

## Final Study Committee on Alternative and Mobile Payment Systems Report

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### **I. Summary of Recommendations**

This report makes two strong recommendations:

- First, that a drafting committee should be formed as soon as possible (ideally by early February 2015) to prepare draft legislation providing “commercial law” rules related to the rights and duties of participants in virtual currency payments transactions when the transaction execution is accomplished through the use of an intermediary. The Study Committee envisions that the drafting committee might create rules on the order of U.C.C. Article 4A to cover virtual currencies, their function as a means of making payments, and the market participants in those payments. Among the types of activities that might be covered in a new uniform law would be transmission of virtual currencies, exchanging sovereign or “fiat” currencies for virtual currencies or vice versa, exchanging virtual currencies for other virtual currencies, and acting as an intermediary or exchange for the transfer, storage, or transmission of virtual currencies. These activities would include market participants operating wallets, vaults, kiosks or ATMs as well as merchant-acquirers and virtual currency payment processors. This proposed coverage is comparable to that proposed on December 16, 2014 by the Conference of State Bank Supervisors and described in somewhat more detail in Part III of this report. We agree with the Conference that “Blockchain 2.0” activities that are not financial in nature should not be included by any charge to a ULC drafting committee. The Study Committee ambitiously urges drafting of uniform legislation for final approval no later than July 2016, if possible.

- Second, that the ULC’s charge to the drafting committee not include “mobile payments” or property-style regulation of virtual currencies, that is, as commodities or securities. The report also expresses a slight preference for the drafting committee’s charge to focus on regulating the rights and duties of participants in virtual currency transactions that involve payments, described below.

Behind the recommendations and preferences are several facts.

- (1) Virtual currency appears here to stay. As of October 11, 2014, 13,372,025 bitcoins were in circulation worth some \$4.76 billion. The number of users of bitcoin wallets is estimated to be 6.4 million in September 2014, and the merchants accepting bitcoins include Dell, Expedia, Overstock.com, Microsoft, and Virgin Atlantic. There are other virtual currencies such as Litecoin, Dogecoin and Peercoin, although not as well established. Ripple Labs operates a platform

for the trading of other virtual property interests, including trading of rewards points, and the like.

Virtual currencies are believed to be attractive to many consumers and an increasing number of merchants, do not require disclosure of sensitive information, cost less to use than legacy banking systems cost, appear to be more secure than use of credit or debit cards, and appeal to those who worry about the stability of the financial system. They are attractive to merchants because payments are final when made – that is, there are no card chargebacks, the risks of non-payment are small, their use reduces retailer security compliance overhead and risk of a data breach, and payments are either instantaneous or confirmed within minutes.

(2) The states are acting now. As reported earlier, New York is on its way to establish a significant regulatory scheme and California, North Carolina, Kansas and Texas are looking at amendments to their money services statutes. The Conference of State Bank Supervisors has just issued the report of its Virtual Currency Task Force that sets forth some “principles” to be used in regulating virtual currency intermediaries.<sup>1</sup> We provide some additional information on how to respond to the CSBS report, below. Because virtual currencies do not enjoy comparable statutory or regulatory underpinnings to other payments systems, the states are under pressure to act. The likelihood for non-uniform action can be seen from the developments in 2014.

(3) The “normal” ULC Procedures need to be sped up if the ULC is to play a role in this arena. The normal time for the ULC to develop an act is two years. That may put the ULC too late for this area. However, a sharper focus on the subject of the study and utilization of the past experience of the ULC could conceivably shorten the time needed for the drafting project, and therefore should be used. Timely action by the ULC can help ensure greater uniformity of approach from state to state.

That said, this report identifies issues that might be addressed and approaches that might be used to prepare a legislative text, and the pros and cons of various approaches rather than specifying conclusions – that latter task is a for a drafting committee. However, as noted in at least one instance, the report does indicate a preference. Because of the need for expeditious action, discussed infra, there has not been as much exploration of observer opinion as is desirable, but that, too, can be left to any drafting committee, and appropriately so under the circumstances.

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<sup>1</sup> Attachment 1 to this report contains the CSBS report and principles issued on December 16, 2014.

## II. Scope of the Proposed Drafting Committee Project

The Study Committee suggests, consistent with the observations expressed in conference calls of the committee, advisors, and observers that any drafting committee appointed should focus on creating a statutory background for the rights and duties of parties when virtual currency is a medium of payment because none now exists and the ULC has significant prior experience here.

