To: ULC Drafting Committee for the Uniform Regulation of Virtual Currency Businesses Act, Chairman Miller, ABA and ALI Advisors, and Observers

From: Sarah Jane Hughes, Reporter

Date: March 22, 2016

Re: Issues for Resolution at the Meeting on April 2-3, 2016, in Chicago

This memorandum reflects on the notes I took during the Palo Alto meeting, comments received in written form in the 10-day window announced at the Palo Alto meeting, a small number of conversations outside the meeting room in Palo Alto or subsequent to it, and more recent developments.

One of our most important responsibilities and daunting challenges is to prepare to regulate an evolving industry.

It is important to keep in mind the charge to the Drafting Committee, which was to frame the business activities that State legislation addressing licensure, prudential-lite regulation, and user protection issues primarily should cover with the reference point being contemporary money transmitter/ money services businesses licensure and regulation. If we stray too far from the charges from the ULC's leadership, we may put enactability at risk.

This memorandum does not work line for line through all of the comments received on each issue it addresses. (They were so helpful.) This is more a summary on issues that were particularly hot in Palo Alto, issues on which there seemed to be consensus, and issues on which the post-meeting written and oral comments suggest there is more work to do.

My personal position is that state licensure statutes do not need to replicate requirements that exist in other federal or state statutory or regulatory regimes. It may be very desirable, however, to mention the others in commentary so that there is, as of the time of enactment, one location for prospective license applicants to see the range of law that will govern the product or service being licensed.

This memorandum covers six high-level issues. Some of these issues have sub-parts.

Issue 1: The scope of the project – Section 102, key definitions in Section 103 ("virtual currency" and "virtual currency business activity" and more), and Section 104. Given the attention that these issues received in Palo Alto, it is no surprise that we received additional comments on them.

The Palo Alto meeting produced what appears to be a consensus that the term "virtual currency business activity" should be framed with reference to a small number of active verbs that describe activities that traditional providers of money transmission and safe storage of assets and that rotate around the types of risks to users that exchanges, money transfers, and asset storage may present. This consensus suggests that the "scope" provision, section 102, should read something like this going forward:

> **Section 102. Scope.** This [act] governs the operation of a business, wherever located, that engages in virtual currency business activity, as defined in this [act], with a resident of this [State or jurisdiction] or that involves the property of a resident of this [State or jurisdiction].

This has the benefit of avoiding an overly broad scope for the URVCBA, which had troubled Stakeholders. *E.g.,* Dax Hansen's February 18, 2016, email to me, at 2 (previously distributed to those attending the Palo Alto meeting), explaining concerns about including references to "facilitating" or "assisting" in virtual currency business activities). It does raise questions, described in a later section of this memorandum about the licensure of "agents" as is common in money service business and money transmitter statutes.

However, comments since Palo Alto reflect divergent opinions on four central issues – (1) the definition of "virtual currency," (2) the definition of "virtual currency business activity," (3) the scope of coverage of "multi-sig" providers or entities that only hold back-up credentials should have under this act, most probably in the definition of "virtual currency business activity," and (4) whether to make the definition of VCBA as clear as we can or to allow it to depend on facts and circumstances. For the strongest case for allowing a "totality of the facts and circumstances" approach to the VBCA determinations, see Anne Shere Wallwork's February 29, 2016, comment filed on behalf of Treasury's Office of Terrorist Financing and Financial Crimes, at 1. Carol Van Clef urged a "facts and circumstances" approach in Palo Alto.

Question 1: What definition of "Virtual Currency" will the Drafting Committee adopt? The definition of the term "virtual currency" used for the February meeting was built on (1) FinCEN's guidance regarding its MSB regulations in March, 2013, and additional guidance FinCEN published through August 2015, (2) the definition suggested in the Conference of State Bank Supervisors' (CSBS) September 2015 Framework, and (3) the BitLicense regulation adopted in June 2015.

Moving forward, this definition presents two issues for more discussion – which model to use for the next draft, and which exclusions from the definition make the most sense to the Drafting Committee.

A. Which base line definition should the ULC draft use?

At the Palo Alto meeting, Anne argued forcefully for reliance on the relatively short, and therefore appealing, baseline definition adopted by the Financial Action Task Force ("FATF"). That definition reads:

> Virtual currency is a digital representation of value that can be digitally traded and functions as (1) a medium of exchange; and/or (2) a unit of account; and/or (3) a store of value, but does not have legal tender status (i.e., when tendered to a creditor, is a valid and legal offer of payment) in any jurisdiction.

FATF, *Virtual Currencies Key Definitions and Potential AML/CFT Risks* at 4 (June 2014) (footnotes omitted).

