From: Fred Miller, Chair of the Regulation of Virtual Currency Businesses Act Drafting Committee

Sent: June 9, 2017

To: Roster of Committee Members, Advisors, and Observers

Subject: Particular Issues to be Resolved and Potential Waivers of Line Reading

Issues to be Resolved by the Conference

Since its last meeting, the drafting committee has received many helpful suggestions from Observers. The Reporter and I believe most can be accommodated in the annual meeting draft as consistent with the positions taken by the drafting committee. Several significant issues, however, cannot.

Issue 1: Section 502 -- Substitution of UCC Article 8 in favor of the common approach of specifying "permissible investments" as the primary means of consumer protection in "money transmission" statutes.

Coinbase, a provider of e-wallet and exchange services based in California and holder of "money transmitter" licenses from numerous states and a BitLicense from New York State, commented: "We have one principle concern with the latest draft of the act: its wholesale adoption of UCC Article 8 provisions in lieu of simpler full-backing, permissible investment obligations already employed by states which regulate virtual currency businesses as a fundamental consumer safeguard." The letter is attached.

Up to now we have had strong Observer support for the act, but CoinBase's position could well unravel our work. We have reached out to them to change their position; we have learned that Coinbase has retained prominent counsel to advise them. [1]

The adoption of the provisions of UCC Article 8, particularly Part 5, and the drafting committee's adoption of a mandate to treat virtual currency as a "financial asset" and, thus, provide a clear set of rules for it as collateral under UCC Article 9 would assist in our opinion a significant issue the virtual currency industry now faces, the difficulty in obtaining adequate credit. Currently the application of commercial law rules to virtual currency is unclear.

Nonetheless, commercial law rules for virtual currency transactions is not one of the major goals of our effort, which is directed more to providing a regulatory framework than

[1] Update from the Reporter as of June 8, 2017: Commissioner Ed Smith has had discussions with counsel for Coinbase, which may lead to Coinbase being willing to support the act. Two small changes to Section 502 in the Draft being circulated June 9, 2017 were suggested by Commissioner Smith following his conversations with counsel for Coinbase.

providing commercial law rules, and it now appears going the adoption of the UCC Article 8 approach could impair those goals.

Given we only have three hours to read the act, there would seem to be little time to draft and debate an alternative to Section 502, the section of the act involved, if the floor decided not to adopt the UCC Article 8 route.

We do have an earlier version of Section 502 that provided as much and perhaps more protection for customers as does UCC Article 8, and there also is Section 703, which permits other law to supplement the act even if what law, and how it could apply, would remain for the courts to work out. Thus, the issue for the Conference to decide is: should we keep the UCC Article 8 approach? Or, should we incorporate the version set out below into the draft instead of the UCC Article 8 approach? The alternative version could read as follows:

Section 502. Property Interest of Entitlement Holder of Virtual Currency in Control of Licensee or Provisional Registrant.

(a) Except as otherwise provided in this [act], to the extent necessary for a licensee or provisional registrant to satisfy all entitlements to virtual currency in the control of the licensee or provisional registrant in which residents have a property interest, the interests of residents in that virtual currency are pro rata property interests without regard to the time of acquisition by the licensee or provisional registrant, or by the resident, and are:

(1) held for the entitlement of the residents;

(2) are not the property of the licensee or provisional registrant; and

(3) are not subject to the claims of creditors or of purchasers from the licensee or provisional registrant.

Reporter's Notes

Alternative subsection (a) is substantially UCC § 8-503 and as combined with § 8-504, it is more protective. Compare UCC §§ 8-503, 8-510, 8-511.

Of course, other related changes may also need to be made in other parts of the act.

Issue 2: Subsection 103(b)(8) and Section 210

A *de minimis* exemption for providers in Section 103(b)(8) of the act and an *on ramp* for "provisional registration" under Section 210. The Drafting Committee has supported both the exemption and the on ramp or "provisional registration" concepts since the early days of our work. The harder work in each case has been to decide which threshold amounts to use to differentiate among those exempt from the act's requirements, those in this interim, exploratory "provisional registration" pre-licensure state, and those whose businesses are sufficiently robust to require full licensure.

Each subject was considered at many of the Drafting Committee's meetings with no particular basis for selecting one figure over another emerging for any of the three situations. All participants were agreed that the exemption and on-ramp were important features of any final act whose goal is to facilitate innovation in the virtual currency business "space." This agreement was in spite of the fact that current money transmission and money services statutes do not have comparable exemptions or on-ramps.

Both the May 4, 2017 comment from the Electronic Frontier Foundation (EFF) and the May 4, 2017 comment from CoinCenter – already in the record for this project -- advocate that higher threshold figures for the *de minimis* exemption (§ 103(b)(8) of the act), and for qualifying for the provisional registration (§ 210 of the act). In the draft submitted to the Style Committee, the full exemption was for dollar-equivalent business acivity of less than $5,000 and the top range for provisional registration was $35,000. The low-activity range basically allows very basic experimentation with new products and services, and certain academic experiments. The $35,000 cap on activities under a provisional registration has been viewed as encouraging start-ups to embark on suitable "in the wild" testing of their products and services. These opportunities are needed to facilitate innovation in the virtual currency community.