There are a variety of reasons to focus for the immediate future on virtual currencies payments transactions alone. These include:

- **Mobile payments** as reasonably defined can be viewed as employing variations of existing payment methods that are subject to significant federal regulation at this time.<sup>2</sup> This is not to say that mobile payments may not need additional rules, particularly for transactions not covered by the federal consumer protection rules mentioned in footnote 2, mobile payments that are billed by mobile telecommunications carriers and collected as part of consumers' regular mobile services statements.

Among the types of problems that arise with mobile payments not covered by federal consumer protection laws at this time are third-party billing that is processed and collected by the carrier. The CFPB on December 17, 2014, filed suit against Sprint for billing third-party charges that allegedly were imposed without the consumer-customers' authorization.<sup>3</sup>

- Virtual currency lacks "legal tender" status that government-backed or "fiat" currencies enjoy. Its value depends on the market, and has been subject to price volatility. There are no clearly applicable legal rules for virtual currencies that relate to the rights and duties of parties to virtual currency transactions. For a helpful discussion of how Bitcoin and some other virtual currencies work, see Bitcoin, *How Bitcoin Works*, <https://bitcoin.org/en/how-it-works> (last visited Oct. 12, 2014). Essentially, Bitcoin allows people to send and receive payments online with an entirely decentralized peer-to-

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<sup>2</sup> Mobile payments often are executed in many cases via existing credit or debit card "rails," such as the systems operated by legacy credit card systems such as MasterCard, VISA, or Discover. Where the transaction is processed as a credit card, provisions of the federal Fair Credit Billing and Truth in Lending Acts apply. Where the processing is as a debit to an account maintained with a depository institution, provisions of the federal Electronic Fund Transfer Act apply. Moreover, there certainly are some federal and state legal rules for mobile payments and so any new legal rules present an additional issue of coordination with those rules. To the extent there may be some overlap with virtual currency, the existing rules for mobile payments will apply and the virtual currency rules that might also apply can be applied by courts in a manner that makes sense in a particular case, much as courts before UCC Article 2A was promulgated worked out a balance between Article 2 rules and common law rules in creating appropriate rules for leases. One intersection illustrating overlap is Squire, a mobile payments provider, is that building software that will accept bitcoins.

<sup>3</sup> Grant Gross, *US agency sues Sprint for alleged unauthorized charges*, NETWORKWORLD.COM (Dec. 17, 2014 9:50 PT), <http://www.networkworld.com/article/2860774/us-agency-sues-sprint-for-alleged-unauthorized-charges.html> (last visited Dec. 17, 2014). The complaint from the CFPB mirrors complaints made by the U.S. Federal Communications Commission, the Federal Trade Commission and 51 state-level governments against AT&T earlier this year. In October, AT&T agreed to pay US \$105 million to settle those complaints of similar unauthorized third-party charges.

peer network. Bitcoins are generated by an open-source software program at a controlled rate and transmitted to a network of volunteer bitcoin “miners,” who perform complex calculations to solve cryptographic puzzles. Bitcoins are stored in anonymous digital wallets and each bitcoin purchaser has a unique bitcoin address that can be used to exchange bitcoins with other users and merchants. A publicly visible ledger – known as a “block chain” is the method by which transfers of ownership of virtual currencies take place, and also by which the number of virtual currencies units that are assigned to any address can be seen. Bitcoin’s explanation of the block chain is that it is

“a **shared public ledger** on which the entire Bitcoin network relies. All confirmed transactions are included in the block chain. This way, Bitcoin wallets can calculate their spendable balance and new transactions can be verified to be spending bitcoins that are actually owned by the spender. The integrity and the chronological order of the block chain are enforced with cryptography.”

Bitcoins also can be stored with intermediaries, called “exchanges.” Exchanges pose insolvency and security risks and many of the same types of transaction-execution concerns that drove the decision to regulate wholesale funds transfers in U.C.C. Article 4A and consumer funds transfers in the federal Electronic Fund Transfer Act more than 30 years ago.