In comparing the FATF definition with the September 2015 CSBS Framework's definition, I have two observations: (1) the CSBS definition has effectively been approved by state banking agencies, and (2) the CSBS definition resolves a problem that was raised in Palo Alto that the FATF definition does not. That problem arises because of the news that the government of Estonia has declared bitcoins to be "legal tender." We then learned that the Diet in Japan may make a similar decision later this year.

The CSBS definition reads:

> Virtual Currency is a digital representation of value used as a medium of exchange, a unit of account, or a store of value, but does not have legal tender status as recognized by the United States Government. Virtual Currency does not include the software or protocols governing the transfer of the digital representation of value. Virtual Currency does not include stored value redeemable exclusively in goods or services limited to transactions involving a defined merchant, such as a rewards program.

CBSS, State Regulatory Requirements for Virtual Currency Activities/ CSBS Model Regulatory Framework, at 2 (Sept. 15, 2015).

Thus, the CSBS definition has sidestepped the problem that bitcoins are no longer not "legal tender in any jurisdiction." Thus, the CSBS definition avoids complications for virtual currency business and innovators and for state regulators by limiting the definition to virtual currencies not recognized by the government of the United States. As you see, the CSBS definition shares many important features of the FATF definition of which FATF and the U.S. Treasury representatives, including Anne herself, I surmise, should be proud, but it avoids the loophole that the FATF definition suddenly contains.

I recommend that the revised definition of the term "virtual currency" closely follow the CSBS model. State regulators should not have to track what is happening in terms of recognition of any virtual currency other than recognition by the United States of one or more virtual currencies as legal tender here. Thus, the CSBS limitation that "legal tender" is what the United States Government deems it to be, not what some other national government or tribe deems it to be, seems like the most practical and enactable option. A definition based on what is legal tender in the United States also helps virtual currency businesses plan.

The Drafting Committee must settle the definition of "virtual currency" at the April meeting because the Drafting Committee on abandoned property has signaled it will use for its definition whatever definition this Committee decides to use.

B. What exclusions are appropriate?

We have to consider additional requests for **exclusions** from the definition urged by Observers and others, such as the Entertainment Software Association submitted. Some of these can be left to the definition of "virtual currency business activity" or included among the Exemptions provided in section 104 of the draft.

The definition of the "virtual currency" discussed at the February meeting had numerous carve-outs that were drawn from the same three sources as mentioned in the introduction to this section, above. There are two ways to approach exclusions. The first is to include them as the February draft shows and the second is to carve them out of the definition of "virtual currency business activity." Reflecting on our Palo Alto conversations, I recommend we do some of each.

The Entertainment Software Association proposed, in its February 19, 2016, letter to the Drafting Committee and Chairman Miller that the following be excluded from the definition of the term "virtual currency":

- Digital units under in online gaming platforms, to the extent that the units are for purposes of advancing game play or enjoying other entertainment experiences with a closed universe of a particular game.

- Digital units redeemed for tangible goods, only to the extent that the goods are small-dollar-value items of no worth from a money-laundering perspective such as a game-branded tee shirt.

- Digital, in-game units exchanged by a gamer for "another or platform-level currency for in-game points unless they can be converted into convertible virtual currencies outside of the game(s) or platform(s) from which the original digital units were received.

- Digital units used within the same online gaming platform (e.g., a movie rental or game console) to purchase intangible goods or services and only to the extent that the exchange or purchase is used within the same closed universe of gaming.

These proposals make sense to me for the reasons proffered by the ESA: they do not appear to have a sufficient relationship "to moving money in the real world" to qualify as "money transmission" or storage. ESA, February 19, 2016, at 1. To bring the second into the URVCBA, we should set a dollar limit for each item and separately for all items within a set period of time. Otherwise, a market for these items could emerge as a means of moving real money in the real world, as the recent Department of Homeland Security seizure of Amazon gift card credits shows. Otherwise, unless instructed otherwise, these carve-outs will go into the definitions.

Question 2: Which Definition of "Virtual Currency Business Activity" Should the Drafting Committee Adopt? Like the definition of "virtual currency," the definition of "virtual currency business activity" needs to be decided so that scope, the on-ramp, and many other issues we discussed in Palo Alto can be settled in time for the submission to the Style Committee at its late April meeting and submission to the Commissioners by the June 1 deadline.

