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Recent Key Bitcoin and Virtual Currency Regulatory and Law Enforcement Developments

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In recent months, US federal and state regulators have continued to focus on Bitcoin and the adoption of a regulatory framework for it and other "virtual currencies," as well as the enforcement of existing securities laws to offerings denominated in bitcoins. This advisory addresses the following developments.

- The Financial Crimes Enforcement Network (FinCEN) recently released two administrative rulings ("Administrative Rulings") clarifying the application of the Bank Secrecy Act (BSA) and FinCEN regulations to Bitcoin. The Administrative Rulings elaborate upon guidance that FinCEN previously issued ("Prior Guidance").
- During recent speeches, New York State Department of Financial Services (DFS) Superintendent Benjamin Lawsky clarified the scope of the DFS' proposed regulations governing the licensing and regulation of virtual currency businesses (the "BitLicense").
- In an opinion piece for *The Wall Street Journal*, Commissioner Mark Wetjen of the Commodity Futures Trading Commission (CFTC) expressed support for constructive policymaking and regulation relating to virtual currencies such as Bitcoin.
- Over the past two months, the Securities and Exchange Commission (SEC) has conducted an informational sweep of crowdsales of crypto-equity to determine if the sales violate US securities laws.
- Finally, the US Department of Justice initiated criminal proceedings against Trendon Shavers, the operator of Bitcoin Savings and Trust (BCS&T). The proceeding constitutes the first criminal securities fraud case directly involving Bitcoin.

Administrative Rulings on Bitcoin Exchange and Payment Processing Platforms

On October 27, 2014, FinCEN issued the Administrative Rulings, which clarify that certain companies operating in the Bitcoin economy may be considered money services businesses for purposes of the BSA. Absent an applicable exemption, a money services business must register with FinCEN, adopt, among other things, anti-money laundering policies and procedures satisfying the requirements of the BSA and USA PATRIOT Act and may be required to apply for a money transmitter license in each state in which it offers services.

One of the Administrative Rulings was issued in response to a request for interpretation from a company that sought to establish a Bitcoin exchange platform that would (1) hold customer funds (both US dollars and bitcoins) in pooled accounts segregated from the exchange's operational accounts, (2) not allow third-party deposits or transfers of customer funds to third parties and (3) use a matching engine to facilitate trading of US dollars for bitcoins directly between users. The Administrative Ruling found that the proposed activities would meet the definition of money transmission, because the exchange platform would be "facilitating the transfer of value, both real and virtual,

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between third parties" and doing so would be the primary purpose of the platform's system. As a money transmitter, the company would be required to comply with various FinCEN regulations, including but not limited to those requiring the implementation of anti-money laundering policies and procedures and recordkeeping, reporting and transaction monitoring.

The company contended that it satisfied the "payment processor exemption" from the definition of money transmission, which requires satisfaction of four conditions: (1) the entity must facilitate the purchase of goods or services, or the payment of bills for goods or services (other than money transmission itself); (2) the entity must operate through clearance and settlement systems that admit only BSA regulated financial institutions; (3) the entity must provide the service pursuant to a formal agreement; and (4) the entity's agreement must be at a minimum with the seller or creditor that provided the goods or services and receives the funds ("Payment Processor Exemption"). Finding that the company would not satisfy conditions (1) and (2), the Administrative Ruling concluded that the company could not avail itself of the Payment Processor Exemption. Furthermore, in discussing the Prior Guidance, the Administrative Ruling concluded that the company would constitute an "exchanger" and thus would not qualify for the "user" exemption under FinCEN regulations. An overview of the Prior Guidance is available here.

The second Administrative Ruling related to a proposed business model in which a payment processor would (1) enter into an agreement with a merchant and would integrate its payment processing software into the merchant's website, (2) accept from consumers purchase orders for goods or services that are paid in fiat currency, and (3) use bitcoin reserves acquired and held by the payment processor to deliver to the merchant payment related to that purchase order in bitcoin of equivalent value to the fiat currency received. The Administrative Ruling found that the proposed business model would constitute money transmission, because "it engages as a business in accepting and converting the customer's real currency into virtual currency for transmission to the merchant" and does so as the primary purpose of the platform's system. The Administrative Ruling further concluded that the Payment Processor Exemption would not be available to the described business model, because the clearance and settlement services offered by the payment processor would not be restricted to only BSA-regulated financial institutions, noting that "the payment of the [b]itcoin equivalent to the merchant, by definition, takes place outside such a clearing and settlement system...."

The Administrative Rulings amplify FinCEN's Prior Guidance released on March 18, 2013, and prior administrative rulings released on January 30, 2014, that addressed the application of the BSA and FinCEN regulations to virtual currency miners and to virtual currency software developers and direct proprietary investors in virtual currency.

