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To: Chairman Fred Miller, Uniform Law Commissioners Serving on the Uniform Regulation of Virtual Currency Business Act Drafting Committee, Advisors and Observers

From: Sarah Jane Hughes, Reporter

Date: May 31, 2016

Re: Issues Memorandum to Accompany the May 31, 2016 Annual Meeting Draft of the Uniform Regulation of Virtual Currency Business Act

This memorandum accompanies the May 31, 2016 Annual Meeting Draft of the Uniform Regulation of Virtual Currency Business Act ("URVCBA"). This memorandum deals with six major issues presented in this Draft. Additional information describing reasons why certain drafting choices were made and offering background information on other provisions appears in the Reporter's Notes that accompany the Annual Meeting Draft, which are lengthy in a few cases.

Before describing the major issues, however, I would like to thank Commissioners and Observers for the many helpful comments received both recently and since January of this year. I have been grateful for the spirit of collaboration and interest in crafting a licensing and regulatory regime that will spur innovation in the virtual currency business arena to the extent feasible. I would particularly like to thank Observers who provided background materials and demonstrations to the Drafting Committee.

The issues described in this memorandum, in their relative order of significance in my opinion, include:

1) The definition of the term "virtual currency,"
2) The definition of the term "virtual currency business activity,"
3) The scope of the draft and of exemptions from its coverage,
4) The treatment of start-up providers through a less form of state regulation to be called "provisional registration" – also referred to colloquially as an "on-ramp,"
5) The requirements for security and net worth, and,
6) The encouragement of and model for reciprocal licensing arrangements among participating states.

This memorandum proceeds through these issues in the same order. It is important to recognize that, to some extent, these issues overlap and any changes made to the definitions, scope, or exemptions, in particular, will require adjustments to other portions of the Draft.

Definition of the Term "Virtual Currency"

As members of the Drafting Committee, Advisors and Observers have experienced this project, the definition of the term "virtual currency" has been a challenge. The Annual Meeting Draft contains the following definition in Section 103(25):

> "Virtual currency" means a digital representation of value that is used as a medium of exchange, a unit of account, or a store of value and that is not legal tender. The term does not include (a) the software or protocols governing the transfer of the digital representation of value, (b) stored value or digital units redeemable exclusively in goods or services limited to transactions involving a defined merchant, such as an affinity or rewards program, (c) digital units used within a game or game platform, or (d) digital units used within the same online gaming platform to purchase intangible goods or services used within the same closed platform.

The recent administrative ruling from FinCEN on the coverage of points awarded by game publishers or purchased by players/gamers, which is more fully described in the next section, may allow a slight addition to the exclusion stated in this version of this definition.

Definition of the Term "virtual currency business activity" and Secondary Definitions supporting it

The February 2016 Drafting Committee meeting produced consensus that the nature of the business activity that this project should focus on included three core and not necessarily overlapping activities – the exchange or sale, the transfer, and the storage of virtual currency on others' behalf. Work between that meeting and the Draft submitted to the Committee on Style focused on fleshing out how the verbs "exchange, transfer, and store" would shape the scope of the draft and particularly the definition of "virtual currency business activity." To achieve that result, Section 103(27) of the Annual Meeting Draft uses the following, rather lengthy definition:

> "Virtual currency business activity" means engaging as a business in virtual currency exchange, transfer, storage, or virtual currency administration, in the exchange, transfer or storage of credentials that are sufficient to transact or prevent the exchange, transfer or storage of virtual currency, whether by performing these activities alone or under an agreement with a virtual currency

control services vendor, in holding e-precious metals or e-certificates of precious metals on behalf of other persons or issuing shares or e-certificates representing interests in precious metals, or in making a market in digital, in-game units outside the game or platform from which the original digital units were received or facilitating person-to-person or user-to-user exchanges of digital, in-game units in exchange for legal tender. The term does not include a person not otherwise engaged in virtual currency business activity on behalf of third parties that contributes connectivity software or computing power to a decentralized virtual currency, provides data storage or security services for a virtual currency business and is not otherwise engaged in virtual currency business activity on other persons' behalf; or obtaining virtual currency solely to purchase goods or services for one's own purposes or receiving virtual currency from the purchase or sale of goods or services, obtaining virtual currency for investment purposes, [storing, holding, or maintaining custody or control of virtual currency by a trust company holding a charter from this state or a charter recognized by this state to the extent that the state expressly authorizes a trust company generally or by virtue of specific permission to engage in virtual currency business activity,] developing, marketing, and licensing software to be used at an enterprise level by persons not exchanging, transferring, or storing virtual currencies on their own behalf, possessing virtual currency credentials sufficient to prevent virtual currency transfers or exchanges in order to provide a service such as an escrow, transferring from one person to another effected without the services of any intermediary, or engaging in activities with another person to the extent the person is exempt from this [act] under Section 104.