Other participants in the virtual currency industry operate, for example, ATMs at which individuals can purchase Bitcoins for cash or serve as payments processors for merchants. For example, Coinbase is operating 1.7 million consumer wallets and has 36,000 merchant customers, does not charge fees to convert Bitcoin to local currencies for merchants up to \$1 million, and only imposes transaction fees for transactions exceeding \$1 million. Merchants receive payments into their bank accounts faster than they receive settlements under legacy payments systems.

Virtual currencies could be regulated for other purposes than underlying a new payment system. Virtual currencies also can be seen as stores of value or as commodities. Transfers of stored value are regulated for some purposes. Transfers of commodities are regulated for certain purposes, and if the transfer is a “sale” then UCC Article 2 could apply. Virtual currency also has been characterized as “property” by the IRS,<sup>4</sup> leading to the thought it could be so treated for other purposes. The most obvious possibilities for action by the States would involve (1) UCC Articles 2, 8<sup>5</sup> and 9<sup>6</sup>, (2) blue sky laws, and (3) unclaimed property acts. Aside from the fact the ULC has a process or basis for further study in these areas, for a drafting committee to consider the possible applications of virtual currency as “property” rather than only as a means of

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<sup>4</sup> *IRS Virtual Currency Guidance: Virtual Currency is Treated as Property for U.S. Federal Tax Purposes; General Rules for Property Transactions Apply*, IR-2014-36 (Mar. 25, 2014) available at <http://www.irs.gov/uac/Newsroom/IRS-Virtual-Currency-Guidance>.

<sup>5</sup> Bitcoins could be treated as “commodities” and the commercial wallets and exchanges holding them for customers could be seen as commodities accounts. The Commodities Futures Trading Commission held a hearing on virtual currencies on October 9, 2014. The meeting notably coincided with the execution of the first CFTC-approved bitcoin swap, conducted by TeraExchange, a swap-execution facility whose Bitcoin-derivative offering was vetted by the CFTC.

<sup>6</sup> If Bitcoins are exchanged for goods, UCC Article 2 may be applicable. Bitcoins as property could be a type of collateral under UCC Article 9.

transferring value or otherwise effecting payments, would unnecessarily complicate its progress, and slows it considerably.

Accordingly, the Study Committee does not recommend consideration of mobile payments in the drafting committee's charge, because (1) so many mobile payments are regulated at the federal level at this time, and (2) the issues surrounding mobile payments and virtual currency payments are not similar. And, it does not recommend that the ULC authorize a drafting committee to pursue these other potential uses of virtual currencies or other means of regulating them, as described above.

### **III. Possible Approaches for Drafting**

States are moving with respect to possible aspects of the scope proposed for the ULC effort. So far, state action has taken two forms – treating virtual currency transactions and market participants as “money services” or “money transmission” under existing state laws, or proposing a new regulatory scheme that is broader than current state “money services” laws and regulations provide. Several like North Carolina are treating it under their Money Services Acts (or Money Transmitter Acts). The first approach focuses on licensure and “safety and soundness,” but leaves much unaddressed, including the rights and duties of the parties to a transaction. The approach being considered in New York and perhaps California is broadly regulatory, including licensing, safety and soundness, and other provisions. While such an approach may inspire confidence in parties dealing in virtual currency, it also may be exclusionary due to regulatory burden, and may suppress innovation. However, as reported in the Friday, December 19, 2014, Wall Street Journal at page C3, New York has significantly modified and softened by scaling back requirements its Bitcoin proposal based on comments the initial proposal could significantly harm innovation and constitute an undue burden for smaller startups and software developers working with virtual currencies. A third approach could be denominated the “commercial law” approach, which primarily could track perhaps the UCC Article 4A model defining participant rights and duties for the new payment system.

The Conference of State Bank Supervisors (CSBS) has a task force working on a set of principles for virtual currency transactions, which, as mentioned above, they announced on December 16, 2014. The CSBS expects to finalize these principles during the second quarter of 2015 and to influence legislation in a number of states. The drafting committee will want to consider whether and how to incorporate the CSBS principles into any ULC legislation to the extent consistent or adaptable to the charge and instructions to any drafting committee. As we indicated in note 1, above, the CSBS proposed principles – which were published for comment through February 15, 2015, are somewhat more regulatory than we had anticipated, but we would expect that, for example, coverage of “consumer protection” could be handled in the ULC drafting committee's work as part of the “commercial law” approach the Study Committee prefers. Moreover, the drafting committee could work on a more regulatory option for states that desired that level of legislation, or the study committee's preference could be replaced by a more regulatory approach like that the CSBS proposes when the drafting committee is charged.