On November 10, 2014, FinCEN released a statement on banks providing services to money service businesses. The release noted that money service businesses have been losing access to bank services due to the perceived risk of working with money service businesses. The statement reiterated the FinCEN position that banking organizations are expected to manage the risk associated with all accounts and to perform due diligence on money service business accounts. FinCEN also discouraged wholesale termination of money service business accounts by banking organizations. The statement reiterates that banking organizations must adopt policies and procedures to assess a money service business' money laundering and terrorist financing risks. Many bitcoin and virtual currency businesses qualify as money service businesses. As such, FinCEN's statement may positively impact the manner in which banking organizations approach the analysis of related risks for Bitcoin businesses and the virtual currency space.

Virtual currency business operators should consult with legal counsel to determine whether they should (1) register with FinCEN as a money services business, (2) seek licensing as a money transmitter in applicable states, and (3) develop BSA-compliant policies and procedures.

DFS Superintendent Lawsky Comments on BitLicense

As addressed in a Katten Client Advisory dated July 29, 2014, the BitLicense was initially proposed by DFS on July 17, 2014, with an initial public comment period that ended on October 21, 2014. The proposed regulations would require any business that engages in "virtual currency business activity" to obtain a BitLicense from DFS and would require such businesses to adopt consumer protection, anti-money laundering and cyber-security procedures. DFS intends to publish all comments received on its website.

In two recent speeches, at the Benjamin N. Cardozo School of Law on October 14, 2014, and the Money 20/20 conference on November 2, 2014, Superintendent Lawsky provided insight into the approval process for the proposed BitLicense and clarified the nature of the BitLicense.

In both speeches, Superintendent Lawsky noted that the comment period for the proposed BitLicense would be followed by a revised proposal incorporating substantive changes to the regulations. Superintendent Lawsky indicated that the revised proposal is anticipated in December 2014. Under the New York Administrative Procedure Act, the release of the revised proposal would be followed by an additional public comment period.

In the Cardozo speech, Superintendent Lawsky addressed what he characterized as misconceptions regarding certain provisions of the BitLicense, and he provided further guidance on the intended scope of the BitLicense. Noting that the proposal of the BitLicense is a collaborative effort through a public comment process, Superintendent Lawsky suggested that many of the substantive changes in the proposed BitLicense were a response to comments received from the public. He emphasized that the BitLicense framework is meant to provide consumer protection where customer assets are held by service providers in order to protect against fraud and that the regulations are intended to mirror those to which existing financial services companies currently are subject. Consequently, non-financial services activity, such as virtual currency mining and software development, would not require a BitLicense, and individual users would not be subject to licensing requirements. Superintendent Lawsky also noted that the BitLicense's controversial cyber-security requirements—which public commenters noted were more rigorous than those imposed on existing financial institutions—are intended to be applied through amendment to existing DFS regulations for the banking and insurance industries.

At the Money 20/20 conference, Superintendent Lawsky focused on the issue of compliance costs. He explained that DFS is also considering creating a "Transitional BitLicense" to "allow certain small businesses and startups to operate within a more flexible framework for a set period...." Superintendent Lawsky explained that a Transitional BitLicense would emphasize strong consumer protection, anti-money laundering and capital standards; however it would also be applied in a manner that addresses the capital challenges smaller companies and startups face.

Virtual currency business operators should consult with legal counsel to determine how the BitLicense may affect them and what other state licenses or federal registrations may be required.

CFTC Commissioner Expresses Support for Constructive Regulation of Bitcoin

In a November 3, 2014, opinion piece in *The Wall Street Journal*, CFTC Commissioner Mark Wetjen expressed enthusiasm for the potential benefits of Bitcoin and other virtual currencies for individuals, particularly those with limited access to banking or those who rely on mobile payment systems. He noted the need for constructive policymaking and regulation that would serve to encourage the realization of those benefits. Commissioner Wetjen observed that the CFTC's interest in Bitcoin was initially driven by the needs of merchants that accepted bitcoins as payment and that sought to rely on bitcoin derivatives to hedge exposures to price fluctuations. Commissioner Wetjen noted that the CFTC recently had been presented with a swap contract on Bitcoin that has been listed for trading on a registered platform, implicitly referring to the first US dollar/Bitcoin swap that was executed in October on TeraExchange, the first CFTC-regulated swap execution facility involving Bitcoin.

Addressing the CFTC's jurisdiction over Bitcoin, Commissioner Wetjen wrote:

> The definition of "commodity" under the CFTC's authorizing statute could be read to include Bitcoin, in which case the CFTC would have authority to bring enforcement actions against anyone who attempts to manipulate the virtual currency. The CFTC certainly has a responsibility to ensure to the greatest extent the integrity of the derivatives markets, including those for Bitcoin swaps and other virtual currencies.