At the suggestion of several Observers, the Drafting Committee seemed inclined to adopt the verbs "exchange," "transfer" (with or without modifiers), and "deposit" or "store" to frame the types of activities that would fall under the definition of the term "virtual currency business activity." These terms, as CoinCenter's comment points out, have established meaning in traditional financial services parlance that are perhaps less perfect as analogies to the nature of activities in the virtual currency community today. (CoinCenter Letter, at 1, 2/26/2016). In the "money transmission" regimes, "exchange" and "transfer" are common and well understood. The term "deposit" connotes deposits of money, securities, or tangible items so the Drafting Committee may decide not to use it. I will focus on "exchange, transfer, and store" as the operative concepts with which every participant seemed the most comfortable in Palo Alto.

CoinCenter took these three verbs into hand and has recommend that the Drafting Committee discuss defining the key concepts in terms of "custody" and "control" that are central to the types of relationships that virtual currency businesses have with customers. Anne also recommended that additional terms be defined to make the definition of "virtual currency business activity" more robust and in sync with her Office's views. A third source of comments – from the Entertainment Software Association – was received during the Palo Alto meeting and distributed in paper form there, but not

discussed with particularity. The fourth source comes courtesy of Dax Hansen. (Dax Hansen, February 18, 2016, comments on the February 2016 draft.)

CoinCenter's recommended definitions are defined and explained at 1-2 of the February 26, 2016, memorandum to the Drafting Committee:

> **Custody of Virtual Currency** means maintaining an account to which virtual currency is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to the use and benefits of that virtual currency. A business has custody of virtual currency when it:
>
> (1) indicates by book entry that an amount of virtual currency has been credited to a user's virtual currency account;
> (2) receives control of virtual currency from the user or acquires control of virtual currency on behalf of the user and, in either case, accepts this control for credit to the person's virtual currency account; or
> (3) becomes obligated under other law, regulation or rule to credit virtual currency to the person's virtual currency account.

CoinCenter observes that the comparable U.C.C. Article 8 definition triggers a custodial arrangement when the custodian "'receives a financial asset from the person or acquires a financial asset for the person.' The act of 'receiving' virtual currency is not intuitive and it is not easy to define."

CoinCenter, thus, proposes in light of the discussions in Palo Alto a definition of the term "Control" as the second-prong of its proposed definition of the "exchange, transfer, and store" trio of verbs we discussed.

> **Control of Virtual Currency** means possession of sufficient virtual currency credentials or authority on a virtual currency network to unilaterally execute or prevent virtual currency transactions on the virtual currency network.

"Control" … fundamentally means having sufficient credentials to have the *ability* to unilaterally execute or prevent transactions on the virtual currency network." (CoinCenter, February 26, 2016, at 2.) CoinCenter further explained that the addition of "or authority on a virtual currency network" phrase is designed to cover centralized virtual currency administrators. *Id.*

CoinCenter also explains, *Id., at 3,* why it considers the word "unilaterally" to be so important to this definition and to clarity in the definitions leading to the definition of "virtual currency business activity." Please note that Anne Wallwork has expressed concerns that the limitation to use cases in which the person with Control has a unilateral ability to execute or prevent transactions on someone else's behalf. However, my recommendation is that because the unilateral power is necessary to manage the low-risk "multi-sig" recovery services that CoinCenter describes at 3, and that Treasury has authority to capture use cases that raise AML/CFT concerns on its own, and that the URVCBA should be aimed at issues normally in the States' control, this Drafting Committee should focus on use cases that model "money transmission" as it has been regulated by the states. In a subsequent exchange with Peter Van Valkenburgh, he agreed to humor your Reporter and un-split the infinitive so that the resulting definition would read:

> **Control of Virtual Currency** means possession of sufficient virtual currency credentials or authority on a virtual currency network to execute or prevent transactions unilaterally on a virtual currency network.

In thinking about these issues, the keys are common in money transmission and trust company operations – solvency, user protections, and sufficient capital to operate and wind down. CoinCenter's February 26, 2016, memo, at 3, explains its position more fully.

Coin Center also proposes four simple follow-on definitions for consideration:

> **Virtual Currency Transfer** means assuming custody or control of virtual currency from or on behalf of a user and either crediting that virtual currency to the account of another user or relinquishing control to another user or person.
>
> **Virtual Currency Storage means maintaining custody or control of virtual currency on behalf of a user or person.**
>
> **Virtual Currency Exchange** means the exchange of virtual currency for money or for other virtual currency when the exchanger, as least momentarily, has custody or control of the virtual currency being exchanged.

I recommend changing the "Virtual Currency Exchange" to avoid the redundant use of the noun "exchange." On March 19, 2016, I had numerous communications with Peter about this portion of CoinCenter's recommendations and he has proffered a revised definition that it would read:

> **Virtual Currency Exchange** means assuming custody or control of virtual currency on behalf of a user or person in return for money or other virtual currency, and then either relinquishing control to that user or person (Virtual Currency Transfer), or maintaining custody or control on behalf of that user or person (Virtual Currency Storage).