Subsection 103(b)(8) and Section 210 are designed, respectively, to exempt virtual currency activity that poses no real risk to the economy or users and to allow trial or start-up virtual currency business activity. The goal is to avoid imposing regulatory burdens when the level or nature of activities are not seen as imposing substantial risks. A case can be made that different types of virtual currency business activity do not necessarily need to be subject to the same rules.

The Electronic Frontier Foundation recommends that Subsection 103(b)(8) employ a *de minimis* exception of $15,000 and a $100,000 threshold between provisional registration and full licensure requirements. (The EFF's May 4, 2017 comment letter is posted on the ULC's website.)

The EFF and Coincenter also request consideration of their proposal that the dollar equivalent maximums for the exemption and provisional registration ought to take into consideration the type of virtual currency business activity that a provider is offering to the public. The EFF separates providers into two groups -- long-term custodial activities, such as "virtual currency administration," and "storage" with thresholds lower than those mentioned immediately above, and short-term transactional activities, including "transfers" and "exchange" to be governed by higher thresholds than those currently in the act. Under their proposals, the *de minimis* exemption for long-term activities would be the act's current $5,000 and for short-term activities would be $15,000. The threshold for provisional registration would be the act's current $35,000 and for short-term transactional activities would be $100,000. The EFF makes the point that the thresholds they and Coincenter advocate "will do far more to protect innovation" and avoid "potential chilling of innovation." (EFF letter, May 4, 2017, at 2.)

The Drafting Committee debated the thresholds and related sums over several meetings and voted on the $5,000 and $35,000 thresholds at its meeting in March, 2017. Some on the Drafting Committee and others participating were willing to include higher amounts for operations under provisional registrations than the ranges of those recommended by the EFF and

Coincenter. (This included an abolsute cap on provisional registration between $200,000, which seemed too high to some Observers.) One other Observer in a comment on a prior draft required that the cap on provisional registration be $1 million annually.

The Drafting Committee has seen but not had an opportunity to debate the proposals made by EFF and Coincenter in their May, 2017 comments.

A final decision involves whether the dollar-equivalent activity threshold that will pertain to each enacting state should be on an annualized basis or a 30-day rolling average. Whichever standard is adopted should be used both for Section 103(b)(8) and 210.

Accordingly,

Subsection 103(b)(8) could read:

except as to section 302 (and section 502?):

(A) a person whose virtual currency business activity primarily consists of storing or administering virtual currency for residents and whose activity is reasonably expected to be valued, in the aggregate, on an annual basis at $5,000 or less measured by the U.S. Dollar Equivalent of the virtual currency, and

(B) a person whose virtual currency business activity primarily consists of transferring or exchanging virtual currency for residents and whose activity is reasonably expected to be valued, in the aggregate, on an annual basis at $15,000 or less measured by the U.S. Dollar Equivalent of the virtual currency.

Section 210(a) could read in initial part:

(2) A person whose volume of virtual currency business activity will exceed, as applicable to the virtual currency business activity in which the person is primarily engaged, the dollar figures specified in Section 103(b)(8) on an annual basis, but whose volume of activity has not exceeded, if the person primarily is involved in storing or administering virtual currency, $35,000 in U.S. Dollar Equivalence, or has not exceeded, if the person primarily is involved in transferring and exchanging virtual currency, $100,000 in U.S. Dollar Equivalence, may engage in virtual currency business activity with residents under a provisional registration without first obtaining a license under this act . . .

Another issue if the threshold amounts for exemption are raised is whether Section 502 should be made applicable to those small operators to some extent, since the risk is increased, and this may depend on the outcome of the § 502 issue, discussed above.

Again, other related changes may need to be made in other parts of the act.

Issue 3: **Subsection 102(2) – Definition of the term "Bank."**

Section 103(b)(2) currently exempts "a bank" from coverage by this act. Subsection 102(2) currently defines the term "Bank" to include "… a federally chartered or state-chartered depository institution or holder of a charter granted by the Comptroller of the Currency to a person engaged in the business of banking other than deposit-taking." The text continues with two exclusions:

> (1) of industrial loan companies, state-chartered trust companies, or limited purpose trust companies unless the department has authorized the company to engage in virtual currency business activity and
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> (2) of trust companies or limited purpose trust companies chartered by a state with which the enacting state does not have a reciprocity agreement governing trust company activities.

Industrial loan companies are chartered by some states and are eligible for federal deposit insurance. Many states do not charter industrial loan companies. Thus, the chartering and basic treatment of industrial loan companies is a matter of state law and Section 102(2) is an attempt to recognize that reality.

Federally chartered trust companies are governed by federal law in many respects, but pursuant to federal law also are governed by the law of the state in which the account holder resides. Additionally, the states also charter trust companies and may have reciprocity arrangements with other states allowing the trust companies they charter to serve customers in the other state(s). The current draft of Section 102(2) is designed to maintain the ability of each state to decide whether and to what extent to allow trust companies and industrial loan companies to engage in virtual currency business activities and to restrict the participants in virtual currency businesses to the activities the states allow and to providers the states approve unless the providers hold a federal trust company charter.

Waivers of Line by Line Reading

I have requested waivers of line-by-line reading, but no waivers have been granted as of this date.