The Commissioner also noted that Bitcoin and block chain technology have the potential to modernize financial technology and platforms, a theme that was discussed during hearings held by the CFTC in October. He noted that regulators and the Bitcoin industry must address concerns, including consumer protection, to help realize that potential for innovation.

SEC Commences Inquiry Into Crypto-Equity Offerings

The SEC has reportedly sent voluntary information requests to companies and platforms offering equity interests (e.g., equity or profit interests in a company or unincorporated venture) known as a "Crypto-equity" and/or "tokens" usable in a block chain venture (e.g., closed programming environments such as Ethereum or Mastercoin). Crypto-equities are not a form of virtual currency, but are often sold by micro-cap issuers (typically those in the virtual currency economy) directly to investors or indirectly on unregulated online platforms in exchange for investments of, or purchase prices paid in, bitcoins. Tokens are a form of virtual currency, typically used on advanced programming environments known as Bitcoin 2.0 or Blockchain 2.0 projects. Crowdsales of tokens are distinguishable from the mining of bitcoins in that (1) token crowdsales involve the sale of the token directly from an issuer to a purchaser, typically for a payment of bitcoins and (2) the mining of bitcoin is a decentralized reward built into the network protocol as an incentive for the provision of resources in verifying transactions. Crypto-equity is used by issuers in connection with crowd-sourcing a capital raise and, typically, to further software development. Tokens typically are sold with the stated intention on financing software development within a programing environment.

The voluntary information sweep was first reported by the virtual currency news website CoinFire and later confirmed in part by *Wired*. While *Wired* confirmed that an information request had been sent to at least one Crypto-equity company—the Bitcoin Emerging Market Fund, a pooled investment vehicle investing in other Crypto-equities and virtual currency assets—it is not known whether a programming environment administrator has received any inquiry for the crowdsale of tokens and no additional confirmations of SEC inquiry letters have been publicly reported as of November 10, 2014. In fact, some Crypto-currency players have specifically denied receiving any inquiries.

The SEC inquiry appears to focus on whether the crowdsale of Crypto-equity or tokens constitutes the sale of unregistered securities and, therefore, violates US securities laws. The information sweep follows a May 7, 2014, Investor Alert issued by the SEC concerning crowdsales of Crypto-equity. The Investor Alert noted that investment schemes were being offered on Bitcoin-related message boards and for payment in bitcoin and other virtual currencies, and warned of unregistered securities offerings or offers from unlicensed brokers as potential warning signs of investment fraud.

Recent events indicate that the SEC will continue to pursue its regulatory scrutiny of crowdsales of Crypto-equity and tokens. Earlier in 2014, the SEC investigated Eric Voorhees for the unregistered sale of securities of SatoshiDICE and FeedZeBirds, using the Romanian online crowdsale platform MPEx to solicit investors from 2012 to 2013. On June 3, 2014, the SEC and Voorhees settled the claims, with Voorhees disgorging profits and paying a penalty of $35,000.

Parties seeking to conduct a crowdsale of tokens should consult with legal counsel to determine whether such tokens are exempt from the definition of a "security." Issuers of securities should consult with legal counsel prior to conducting private placements or public sales of securities.

US Attorney's Office Files Criminal Charges in Shavers Case

On November 6, 2014, the US Attorney's Office for the Southern District of New York announced the unsealing of a criminal complaint against Trendon Shavers, alleging securities fraud and wire fraud in relation to Shavers' operation of BCS&T. The complaint alleges that Shavers operated BCS&T as a Ponzi scheme, collecting approximately $4.5 million in bitcoin payments from investors.

The criminal complaint follows a civil proceeding previously filed by the SEC. On September 18, 2014, the US District Court for the Eastern District of Texas entered final judgment against Shavers and BCS&T in the civil case filed by the SEC. The final order required Shavers to pay in excess of $40 million in disgorgement, interest and civil penalties. The case was notable in Magistrate Judge Amos Mazzant's determination that "[b]itcoin can be used as money" and that the investment of bitcoin by BCS&T investors "provided an investment of money." As such, interests in BCS&T were deemed to be securities and Magistrate Judge Mazzant found in favor of the SEC.

Conclusion

The recent pronouncements by FinCEN—analyzed in connection with Superintendent Lawsky's speeches and the actions of the SEC and FBI—demonstrate heightened scrutiny on bitcoin and virtual currencies by governmental regulators and the Department of Justice. While such actions may cause certain businesses to panic, it is becoming clear that US federal and state governments are not trying to stifle or control virtual currencies. Rather, these efforts demonstrate that US governmental entities recognize the long-term value of virtual currencies and are trying to create a regulatory regime to foster growth and development, and an atmosphere where institutional and retail investors are protected. Katten continues to monitor developments and assist clients in anticipating and navigating these developments.