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# Bitcoin: Overview of U.S. Legal Treatment

All Payments Expo

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# Outline

Regulatory			
		Federal	State
Prudential	AML	FinCEN	Money transmitter regimes Virtual currency specific regimes (e.g. NYDFS BitLicense; CSBS Model Framework)
	Consumer Protection	CFPB	
	Other		
Tax		IRS	State tax agencies
Market		SEC CFTC	State regulators
Enforcement			
Ponzi Schemes	SEC v. Trendon T. Shavers		
Money Laundering	Silk Road / Silk Road 2.0 U.S. v. Robert M. Faiella and Charlie Shrem; U.S. v. Ross William Ulbricht		
Unregistered Offerings / Exchanges	In the Matter of Erik T. Voorhees In the Matter of BTC Trading, Corp. and Ethan Burnside		
Deceptive Marketing	FTC v. BF Labs, Inc., d/b/a Butterfly Labs		

**DISCLAIMER:** The presentation is a summary of many important issues but does not cover every potential legal or regulatory issue surrounding virtual currency. Make sure to consult counsel.

# State Regulatory Approaches: Money Transmitter Regimes

- A “Money Transmitter” must register transmission of “money” or transmission of “funds” with each state regulator where it does business.
- **New York:** “No person or entity may engage in the business of selling or issuing payment instruments, such as checks, or engage in the business of receiving money for transmission or transmit money without a license from the Superintendent.”
  - “Virtual currencies are on our radar screen because we regulate money transmitters like Western Union and MoneyGram, but our rules were written long before the internet or virtual currencies.” – *New York Department of Financial Services (“NYDFS”) Superintendent Benjamin Lawsky, [Money 2020 Conference](#) (Nov. 2014)*
- **Oklahoma:** A “Money Transmitter” includes “any person who engages in the business of accepting currency or funds denominated in currency, and transmits the currency or funds or the value of the currency or funds...”

## What do State Transmitter Regulations Generally Cover?

### Consumer protection:

- Restitution
- Privacy of consumer financial information
- Financial disclosure

### Anti-Money Laundering:

- AML / KYC compliance program
- SARs / CTRs (for transactions >\$10,000)
- Recordkeeping

### Minimal capital requirements:

- For example: \$100,000 (WI, TX); \$500,000 (OH)
- Bond or securities

### Required Documentation:

- Corporate documents, principal officers, directors, equity owners, operations

## Application of State Transmitter Regulations to Bitcoin

- Coinbase is [registered](#) as a money transmitter in 16 states (plus Puerto Rico).
- Some states (e.g., [TX](#), [KS](#) and [WA](#)) have put out guidance describing treatment of virtual currencies under their money transmitter regimes.
- [CA](#) recently repealed a provision of state law that prohibited the use of anything but the lawful money of the U.S., legalizing the use of Bitcoin in the state.
- Some states have determined that transactions solely involving virtual currency do not constitute money transmission.

# State Regulatory Approaches: New York “BitLicense” Reproposed Regulations and CSBS Model Framework

- On February 4, 2015, the NYDFS [reproposed](#) the “BitLicense” virtual currency regime; comments are due by March 6, 2015.
- On December 16, 2014, CSBS [issued](#) a model framework that largely mirrors NYDFS’s BitLicense proposal; hasn’t been proposed by any state regulator.

## Key Components of the BitLicense Regime

### Activities Requiring Registration:

- receiving virtual currency for transmission or transmitting virtual currency;
- storing, holding, or maintaining custody or control of virtual currency on behalf of others;
- buying and selling virtual currency as a customer business;
- performing exchanges services as a customer business.
- controlling, administering, or issuing a virtual currency

### Activities Excluded from Registration:

- Mere merchant / consumer activities
- Development and dissemination of software in and of itself
- Miners
- Non-financial uses

### Consumer Protection:

- Disclosure of material information; acknowledgement of disclosures; recordkeeping; fraud prevention; documentation

### Books and Records:

- Names, account numbers and physical addresses of own customers / accountholders and, to the extent practicable, counterparties to the transaction; must be maintained for at least 7 years

### Bank Secrecy Act / Anti-Money Laundering:

- AML / KYC compliance program; recordkeeping; designation of compliance officer; report transactions >\$10,000 to NYDFS / FinCEN

### Safeguarding of Assets:

- Must maintain capital requirements determined by Superintendent based on a variety of factors related to risks to customers / counterparties

### Cyber Security:

- Must maintain a cyber security program; annual reports to NYDFS; ensure security of all applications utilized by licensee

### Supervision:

- NYDFS has broad discretion to approve / deny; revoke / suspend licenses

# Federal Regulatory Approaches: FinCEN



- FinCEN has issued regulations implementing the Bank Secrecy Act (“BSA”) / USA PATRIOT Act for Money Services Businesses (“MSBs”) (Money Transmitters are a type of MSB).
- Starting in 2013, FinCEN has issued guidance and administrative decisions as to how Bitcoin and virtual currency fits within the BSA / USA PATRIOT Act regulatory scheme.