Subject to all the foregoing observations, the Study Committee expresses, given timing and ULC prior experience, a slight preference is to begin with a commercial law approach.

However it should not necessarily end there. To illustrate, UCC Article 4A uses the banking system to transfer value in payment, and that system, unlike virtual currency, is regulated. Thus, some safety and soundness concept should be considered, perhaps a conforming amendment to the Uniform Money Services Act and suggested language for other such acts, so a regulatory agency could be given examination powers to assure compliance. Perhaps also a minimal licensing structure recognizable by other states – such as a “passport” arrangement or a program using the NMLS licensing approvals service – could be considered.

#### IV. Particular Issues for a Drafting Committee to Consider

The European Banking Authority issued a report in July 2014 that identified more than 70 risk factors involving virtual currency,<sup>7</sup> which should be examined to determine whether and how they may be addressed. The report uses the following definition of “virtual currencies”:

[Virtual currencies] are a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a [fiat currency], but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically. The main actors are users, exchanges, trade platforms, inventors, and e-Wallet providers.<sup>8</sup>

Among the risk factors are the types of concerns with which U.C.C. Article 4A and the federal Electronic Fund Transfer Act deal. The report suggests that additional study needs to be undertaken in the European Union towards possible regulation of virtual currency market participants., but also observes that many valued features of virtual currencies offer no particular advantage within the European Union because of existing regulatory framework for intra-EU payments, and mentions numerous regulatory obstacles to be overcome if regulation is to proceed.<sup>9</sup>

In addition, as is customary with defining rights and duties of participants in transactions, especially where consumers may be involved, the Study Committee assumes that the Drafting Committee would consider some disclosures about risks so they may be avoided. A separate question exists about whether that goes far enough or whether there should be limits on agreements and practices, and, if so, what they should be.

Jurisdiction over transactions should be addressed, and has been a serious issue in comments and scholarly coverage of New York’s BitLicense proposal. The fact that these transactions are not confined to the U.S. raises what can be done with regard to “protection” of U.S. citizens and what jurisdictional hold a state may have when aspects of the transaction are out of state or off-shore, or neither the consumer nor the provider is otherwise subject to the jurisdiction of a particular state. One possible way to address this might use jurisdiction if a virtual currency regulated participant does business in the state no matter where its customers are. And, much like foreign banks operating inside the United States, foreign virtual currency

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<sup>7</sup> *Opinion of the European Banking Authority on ‘Virtual Currencies,’* 2014 EBA/Op/2014/08 21-36, 38.

<sup>8</sup> *Id.* at 5.

<sup>9</sup> *Id.*

market participants who engage in transactions here may need to select a “home” in the United States for regulatory purposes.

Given the subject is new and the hope for enactment is in all or most of the 53 ULC jurisdictions, another issue is how can the necessary flexibility be maintained so as not to freeze development of products and not degrade uniformity as different states react to new developments differently? Will an approach to allow regulations to vary the statute as in the Truth in Lending Act, and in §6.104 of the Uniform Consumer Credit Code, or, as an alternative approach, the model filing regulation in relation to U.C.C. Article 9, work?

There no doubt will be federal activity as well. How should the relationship with developing federal law be handled? If preemption, can the detail of preemption be worked out with the federal level, or is a U.C.C. §4A-108 approach feasible? Should the federal activity be a floor, allowing the states to go further? Can we encourage state enactment with a rule that if the state acts within federal rules, its law will apply and not the federal?

Finally, what other commercial law type provisions might be included, such as a choice of law, variation by agreement, role of course of dealing or performance and usage of trade, a UCC §1-103 type provision on supplementary law and policies, notice, good faith, etc.

## V. Conclusion

The Study Committee’s sense is that the “commercial law” approach could add value and consistency to the current groundswell of regulatory activity surrounding virtual currencies generally, and with respect to the various market participants who are handling virtual currencies on behalf of others either as vaults or as transaction executors. The Study Committee tentatively is of the opinion that the ULC should pursue some regulation of virtual currencies but not beyond a balance that will enhance opportunities for widespread adoptions of virtual currencies and for additional innovations in the payments space by companies currently working on virtual currency products and applications across state borders.