The bracketed reference to activities of state-chartered trust companies provides states with the option of allowing trust companies to engage in virtual currency business activity.

The period following the February 2016 Drafting Committee meeting also produced consensus that the activities to be regulated should be user-facing, including both consumers and other businesses who employ the services of virtual currency businesses to execute transactions on their behalf. Thus, providers whose products are not offered to users but only to other providers should not be governed by this draft in the same manner that businesses that provide products and services to banks and other financial service industry members are not required to hold bank charters or licenses as service providers. These providers are engaged in innovations that can benefit all segments of this market, but do not themselves sell or exchange, transfer or store virtual currency on behalf of others. The resulting definition in Section 103(27) is still capable of being refined somewhat as innovations occur or the Financial Crimes Enforcement Network ("FinCEN") continues its articulation of which virtual currency activities fall under its Bank Secrecy Act/ Anti-Money-Laundering regulations of "prepaid access" and require that the provider register with FinCEN as a "money service business." FInCEN has bounded its areas of interest to uses that involve administration or exchange and virtual currency that is convertible to legal tender (often referred to as "fiat currency").

In designing the definition, we have attempted to follow as closely as possible two of three possible fonts of information on what constitutes virtual currency and how it should be regulated. The two we have followed include the public statements on the scope of the terms "money services" and "prepaid access" of FinCEN through March, 2016 and the September 15, 2015 Framework published by the Conference of State Bank Supervisors. We have departed in one respect from the definition adopted by the multinational organization, the Financial Action Task Force ("FATF"), for two reasons – first, FATF's positions are focused primarily on the deterrence and detection of money laundering and terrorist finance (which admittedly are two very important goals), and second, the CSBS Framework has been adopted by each state's banking regulator, which we expect will assist the ULC in gaining enactment of the URVCBA.

The core difference in approaches is the determination of what qualifies as "legal tender" for the purposes of distinguishing "legal tender" from "virtual currency" or other forms of exchange. In the Annual Meeting Draft, as with the Draft submitted for the late April meeting of the Committee on Style, the definition of "legal tender" in Section 103 (10) focuses on "means the medium of exchange or unit of value, including the coin or paper money of the United States, recognized by the United States government for the payment of taxes and as a lawful means for the discharge of debts." The FATF definition accepts as "legal tender" those medium of exchange accepted by any government. Thus, under the FATF definition, adoption of a virtual currency by any sovereign tribe or foreign government at any time could cut into the scope of this act and complicate decisions by state regulators. One tribe has already signaled that bitcoin is legal tender in its territory and there were reports, perhaps prematurely, that the government of Estonia was embracing bitcoin as legal tender as well. Given that flux in what constitutes "legal tender" abroad is likely to continue, state regulators need a single frame of reference as to what is "legal tender" and what is "virtual currency" – and using the U.S. government as the arbiter of that distinction seems like the proper choice, no matter how useful the FATF definition otherwise is.

The most significant single issue in the definition of "virtual currency business activity" is the degree to which technology that the virtual currency community refers to as "multi-sig" should be regulated by this Draft. With large potential for innovations, multi-sig technology allows participants to store back-up credentials for their virtual currency assets and to offer the equivalent of escrow arrangements.[1]

The next most complicated issue involves the treatment of in-game and out-of-game assets in virtual games. The issue of whether assets acquired by players/

[1] The vast majority of states require licensure of escrow agents, as such, unless the agent is a licensed attorney or title insurance company. This fact opens a question of how to handle the licensure of these agents, whether under the general licensure schemes or under the URVCBA, a question that the Drafting Committee has not yet addressed because it was raised only in the most recent round of comments. It is one of two dual licensure issues under consideration, the other being the need for any VCB under this act to be licensed as a money service business or money transmitter to the extent that the provider handles exchanges of virtual currency to legal tender or vice versa.

gamers are eligible for treatment under the Uniform Regulation of Abandoned Property Act is separate in our view because of the character of the relationship with the state enacting the legislation and the relationship between the game or platform offering the game and the players/gamers. Pending instructions from the Commissioners to take a different view, we have proceeded with a definition for the purposes of the URVCBA that differs slightly from that included in the Abandoned Property Act draft that the ULC will have for final reading in July.