CoinCenter proposed, at 4, two exclusions on which the participants in the Palo Alto meeting did not agree. However, if the Drafting Committee accepts the definitions of "Virtual Currency Custody" and "Virtual Currency Control" proposed above, the first of the two CoinCenter exclusions is not unnecessary. The second – "possessing, for a reasonably time-limited period, virtual currency credentials sufficient to prevent virtual currency transactions in order to provide a service such as escrow or transaction management" – was discussed in Palo Alto, but not decided upon. Ms. Robinson is circulating the final response from Peter to me in this "conversation," which is dated March 19, 2016.

It is only fair to remind the group that Anne Wallwork has expressed opposition to approaches that exclude this type of "escrow" service on prospective AML grounds. I note that escrow services are common in everyday life and often provided by persons who may have AML/BSA compliance responsibilities independent of State money transmitter laws or federal guidance on "money transmission" from 2011 to date. It seems a mistake not to allow for such services without requiring licensure because in everyday life escrow agents may not require licensure, or to impose double responsibilities on them in the virtual currency space. This is a subject that should be discussed again in Chicago. Please review the discussion by CoinCenter on the micro-transaction escrows the bottom of page 4 of CoinCenter's February 26, 2016 memo to the group and the March 19, 2016, email to me from Peter.

The definition of "Virtual Currency Business Activity" proposed by CoinCenter in the February 26, 2016, memorandum to the group employs a second sentence that requires additional attention from the Drafting Committee based on our Palo Alto conversations.

> **Virtual Currency Business Activity** means engaging as a business in virtual currency transfer, storage, or exchange. The term does not include (i) contributing connectivity, software, or computing power to a decentralized virtual currency network; (ii) possessing, for a specifically time-limited period, virtual currency credentials sufficient to prevent virtual currency transactions in order to provide a service such as an escrow; (iii) obtaining virtual currency solely to purchase goods or services for personal, family, or household purposes or to purchase inventory or equipment; (iv) receiving virtual currency from the purchase or sale of goods or services; or (vi) obtaining virtual currency for investment purposes.

Please note that I have edited Peter's suggested language to escrow arrangements he had in his third exclusion, and that I have omitted "transaction management" because it is too open-ended a concept not to require more attention from the Drafting Committee. Specifically, see Peter's explanation at the bottom of page 4 of the prospect of return of full control to the user of the micro-transaction channel even if the participant disappears or attempts to halt the refund. This needs more discussion in my view. Peter argues forcefully that it is premature to regulate these activities and observes that regulation now might chill important research and development in this field. That is a concern I take seriously. This needs discussion in Chicago as well.

A. Should "agents" be excluded from licensure?

A final topic in CoinCenter's February 26, 2016, memorandum raises a question the Drafting Committee has not discussed much – that of service providers ("vendors") who are not customer-facing entities, because they perform services for virtual-currency businesses and persons who are customer-facing, and would need licenses to operate. CoinCenter favors an approach that requires only the customer-facing entity to be licensed, although it admits that both perform functions, respectively, that would qualify as "custody" for the customer-facing entity and "control: for the other, and because the customer-facing entity is assuming the risk. (CoinCenter memo at 5.) The larger question of requiring "agents" to be licensed should be discussed in Chicago.

Also note that CoinCenter has proposed two additional definitions to frame its view of where risk activities of a customer-facing variety arise. They are:

> **Virtual Currency Control Services Vendor** means a person who has control of virtual currency pursuant only to an agreement or agreements with a person or persons who assumes virtual currency custody on behalf of another.

This definition, CoinCenter maintains, should be the basis for a full exemption from the draft in Section 104. I think the CoinCenter definition needs to be narrowed to eliminate the prospect of multiple control services vendors getting exempt at this time.

The second of the definitions CoinCenter proposed is:

> **Virtual Currency Administration** means issuing a virtual currency and having authority to redeem the currency or withdraw the currency from circulation.

CoinCenter explains its reasoning behind this proposed definition in the February 26, 2016, memorandum at 6.

B. . *Exclusions already in the draft and discussed -- Dealers in foreign exchange*

FinCEN previously adopted a carve-out from the definition of "money services businesses" for "dealers in foreign exchange" that FInCEN has previously adopted.[1] As MSBs they are:

> … generally required to: (1) Establish written AML programs that are reasonably designed to prevent the MSB from being used to facilitate money laundering and the financing of terrorist activities; (2) file Currency Transaction Reports (''CTRs'') and Suspicious Activity Reports (''SARs''); and (3) maintain certain records, including those relating to the purchase of certain monetary instruments with currency, transactions by currency dealers or exchangers (to be called ''dealers in foreign exchange'' under this rulemaking), and certain transmittals of funds. Most types of MSBs are required to register with FinCEN and all are subject to examination for BSA compliance by the Internal Revenue Service (''IRS''). 76 Fed. Reg. 43585 (July 21, 2011).