BSA Requirements for MSBs	Application to Bitcoin / Virtual Currency
<ul style="list-style-type: none"> <li>• <b>SARs:</b> report must be filed when transaction conducted by or through MSB is suspicious and &gt;\$2,000.</li> </ul>	<p>Virtual currency not legal tender; therefore subject to MSB rules.</p> <p>“Users” (Not MSBs); “Exchangers” / “Administrators” (MSBs)</p>
<ul style="list-style-type: none"> <li>• <b>Anti-Money Laundering Program:</b> MSB must develop, implement and maintain an effective AML program.</li> </ul>	<p><b>Mining</b></p> <p>Generally, individual miners and mining businesses are not MSBs.</p>
<ul style="list-style-type: none"> <li>• <b>Currency Transaction Report:</b> report must be filed for transactions involving currency &gt;\$10,000.</li> </ul>	<p><b>Investment Companies</b></p> <p>Generally, <i>bona fide</i> investment companies engaged in investing in / trading in Bitcoin are not MSBs.</p>
<ul style="list-style-type: none"> <li>• <b>Recordkeeping for amounts &gt;\$3,000:</b> must maintain records when issuing / selling a bank check or draft, cashier’s check, money order or travelers check for amounts &gt;\$3,000.</li> </ul>	<p><b>Payment Processing</b></p> <p>A company exchanging convertible virtual currency – for purposes of providing customer payments to merchants in bitcoin – is considered a money transmitter.</p>
<ul style="list-style-type: none"> <li>• <b>Designation of U.S. Resident as Agent:</b> foreign MSBs must designate an agent who resides in the U.S.</li> </ul>	<p><b>Virtual Currency Exchanges</b></p> <p>Generally, a person must register with FinCEN as a money transmitter when engaging in convertible virtual currency transactions as an exchanger.</p>
<ul style="list-style-type: none"> <li>• <b>Records / Retention Period:</b> must retain all records for at least five years.</li> </ul>	<p><b>Customer Due Diligence Proposal</b></p> <p>Generally, covered institutions must identify and verify the natural persons behind legal entity customers.</p>

# Federal Regulatory Approaches: CFTC



- **CFTC Jurisdiction** – anything involving futures (not a spot sale or mere delayed delivery).
  - Bitcoin likely a commodity under the Commodity Exchange Act (“CEA”):
    - CEA § 1a(9): “The term ‘commodity’ means...all services, rights, and interests (except motion picture box office receipts, or any index, measure, value or data related to such receipts) in which contracts for future delivery are presently or in the future dealt in.”
  - CFTC will / stands ready to use anti-manipulation authority in spot market.

- CFTC registration is extensive, burdensome and costly:

Example Requirements:		
File registration forms with the National Futures Association	Maintain daily trading records; AML program	Satisfy reporting and recordkeeping requirements
Comply with business conduct and documentation standards	Appoint a chief compliance officer	Prepare for periodic on-site audits

- CFTC [approved application](#) of TeraExchange as Bitcoin Swap Execution Facility.
- The CFTC is currently reviewing several applications:
  - The North American Derivatives Exchange’s plan to launch a Bitcoin [binary options offering](#).
  - LedgerX’s application for approval as a Bitcoin [derivatives exchange](#).

# Federal Regulatory Approaches: SEC



SEC Jurisdiction	Investment Vehicles
<ul style="list-style-type: none"><li>▪ The SEC has jurisdiction over securities.</li><li>▪ ‘Security’ means “any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate...investment contract, [and] voting-trust certificate...” § 2(a)(1) of the Securities Act of 1933</li></ul>	<ul style="list-style-type: none"><li>▪ Investment vehicles that hold Bitcoins and offer interests in the vehicle are offering securities.</li><li>▪ See Winklevoss Bitcoin Trust <a href="#">S-1</a>.</li></ul>
Bitcoin is not a “Security”	Enforcement Actions
<ul style="list-style-type: none"><li>▪ Bitcoin not a “Security” for purposes of § 2(a)(1) of the Securities Act.</li><li>▪ Not a “note,” “stock” or “investment contract” – lacks important characteristics of these things.<ul style="list-style-type: none"><li>▪ No dividends; no right to vote in proportion of ownership; and no promise to pay sum of money (See R. Grinberg, Bitcoin: An Innovative Alternative Digital Currency, 4 Hastings Sci. &amp; Tech. L.J. 160, (2011).</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ SEC remains interested in Bitcoin Ponzi schemes.</li><li>▪ Recent actions include charges brought against <a href="#">Trendon T. Shavers</a>, <a href="#">Erik Voorhees</a> and <a href="#">Ethan Burnside</a>.</li><li>▪ The SEC has also issued an <a href="#">investor warning</a> on the topic of Bitcoin and virtual currency-related investments.</li></ul>