For the definition of "virtual currency business activity," the main issue is how points awarded by game publishers or purchased from publishers by gamers should be treated. The Drafting Committee has had comments from the entertainment software industry's trade association but has not had an opportunity to consider the effect of FinCEN's most recent guidance, which happens to address this issue. Fin. Crimes Enf. Network, Admin. Ruling on the Application of FinCEN's Regulations to Points Earned or Purchased for Use in Games, March 21, 2016 (unpublished but provided to the Drafting Committee by the recipient) (concluding that game publishers described in three scenarios would not be deemed virtual currency administrators or exchangers because the points awarded or sold do not represent convertible virtual currency). To the extent that points awarded by game publishers can be exchanged for other than convertible virtual currency, the question arises whether those points should be excluded from the definition of virtual currency, their awards excluded from the definition of virtual currency business activity, or the activity exempted from compliance with the URVBCA. In my opinion, FinCEN's administrative ruling effectively settles this issue by excluding the award of points by game publishers – whether transferred by the recipient to another game or another person, used by the recipient to acquire entertainment content offered or sold by the publisher or third parties and either within the same game or a larger network of games or transferred by the recipient to another gamer in the same game or publisher's platforms, or uses to acquire entertainment content or real or tangible goods offered or sold by the publisher or third parties, within the game or the publisher's network, or real world. Because this information was not public at the time that the draft was submitted to the Committee on Style, and is not yet publicly available, the adjustment needed to reflect this ruling is not in the Annual Meeting Draft. The Drafting Committee can make this adjustment at its fall 2016 meeting.

Readers of this memorandum may wish to consider the definitions of "custody," "control," "transfer," and "store" that flesh out the core functions that we collectively identified as critical to this exercise. They can be found in Section 103.

A key issue in the definition of custody and the "multi-sig" issue involves a proposal worked out by Observers and Advisors during the April Drafting Committee meeting is whether the duration of custody ought to be an outcome-determinative factor in whether the provider of the custody service must have a license to operate. Proponents of exclusions for certain multi-sig services suggest that if the provider cannot unilaterally transact with the credentials in its possession or otherwise prevent

transactions it should not be deemed to be engaged in virtual currency business activity. Opponents set forth the prospect that future applications of multi-sig technologies may implicate the types of services and products that are covered in this draft. For this Draft, the exclusions worked out at the April meeting remain in place.

Scope of the URVCBA and Its Exemptions

Section 102 of the Annual Meeting Draft contains a slightly modified scope provision that reads:

> This [act] governs the operation of a person, wherever located, that engages in or holds itself out as engaging in virtual currency business activity with a resident of this [state].

In addition, Section 104 contains a range of exemptions that were drawn from the Uniform Money Services Act and recommendations from Committee members and Observers:

> **SECTION 104. EXEMPTIONS.** This [act] does not apply the exchange, transfer, or storage of virtual currency to the extent governed by the Electronic Fund Transfers Act of 1978, 15 U.S.C. Sections 1693-1693r, the Securities Exchange Act of 1934, 15 U.S.C. Section 78m, or the Commodities Exchange Act of 1936, 7 U.S.C. Sections 1-27f, [as amended], or to activities by any of the following:
> (1) The United States or a state, county, city or other governmental agency, subdivision, department, agency, or instrumentality.
> (2) A bank.
> (3) A person in a payment system to the extent that the person provides processing, clearing, or settlement services solely for transactions excluded or between or among persons otherwise exempted from this [act].
> (4) A person engaged in the business of dealing in foreign exchange as defined in 31 C.F.R. 1010.605(f)(1)(iv) [as amended].
> (5) A person that obtains convertible virtual currency to the extent that the person uses it only to purchase real or virtual goods or services for personal purposes and not on behalf of others.
> (6) A person that mines or manufactures virtual currency and uses it solely for personal purposes, such as to purchase goods and services for personal purposes, so long as the person does not engage in any virtual currency business activity on another person's behalf other than verification and recording of transfers of interests in virtual currency.
> [(7) A person whose virtual currency business activity with residents of this state is valued, in the aggregate, at less than [dollar amount to be specified by Drafting Committee], according to a rolling 30-day average of outstanding balances as converted into a dollar amount utilizing each day's prevailing exchange rate if the person makes a provisional registration with this state, complies with the requirements of Section 210, and applies for a license under [article] 2 prior to the time its virtual currency business activity reaches the threshold established in