To the extent that FinCEN has published virtual-currency specific guidance that takes persons out of the definition of "money services businesses," I recommend that the Drafting Committee continue to follow that guidance. The February draft incorporated FinCEN's guidance into the definitions of "virtual currency" and "virtual currency business activity."

One of the larger issues relating to the scope of the URVCBA is whether to require **trust companies** to obtain special licenses to operate in the virtual-currency space. In this respect, much depends on existing state laws and powers of State regulators. Matt Lambert favored the Drafting Committee with materials about how CSBS assists States in managing trust companies and copies of specific state requirements for interstate operations. He explained that the States do not favor exempting trust companies generally from State regulation as "money transmitters," which I assume tilts towards no exclusion for trust companies in the URVCBA. Dax Hansen urged exclusion of trust companies in his February 18, 2016, email to me, at 2 (Definition of "Bank" in § 103(2)).

Chairman Miller suggested that trust companies could be covered unless, as determined by the head of the State's agency licensing VCB's, the trust company's existing charter regulates their activities in a manner substantially similar to the URVCBA. Dana Syracuse described a somewhat different issue to be discussed: that NYS took the position that the activities of itBit,

[1] A separate issue arises if a virtual currency becomes "legal tender." If it is, then it becomes harder to say that it is not "foreign exchange." And, I think harder to say that it is "property" for many purposes rather than "currency" with the different treatment of those terms for taxation and, since the February meeting, for purposes of the "fraudulent transfers" provisions of the federal Bankruptcy Code, 11 U.S.C. § 550. On the latter question, see In re Hashfast Technologies, Inc. (N.D.Calif. February 23, 2016) (deeming BTC "property" for the purposes of a clawback with the result that the recipient may be required to return more than $1 million to the bankrupt's estate given the rise in value of the BTC he received for a testimonial from the petitioner). The ruling was from the bench and I will forward the opinion to the group when the judge's opinion becomes available. Of course, when traded as a commodity, the CFTC's position that virtual currency is a commodity would still be correct.

the trust company it chartered last May, all took place inside NYS. So, the issue of the location of certain activities and the knotty problems of jurisdiction will continue to require discussion at the Chicago meeting. I gather from Matt Lambert's comments that most States have not adopted NYS' position on this question.

Question 3: How to handle "Multi-Sig" use cases as virtual currency business activity. There are at present six use cases for multi-sig virtual currency activity. On March 5th, I asked Observers to provide explanations of these use cases and commentary on which, if any or all, of the various articles of the Draft should apply to each use case in advance of or at the Chicago meeting. At the April meeting, the Drafting Committee should decide which of the use cases require which portions of the regulatory scheme that the Draft Act should require. I expect that the Drafting Committee will receive either a video or power point presentation that would help the Drafting Committee review the divergent positions on multi-sig we heard at the February meeting and in comments from Anne and CoinCenter since it. We should set aside a 30-minute slot on the agenda to discuss multi-sig use cases and questions the Drafting Committee may have after reviewing the presentation on multi-sig that may be circulated in the next few days.

Chairman Miller and I are circulating a power point presentation on multi-sig use cases prepared by CoinCenter at my request. He and I plan to allocate time for discussion of any questions the Drafting Committee may have during the Chicago session. We urge Commissioners to come with their questions ready, or even to send them in advance if possible, because we are not able to allocate time in Chicago to present the power point.

Question 4: Should the URVCBA include *de minimis* exclusions other than those discussed in Palo Alto? As explained above, the ESA argued for an additional exception to the definition of "virtual currency." Entertainment Software Association's February 19, 2016, comment, at 1. The exclusion would cover digital units that may be redeemed for "real world" tangible goods of "small dollar value of no worth from a money laundering standpoint (e.g., a branded t-shirt)." The next draft will show such an exception with a specified dollar limit for discussion.