We would like to thank the Advisors appointed by the American Bar Association, Richard Field, Stephen T. Middlebrook, Peter Winship, Damier Xandrine, and Michael Hawes, and numerous Observers who have offered valuable perspective and specific comments. We were especially pleased to have had representatives from the Conference of State Bank Supervisors participate in the Study Committee’s work. We would be remiss if we failed to mention the gracious offer from Professor William Covington of the University of Washington’s School of Law to provide research support to the ULC as its work on virtual currencies continues. We also commend and thank the entire ULC staff assigned to this Study Committee for their terrific support of the Study Committee’s work.



## **Draft Framework**

State financial regulatory regimes applying to virtual currency activities should include:

1. **Licensing Requirements** – State licensing requirements for entities engaged in virtual currency activities must include:
  - a. Credentialing of business entity owners, directors, and key personnel
  - b. Details on the banking arrangements of the business entity
2. **Use of Licensing Systems** – In order to efficiently and effectively process and evaluate license applications, it is important for states to have a robust licensing system in place. A critical piece of such a system is the ability of states to share licensing and enforcement data in real time.
3. **Financial Strength and Stability**
  - a. Net worth or capital requirements, with flexibility for Commissioner to set requirements based on activities and volume
  - b. Permissible investments
  - c. Information on method of calculating value of virtual currency
  - d. Surety bond requirement, with flexibility for Commissioner to determine amount based on business model and activity levels, not number of locations
  - e. Policies, procedures, and documentation for disaster recovery and emergency preparedness plans
4. **Consumer Protection**
  - a. Required consumer protection policies and documentation of such policies
  - b. Holding an actual amount of virtual currency in trust for customers and ensuring that amount is identifiable separately from any other customer or virtual currency business entity holdings
  - c. Required policies and documentation of complaints and error resolution
  - d. Required receipt to consumers with disclosures regarding exchange rates
  - e. Required disclosures to consumers about risks that are particular to virtual currency
  - f. Required disclosure of virtual currency insurance coverage, which at a minimum includes notice that virtual currency is not insured or otherwise guaranteed against loss by any governmental agency
  - g. Public disclosure of licensing information and agency contact information
5. **Cyber Security**
  - a. Required cyber security program and policies and procedures
  - b. Customer notification and reporting requirements for cyber security events



- c. Third party cyber security audit, with flexibility for Commissioner to determine the appropriate level of the audit based on business model and activity levels
- 6. Compliance and Bank Secrecy Act/Anti-Money Laundering
  - a. Required implementation and compliance with BSA/AML policies, including documentation of such policies
  - b. Required compliance with applicable federal BSA/AML laws and recognition of state examination and enforcement authority of BSA/AML laws
  - c. Verification of accountholder identity
- 7. Books and Records
  - a. Required access to books and records by regulatory authorities
  - b. Commissioner to determine form and format of books and records production
  - c. Compliance with federal requirements (including Electronic Funds Transfer Act and Bank Secrecy Act)
  - d. Audited financial statements consistent with generally accepted accounting principles ("GAAP") as recognized in the United States, with flexibility for Commissioner with regard to compliance timeline
  - e. Transaction volume
  - f. Transaction-level data, including, but not limited to:
    - i. Names, addresses, and IP addresses of parties to transaction
    - ii. Identifiable information of virtual currency owner
    - iii. Transaction confirmation
    - iv. For foreign transactions, country of destination
  - g. Agent lists and information regarding agents' compliance with applicable state and federal laws and rules
  - h. Commissioner to have authority to require periodic reports of condition and to determine frequency and information to be contained therein
  - i. Applicability of state escheatment laws
- 8. Supervision
  - a. Facilitating and supporting regulatory cooperation and information sharing with other state and federal regulators
    - i. Authority to consult and coordinate
    - ii. Authority to conduct joint or concurrent examinations
    - iii. Authority to use and adopt reports of examination prepared by other state and federal regulators
    - iv. Preserving confidentiality of regulatory information by exempting regulatory information from state public records disclosure laws
  - b. Investigative subpoena authority
  - c. Authority to initiate enforcement actions, including:
    - i. Formal or informal actions



- ii. Removal of officers and directors
- iii. Impose civil money penalties
- iv. Authority to take control
- v. Authority to appoint a receiver