this section and if the department has not suspended or revoked the provisional registration, the registration has not expired, and the department has not denied a license under Article 2 to the person. A person that qualifies for the exemption under this paragraph must file an application for a license with this state or use the reciprocity provisions of [article] 2 to retain the exemption to remain exempt during the processing of its application. A person that qualifies for the exemption but does not obtain a license from this state is no longer exempt and shall halt all virtual currency business activity with residents of this state within 48 hours of being notified that its application for license was denied and assist the department in the orderly winding down of its virtual currency business activity in this state or otherwise affecting residents of this state. A person that registered as a provisional registrant under Section 210 may declare themselves as no longer doing business in this state or jurisdiction or as being inactive in all states in the United States and no longer be subject to the requirements of this [act] by providing notice to the department.] and

(8) Lawyers and title insurance companies engaged in the provision of escrow services to users.

The term "bank" is defined in Section 103(2) and excludes both trust companies and industrial loan companies because state statutes and regulations control their range of activities differently than those of chartered depository institutions. The virtual currency trust company, itBit, chartered by New York State in 2015, abruptly withdrew from doing business with residents of Texas in April, 2016. Although little explanation was offered for the withdrawal, other states had challenged itBit's claims that its New York charter allowed it to operate on a nationwide basis. As for industrial loan companies, most states do not offer ILC charters. For this Draft, at least, it seemed proper to keep ILC's in its scope.

Item (3) is intended to exempt only those persons engaged in executing transactions otherwise excluded or persons otherwise exempted from this Draft. It is not intended as a loophole to any other extent.

Item (4) reflects the published position taken by FinCEN on the scope of virtual currency activity that qualifies as a "money service" for its regulatory purposes.

Item (7) relates to the "on-ramp" discussed in the next section of this memorandum.

Item (8) was added for the Annual Meeting Draft at the recommendation of a Drafting Committee member, but has not been discussed by the Committee as a whole. Its purpose is to protect those engaging in escrow services to the extent that they currently are exempt from licensure as escrow agents under state law. This Commissioner also proposed exempting foreclosing secured creditors from the scope of this Draft, but I have not yet incorporated that change.

An "On-ramp' for Start-Ups and Research Purposes

Section104(7), which is included on page 5 of this memorandum in full, would exempt from licensure any person whose volume of virtual currency business activity is below a threshold based on the US Dollar equivalent if the person complies with the requirements of Section 201.

Section 210 specifies what "provisional registration" entails and the conditions under which a provider of virtual currency business services may engage in it without awaiting full licensure. Among these are registration with the state with whose residents the provider intends to conduct virtual currency business activity, registration with FinCEN as a money services business, if required under FinCEN's then-applicable guidance, and various additional compliance obligations under other articles of the Draft act.

The Reporter's Notes to Section 210 describe other features of Section 210 and the consensus position that an on-ramp would benefit the virtual currency community on a national level. They highlight what are real concerns in the virtual currency community that start-ups and researchers working on virtual currency products and services need the on-ramp – or other form of "safe harbor" – in order to launch businesses without the risk of violating 18 U.S.C. § 1960, which imposes federal criminal liability if one of three prongs is met, and in two of the three instances without a scienter requirement.

At the suggestion of one comment in the most recent round of comments, Section 210 now makes a period of inactivity grounds for a self-driven relinquishment of a Section 210 provisional registration.

Section 210's "provisional registration" is apart from the reference in Section 203 to "provisional operation" by a provider that has applied for licensure under the reciprocity option enacted by the relevant state. Provisional operation requires that the provider hold a valid license from a state participating in reciprocal licensure under this act or a program in which the state involved has agreed to participate.

Neither "provisional registration" nor "provisional operation" are intended to convey a property interest to the provider(s) involved. Neither are transferable or assignable, either.

Security and Minimum Net Worth Requirements

The task assigned to this Drafting Committee was to set forth a vision of what a prudential-lite version of the Uniform Money Services Act and state money transmitters statutes would hold for virtual currency businesses, which are in their infancy in most cases. One of the biggest obstacles to state licensure as "money services" or "money transmitter" businesses for virtual currency businesses is their inability to obtain surety

bonds in the marketplace. Another is the cyclical nature of the funding/ capitalization in the technology sector as a whole and virtual currency businesses in particular. Thus, we had to get creative.