Issue 2: Capital requirements. The Drafting Committee requested more information about ways to approach capital requirements that reflected the marketplace and offered suitable levels of capital for ongoing responsibilities and winding down of a VCB's affairs. Here are ideas gathered since the meeting in Palo Alto and most of the best of these, particularly the use of the Basel III analogies, came from a conversation I had with Dana Syracuse subsequent to the meeting as the Commissioners seemed comfortable with his offer to think about the structure for capital requirements:

The "traditional" money transmission/money services licensing statutes and regulations have focused on licensees posting surety bonds in the range of $500,000 or more, having capital in specified amounts maintained in prescribed types of permissible investments, and in some jurisdictions, making contributions to a state insurance fund in amounts that vary and often range from 2% of volume or require a fixed contribution such as $100,000 or more.

For virtual currency businesses, the surety bond requirements are non-starters: they are mostly unavailable to start-up VCBs. So, we need to take a different approach.

Dana has suggested that we look at a Basel III approach to capital: separate the capital required to cover "custodial relationships" as assets under management for which Basel III would require capital of 6.5%, and add 4% for winding-down costs as the baseline. A separate figure of 2% of average amounts transmitted over a fixed period of time (TBD) would cover the transmittal aspects of the business.

Dana identified two different lines of business – hot wallets and trusts for which he added a different calculus might be required:

▪ For trusts, the NYS DFS approach for trusts is to require 21% of assets under management or $10 million, whichever is less, at least until DFS was more comfortable with the entity and then might lower the requirements.

▪ For hot wallets, there is no fixed approach. A Basel III style approach could be taken, as suggested above, or he and I came to the realization that a carrot-and-stick approach could be developed under which a company that offered a hot wallet option might be able to hold up to a fixed dollar equivalent of VCs without having separate capital for the hot wallet assets, and to follow the assets under management approach for any amount that exceeded the fixed dollar threshold or for all assets under management if the threshold were exceeded by assets held in a hot wallet. This could allow each VCB to decide whether to grow its own business in the direction of hot wallets or not.

Additionally, it will help entities planning to apply for licenses and regulators preparing to receive license applications to have a listing of how applicants should structure their thinking about capital. Consistent with the charge to craft a "prudential lite" approach (as Commissioner Ramasastry mentioned again at the February meeting), the Drafting Committee heard comments from Observers that the start-ups and other innovators in the virtual currency business community operate differently from new entrants in the traditional regulated financial services industry – they raise money and more money, spend it, and raise more as their businesses grow. The Commissioners, and the regulators, will understand that the capital in a start-up ebbs and flows and the track record ideas noted below (thanks to Dana, again) should provide a greater degree of confidence that capital will come to businesses with histories of attracting capital.

To meet the need to assist license applicants and prospective on-ramp participants in planning, the Drafting Committee could consider adding to Article 2 (Licensure) the following requirements to describe for the state agency:

▪ A description of any complex corporate structure and services of a corporate applicant, with specific information about shared services and the extent to which capital is maintained on a separate basis for one or more VCB's in the structure and the extent to which it is blended.

▪ A description of the flow of funds – cryptocurrencies and US Dollars – between the VCB and its corporate parent, and where the central point of liquidity is.

▪ A description of the anticipated flow of funds.

▪ A description of the long-range flow of funds and plans for financial stability and generation of revenues.

▪ A description of the applicant's plans for making up funding gaps, including any commitments for funding in hand.

- A description of the applicant's track record for raising funding in the past.

Issue 3: What additional user protections including the legal status of virtual currency in the hands of VCB's and provisions of Article 8 or other alternatives that might be adapted for virtual currency business activities should be considered? We had robust discussions about user protections in Palo Alto, and we need to allocate time in Chicago for additional discussions. Fred and Ed Smith have been particularly engaged in looking at the Article 8 issue discussed in Palo Alto, and have produced two alternative approaches for consideration.

At the Palo Alto meeting, Commissioner Edwin Smith raised the issue of whether assets in storage or being transmitted by providers licensed under the Uniform Act – and I presume providers on the on-ramp – would be subject to the providers' creditors. Those in attendance then debated the pros and cons of treating the assets as "property" or as "currency" along the lines of practices among insured depository institutions as opposed to practices of securities and commodities broker-dealers. Commissioner Smith suggested that we look at U.C.C. section 8-503 for a model that treats the assets as not subject to claims by the providers' creditors. Eventually, as Ed Smith explained it to others, the discussion centered around whether custody of virtual currency or credentials was a bailment or non-bailment arrangement.

Chairman Miller and Commissioner Smith engaged in an offline exchange that produced two alternatives:

Commissioner Smith provided the first alternative, drawn from UCC Article 8, after some consultations with other Article 8 and UCC experts, particularly Professors Neil Cohen, Carl Bjerre, and Ken Kettering, begins with U.C.C. § 8-503(a), which provides:

> To the extent necessary for a securities intermediary to satisfy all security entitlements with respect to a particular financial asset, all interests in that financial asset held by the securities intermediary are held by the securities intermediary for the entitlement holders, are not property of the securities intermediary, and are not subject to the claims or creditors of the securities intermediary, except as otherwise provided in Section 8-511.

