substitutes for Section 502 of the URVCBA, which had three goals. First, like UCC Article 8, it imposed on providers with control a duty to maintain an amount of each type of virtual currency sufficient to satisfy the aggregate entitlements of its customers

to that type of virtual currency. Second, if the provider violated the first requirement, the property interests to which its customer “users” would hold would be pro-rata interests without regard to the time the users became entitled to the virtual currency or the provider obtained control. Third, Section 502(c) provided that the virtual currency described in Section 502 is held for the persons entitled to it, not the property of the licensee or registrant, and is not subject to the claims of creditors of the licensee or registrant.

Section 4 mandates that a licensee or registrant under the URVCBA agree (and failing explicit agreement be deemed to agree) with their customers to certain key terms. The agreement:

- (1) must specify the jurisdiction whose law will govern the agreement, which in essence must be one that has enacted UCC Article 8 (see companion act Section 2(a)(1), (4) and Section 4(a)(1) and (2)), and whose law applies to issues specified in Article 2(1) of The Hague Securities Convention (see also, companion act Section 5 on the obligation to maintain an office that complies with the Convention, which requires that only one office be situated in the United States, not that one office exist in each state);
- (2) must state the licensee or registrant is a securities intermediary (under UCC Article 8, a person who maintains an account into which financial assets are accepted) and the licensee's or registrant's control creates a securities account, the virtual currency is treated as a financial asset, and the licensee or registrant will not grant a security interest in the virtual currency which the licensee or registrant is obligated to maintain under UCC Section 8-504(a) (see Section 4(3));
- (3) must not provide a standard for the licensee or registrant to comply with the duties of a securities intermediary under Article 8 Part 5 that is less protective of the user than the standard under Article 8 Part 5; and
- (4) must not provide a different choice of law rule (see Subsection 4(a)(5) and Section 5)).

Section 6 of the companion act then makes a violation of the companion act a regulatory violation of the URVCBA to trigger the latter act's Article 4 enforcement provisions.

The companion act does not make a security interest created in violation of companion act Section 4 void because that could impair the rights of innocent third parties, such as a purchaser from the secured party after default, and cuts off in UCC Section 8-502 an adverse claim because of an unauthorized transfer to protect an innocent purchaser of virtual currency, which protects the “negotiability” of virtual currency as a method for payment. Enactment of the companion act will repeal URVCBA section 502, but preserves the protections Section 502 granted in companion act Section 4. See Section 13 of the companion act.

Section 7 of the companion act merely indicates that the treatment of virtual currency as a “financial asset” subject to UCC Article 8-style provisions should not determine its treatment under other law. This provision signals that this companion act in no way intrudes on the ongoing debate about the correct characterization for other federal or state law purposes or under treaty obligations of the United States about virtual currency, such as whether it is “currency,” “foreign currency,” a “security,” a “commodity,” a form of “prepaid access,” or property subject to capital gains treatment in the United States. These fascinating debates do not affect the decision of the Drafting Committee to

“opt-in” to UCC Article 8 rights and duties for virtual currency under the “control” of a person subject to the URVCBA, whether a licensee or a registrant.

The remainder of the companion act includes familiar provisions relating to supplementation, effective date, and the like.

You will note that this companion act has longer-than-usual draft Official Comments for its primary provisions, and that certain of them are duplicated in the draft Prefatory Note. We did this to explain the companion act to those less familiar with ULC procedures and other ULC uniform acts than Commissioners will be, and to acquaint everyone not yet fully acquainted with the Hague Securities Convention, which went into effect in 2017. The Drafting Committee has not reviewed or approved the Prefatory Note or the Official Comments. As we finalize the text, Prefatory Note, and Official Comments to this companion act following the Annual Meeting, we will remove as much duplication as possible and, of course, conform both to the final text of the companion act.