On the subject of security, Section 204 does away with any surety bond requirement. Instead it offers a more open-minded vision of what security might mean in the start-up businesses' context and specifically provides:

> (a) Except as otherwise provided in subsection (b), a letter of credit or other security acceptable to the department, in an amount and type given the nature and extent of risks in the applicant's business model, must be provided to the department before any license may be issued. The security need not be posted until a license has been approved.

The Reporter's Notes to Section 204 offer additional explanation:

> Surety bonds are not available at this time for virtual currency start-ups and even longer-lived virtual currency businesses have trouble finding a surety bond for their operations. Accordingly, the security described in Section 204 does not and should not include surety bonds because such a requirement effectively prevents most virtual currency businesses from being licensed at this time. The market may improve as surety bond companies are more familiar with the operations of virtual currency businesses and as states clarify their positions on licensure and regulation of virtual currency businesses and the relationship of virtual currency businesses to traditional money services and money transmission that states otherwise regulate. But, lacking a market today for bonds to issue, this act does not require them as a form of security – no matter how common or appropriate they may be for other forms of licensees to offer to regulators.
>
> The amount of security required may be minimal depending on the scope of activities that the applicant presents as its business model in a given state. The type of security may include a guarantee or, possibly, even a letter asserting compliance based on submissions under Article 7.

One additional issue raised by an Observer in the most recent round of comments is the general requirement that surety bonds survive the entity as a concern operating in its own name. Given the likelihood that many start-ups in this community may be acquired by other entities, this is an issue that requires additional discussion by the Drafting Committee. I do not imagine that the solution will move away from that suggested in this Draft per se, however, which in customary fashion adheres to the principle in suretyship that the security follows the debt.

The issue of net worth or capital requirements has been considered by the Drafting Committee. For the Draft submitted to the Committee on Style, we followed the recommendation of one Observer who suggested that an approach in sync with Basel III – of specified operating capital and specified winding down capital – should be

considered. For that purpose, that Draft used a total of 10.5 per cent of the value in dollar equivalents of transaction volume, split at 6 and 4.5 %, respectively. Comments from Observers in the recent round suggest that these figures are too high and offered as their explanation (1) the start-up nature of the providers, and (2) the fact that they, unlike banks, are not operating on a fractional reserve basis. Thus, these comments encouraged the use of a smaller minimum net worth and suggested that a figure of 2 per cent might suffice. This figure remains to be decided by the Drafting Committee.

High minimum net worth or capital requirements in state licensure laws are often cited as obstacles to innovation by members of the virtual currency community. High capital requirements are more commonly applied to providers that operate on a fractional reserve or other leveraged form of business, which is not what this Draft will allow for virtual currency businesses. At the recommendation of the Chairman and a Commissioner, this Draft like its immediate predecessor includes an analog to UCC §8-503, which imposes a bailment on the provider and protects the virtual currency assets in its custody or control from the claims of the provider's creditors as strongly as we felt appropriate. This bailment provision can be found in Section 503.

Reciprocity in Licensing

This Annual Meeting Draft has three alternative treatments of reciprocal licensing for consideration by the Commission and by states that may enact the URVCBA following its approval by the Commission. The first is based on multilateral arrangements crafted by the Conference of State Bank Supervisors ("CSBS") that roughly 26 states have adopted. It relies heavily on the Registry operated by a CSBS subsidiary for licensing and renewal purposes that was originally established after the SAFE Act. This registry is known as the Nationwide Multi State Licensing System and Registry. Two Drafting Committee members have suggested following the ULC's own Uniform Athlete's Agents Act approach for reciprocal licensing. The Drafting Committee has not yet discussed that alternative and so it is not among the solutions offered in this Annual Meeting Draft.

Reciprocal licensing arrangements are one way, if broadly adopted by States, of reducing the burdens of licensure by new entrants in the virtual currency business community. To the extent that States seek to encourage licensure, then States may wish to adopt and implement reciprocal licensing arrangements that, in fact, reduce the paperwork and proof requirements of obtaining licenses in multiple states and reduce the time waiting for full licensure. Of course, the on-ramp set forth in Section 210 of this Annual Meeting Draft also offers a means of encouraging start-up providers to signal their intentions to seek licenses and offer some services prior to the need for or receipt of full licensure.