Section 8-511 sets the priority rules for contests between securities intermediaries, entitlement holders and creditors of the securities intermediaries.

As explained by Ken Kettering who joined the conversation led by Commissioner Smith, Article 8's rules were drafted to provide for flexible expansion of the scope of terms such as "securities intermediary" – a person in the business of maintaining securities accounts for others. He also mentioned that the definition of securities account appears to permit that an account can be a securities account if the person maintaining the account agreed to treat the asset credited to the account as a financial asset. (Smith email to Neil Cohen, March 4, 2016, 4:09 PM, summarizing advice from Ken Kettering.) Commissioner Smith also explained that the URVCBA should require the licensee to agree with the customer that the licensee will treat the virtual currency held for the customer as a financial asset. All of the rights of creditors of the licensee "fall away" and the customer gets a securities entitlement, the licensee has a duty to maintain [the asset], and valuable adverse claim cut-off rules for wrongful transfer of the virtual currency by the licensee come into play.

Additional suggestions conveyed via Commissioner Smith from Professor Bjerre include: (1) "that the arrangement between the licensee and customer be a securities account as defined in U.C.C. § 8-501(a)," and (2) "that the virtual currency be treated as a financial asset in the securities account." Professor Bjerre also explained that including (1) above would help "preclude misunderstandings about" (2) above. He also suggested that the Drafting Committee consider, in commentary, the issue of common practices among some securities brokers of excluding "cash" as a financial asset so as to avoid interpretation problems given the "supposed cash-like nature" of virtual currencies. I need to ponder these more and get more information from Professor Bjerre. Additionally, Professor Bjerre suggested that the URVCBA should (a) void the licensee's attempt to undermine by contract U.C.C. §8-504(a)'s duty to maintain financial assets, and (b) "prohibit the licensee from using U.C.C. §8-110(b) and (e) to choose an applicable law other than that of an adequately regulated jurisdiction."

The Drafting Committee has the option in Article 7 of the URVCBA to adopt the U.C.C. Article 8 approach, or to tailor its major principles into VCB-specific language.

Chairman Miller has proposed a simple provision, based on Oklahoma's trust fund statutory provisions:

> All virtual currency or rights transferred to a licensee are held in trust by the licensee pro rata for the benefit of the persons transferring the virtual currency or rights to it to the licensee and the licensee has no property interest in the interests held in trust.

Chairman Miller suggests that other details to the extent necessary can be discussed in commentary. *See generally,* http://www.fullertonlaw.com/construction-law-survival-manual/trust-fund-laws-and-agreements.html.

If the Drafting Committee adopts either of these alternatives or arrives at a different decision, then the solution chosen should be placed inside Article 7 (Content and Form of Disclosures and User Protections). Additionally, if the UCC § 8-503(a) approach is decided upon, the Drafting Committee can discuss what other provisions of Article 8 it might want included in the next draft of the URVCBA. (Note to Commissioner Smith and Chairman Miller, if you believe I have misstated your positions or those of others mentioned, please be prepared to set the record straight at the April meeting.)

Issue 4: The framework for an on-ramp option. I found very useful the many ideas fleshed out in Palo Alto. Among these, the passionate comments from Anne Wallwork following the meeting revealed one piece of the on-ramp puzzle we did not discuss: the need for firms stepping up to register themselves with FinCEN as MSBs, even if they do not yet require full licenses under the URVCBA being drafted. Those contemplating the "on-ramp" should be instructed in text or comments to register themselves with FinCEN before they open shop.

The need to register with FinCEN as MSBs may seem antithetical to an "on-ramp" option, but 18 U.S.C. §1960 intervenes. Section 1960 has three prongs, two of which complicate the on-ramp option. First, it makes it a misdemeanor or felony to operate an unlicensed money transmitting business if the state required such businesses to be licensed and the provider has no license. This prong has no scienter requirement. Section 1960 also reaches those who fail to comply with Treasury regulations covering MSBs, which included registering with FinCEN. This prong also has no scienter requirement.

However, to make it clear to entities thinking of the on-ramp option, I propose adding a requirement to the on-ramp that requires the entity to demonstrate that it has complied with the FinCEN registration requirement. That avoids the prospect of offenses punishable by imprisonment for up to 5 years, serious penalties, and civil or criminal forfeiture of the property connected to the violation of the registration requirement. It is also important to note that individuals and groups as well as organizations can be charged with § 1960 violations.