## IRS

- **Guidance (Mar 2014):** Bitcoin should be treated as “property” under [federal tax law](#).
- All purchases with Bitcoins are taxable events, including:
  - Purchases of goods.
  - Wages paid to employees using virtual currency (taxable to the employee; must be reported by employer on Form W-2).
  - Payments using virtual currency made to independent contractors / service providers.

## CFPB

- **Proposed Updates to Regulation E (Nov 2014):** the CFPB proposes [new rules](#) relating to prepaid market disclosures.
  - May apply to virtual currency and related products / services.
  - Would require: disclosure of material information / general terms and conditions; documentation; complaint mechanisms and remedy for errors.
- **Consumer Advisory (Aug 2014):** the CFPB issues consumer [advisory warning](#) about virtual currencies.
  - Hackers; scams
  - Fewer legal protections (compared to fiat currency)
  - Costs difficult to calculate



# Enforcement: Money Laundering

- ***Money laundering capabilities of virtual currencies a concern for authorities:***
  - **Silk Road / Silk Road 2.0**: online black marketplaces used to facilitate criminal activity. Shut down by joint government task forces.
    - Ross Ulbricht (founder of Silk Road) **found guilty** in Feb. 2015 of conspiracy to distribute controlled substances, computer hacking and money laundering.
    - Blake Benthall (operator of Silk Road 2.0) was **arrested** in Nov. 2014 on similar charges.
  - **Charlie Shrem**: Shrem, a former vice chairman of the Bitcoin Foundation, was, along with Robert Faiella, arrested for **unlawfully converting** dollars into Bitcoin for users of Silk Road.
    - Shrem and Faiella were charged with operating an unlicensed Money Transmitting Business (failure to register with FinCEN), money laundering and willful failure to file SARs with FinCEN. Both pleaded guilty in Sept. 2014.
    - Shrem sentenced to **two years**; Faiella sentenced to **four years**.

# Enforcement: Ponzi Schemes and Unregistered Securities Offerings / Exchanges

- ***Bitcoin used to perpetrate a Ponzi scheme:***
  - **Trendon T. Shavers:** The SEC [charged](#) Shavers, founder / operator of Bitcoin Savings and Trust, with soliciting investments in Bitcoin-related investment opportunities to perpetrate a Ponzi scheme.
    - A judge levied a [\\$40 million](#) fine against Shavers for violating Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act.
- ***Unregistered securities offerings / exchanges involving Bitcoin:***
  - **Ethan Burnside:** Sanctioned by SEC for [operating](#) two digital currency exchanges without registering them as either broker-dealers or stock exchanges.
    - Ordered to pay [\\$68,000](#) in fines for violating the Securities Act, Exchange Act and Investment Company Act.
  - **Erik T. Voorhees:** Sanctioned by SEC for [violating](#) Sections 5(a) and 5(c) of the Securities Act for publicly offering unregistered securities in two of his bitcoin-related ventures, SatoshiDICE and FeedzeBirds.
    - Ordered to pay a fine of [\\$50,000](#) and is prohibited from making a Bitcoin security offering for next five years.

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Mr. Grinberg is an associate in Davis Polk's Financial Institutions Group. His practice focuses on bank regulatory advice, including Dodd-Frank Act regulatory implementation, the preparation of living wills, Basel III capital and liquidity, Volcker Rule, and financial institution capital markets and M&A transactions.

In addition, Mr. Grinberg wrote the first widely read and cited academic paper on Bitcoin, and is often consulted by the media as an expert on digital currencies. He advises clients on the novel regulatory issues relating to Bitcoin and digital currency-based businesses.

Before joining Davis Polk, Mr. Grinberg programmed trading server software for Bridgewater Associates, one of the world's largest hedge funds.

### Education

- B.S., Computer Science, Yale College, 2005
- M.Sc., Computer Science, University of Texas at Austin, 2007
- J.D., Yale Law School, 2011
  - Executive Editor, *Yale Law & Policy Review*