The lack of scienter requirements is a change in 18 U.S.C. §1960 made by the USA PATRIOT Act in 2001. Thus, it is now far easier to prosecute unregistered and unlicensed money transmitter businesses than it formerly was. Do businesses get prosecuted? Yes, as Ripple Labs and its subsidiaries will attest from the spring 2015 FinCEN prosecution they settled. (For a brief discussion of that action and section 1960, see Sarah Jane Hughes and Stephen T. Middlebrook, *Developments in the Law Affecting Electronic Payments and Financial Services*, 71 BUS. LAW. 361,364-365 (Winter 2015-2016).) The Statement of Facts and Findings cited in the article shows the thinking of FinCEN on this score. Everyone should note that the activities cited include activities prior to FinCEN's March 18, 2013, Guidance on virtual currency; FinCEN explains why.

To make it even more clear that registration with FinCEN is a must-do proposition, we can cite in commentary FinCEN's 2015 action against PayPal, which is described in the same Business Lawyer article mentioned in the preceding paragraph.

Foreign-located MSBs are subject to FinCEN's July 2011 final rule on MSBs.[2] They must comply with record-keeping, reporting, and anti-money-laundering program requirements. They must register with FinCEN if they offer services to persons located in the United States.[3] For additional information about foreign MSBs offering services in the United States, see 76 Fed. Reg. 43585, 43588.

In whatever implementation guide or other materials the Committee may ask be prepared to accompany the Uniform Act, it is important to make clear that section 1960 is one of the more substantial issues in launching a virtual currency business.

The issues related to Section 1960 brings us back to the label that will be attached to the on-ramp opportunity. CSBS has articulated concerns about enhanced due process rights if the on-ramp is designated as a "provisional license" and participants in Palo Alto seemed to share those concerns. Provisional registration with the State regulators – and also with FinCEN – may offer a suitable middle ground. Getting this framed in Chicago will make it possible to provide the rest of the on-ramp provisions in time for the Style Committee's late April meeting.

On March 5th, I asked the Observers who represent virtual currency innovators and our ABA and ALI Advisors to identify options for keeping the on-ramp without putting participants at risk of violating state laws or Section 1960. Stakeholders should expect to provide more information about their ideas at the April meeting. No one has responded on this question as of earlier today.

The next draft should set out the requirements to be on the on-ramp, including the necessity of the filing with the regulator, a risk-based AML plan and a KYC plan that would satisfy requirements that

[2] 31 C.F.R. 1010.100(ff)(1)-(4) for discussion of activities that MSBs engage in.
[3] 31 C.F.R. 1022.380 *et seq.*

apply to money transmitters, in addition to any other requirements that may be included in the draft or otherwise apply. The extent of these responsibilities overlaps with Issue 5, which follows.

Issue 5: To what extent should the URVCBA incorporate compliance requirements already addressed at the federal or state levels? As the immediately preceding discussion reveals, there is potential for enacting overlapping or even redundant compliance duties. Chairman Miller asked me in the February draft not to include overlapping duties and the draft you discussed followed that instruction. However, in Palo Alto, it seemed that there was some push-back from Commissioners on this issue. Thus, I need additional instructions – and the Commissioners should decide – on the extent to which the URVCBA will include specific provisions on cybersecurity, disaster recovery, and so on. It remains my view that, to the extent such requirements already exist, they need not be reiterated in the URVCBA. Obviously the Commissioners will have the last word on this subject. For Observers favoring this approach, see Dax Hansen's February 18, 2016, email to me that was circulated at the Palo Alto meeting, at 1. For Observers opposing this approach, see Anne Wallwork's email mentioned above, *passim.* Dana Syracuse took a middle position as I recall, arguing for AML provisions on the ground that FInCEN's guidance might not cover all of the activities being considered for coverage in the definition of VCBA described above. I remain unpersuaded that the States should require more aggressive AML measures than FInCEN has published in regulation or guidance, not because I am not committed to vigorous AML enforcement, but to allow "financial services" providers one location for all the AML requirements that apply to them.

The February draft reserved all of Article 8 for future work on issues such as AML, and cybersecurity requirements. Fortunately, the BitLicense has practical templates if the Drafting Committee chooses to include these requirements.

Issue 6: To what extent should thresholds for "unfair or deceptive practices" and "unsafe and unsound practices" be specified in the next Draft? For brief discussion of this issue, see Dax Hansen's February 18, 2016, email to me, at 1-2, urging "alignment" of the scope of such provisions with the actual risk of harm. The February draft, at the Chairman's suggestion, set some thresholds to avoid hyper-technical violations as the basis for regulator actions. This issue is for discussion in Chicago.