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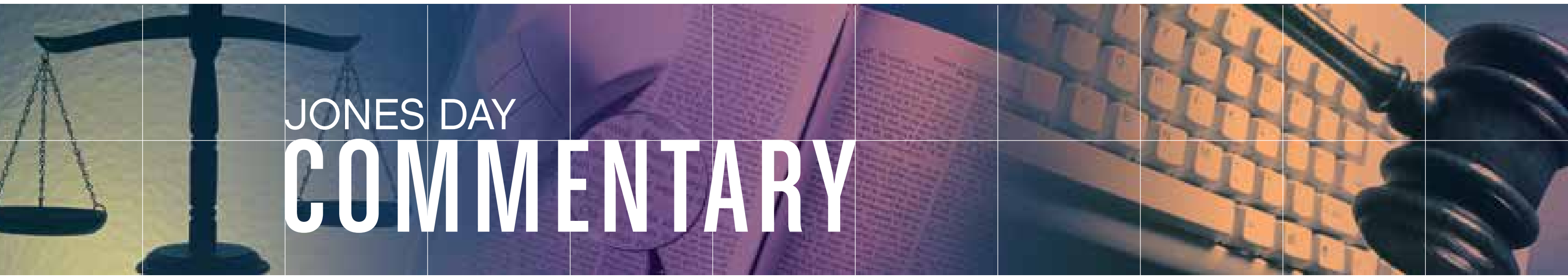

THE NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES: LEADING THE CHARGE TO REGULATE BITCOIN

As we have previously written,[1] the New York Department of Financial Services ("DFS") is emerging as an aggressive regulator of financial institutions based in New York or doing business in the state. Recent information, including a DFS memorandum and DFS subpoenas issued to key industry players, suggests that DFS has turned its attention to the regulation of virtual currencies, including "Bitcoin."

WHAT IS BITCOIN?

Bitcoin, which emerged in 2009, is the most well-known virtual currency system.[2] It involves a highly technical process in which computers in a peer-to-peer computer network solve complex mathematical equations.[3] Once a computer in the network finds the solution, which occurs approximately every 10 minutes, the entire system must verify the result.[4] The individual who owns the successful computer receives 25 bitcoins.[5] This process is known as "mining," and the individuals involved are called "miners." Mining distributes the currency without the involvement of a centralized financial authority.[6]

The Bitcoin system was designed to generate bitcoins at a predetermined rate.[7] As more computers join the network and more equations are solved, the math becomes increasingly difficult.[8] This design feature limits the generation of bitcoins to ensure that supply does not exceed demand.[9] The system will ultimately generate no more than 21 million bitcoins, an upper limit expected to be hit around 2140.[10]

Although the Bitcoin system runs on free, open-source software, the computing power required and related cost makes mining bitcoins uneconomical for the average person.[11]

Distribution of bitcoins occurs when miners purchase items using bitcoins or sell them.[12] Bitcoins can be purchased with traditional currency and privately traded. Additionally, several exchanges trade bitcoins.[13] Bitcoins can be spliced into smaller fractions called "satoshis," named for the inventor of Bitcoin, Satoshi Nakamoto.[14]

Proponents point to the decentralized nature of the Bitcoin system as one of its most distinguishing and important features. The system neither requires nor allows a central authority to oversee distribution of the currency.[15] As one commentator notes, this feature is attractive in an era of economic uncertainty and a "lack of faith in financial institutions."[16] In addition, bitcoins are easily transferrable, offer a high degree of anonymity,[17] and reduce transaction costs.[18] Some members of the law enforcement and regulatory community have claimed that the ease with which bitcoins can be transferred, and the relatively anonymous nature of these transactions, benefit those engaged in money laundering and other illicit transactions.[19] In fact, it is the anonymous nature of Bitcoin transactions that concerns the law enforcement and regulatory community the most.

REGULATION OF VIRTUAL CURRENCIES

As Bitcoin and other virtual currencies have emerged as potentially viable alternatives to traditional currency, regulators have shown an increased interest in the industry.

In March, the Treasury Department's Financial Crimes Enforcement Network ("FinCEN") announced that virtual currency "exchangers" and "administrators" must register as Money Service Businesses ("MSBs") for purposes of anti-money laundering regulations.[20] FinCEN is tasked with preventing money laundering and financing of criminal activities, such as terrorism. Because Bitcoin transactions are basically anonymous, FinCEN sought to impose rules about identifying the senders and receivers of money on those trading certain virtual currencies. In particular, FinCEN focused on "convertible virtual currencies." A convertible virtual currency is one that "either has an equivalent value in real currency, or acts as a substitute for real currency."[21] The term "virtual currency" has been used to describe anything from currency used in a computer game to an electronic gift card to Bitcoin, so the distinction of "convertible virtual currency" is crucial. Ordinary "users" of virtual currency—individuals who obtain virtual currency to purchase goods or services—are not required to register.[22] FinCEN recently emphasized that administrators and exchangers of virtual currency are bound by the same regulations that apply to established financial institutions.[23] Chief among these requirements is the obligation to identify all parties to a transaction and report suspicious activities. In other words, anonymity is not allowed.[24]

In July, the Securities and Exchange Commission ("SEC") received a registration statement for the creation of an exchange-traded Bitcoin trust.[25] The same month, the SEC charged an individual with operating a Bitcoin-related Ponzi scheme.[26] The federal judge overseeing the case ruled that the SEC could pursue the lawsuit and held that "Bitcoin is a currency or form of money" and that the investments in the alleged scheme "meet the definition of investment contract, and as such, are securities."[27]

In August, the Senate Committee on Homeland Security and Government Affairs announced that it had initiated an "inquiry" into virtual currencies. The Committee noted that the "expansive nature of this emerging technology demands a holistic and whole-government approach in order to understand and provide a sensible regulatory framework for their existence."[28]

DFS: INCREASED INTEREST IN BITCOIN

DFS's activity surrounding Bitcoin in recent months suggests the department will be actively involved in shaping the regulatory framework for entities engaged in certain types of virtual currency transactions in New York. In August, DFS subpoenaed 22 entities and investors involved in the Bitcoin industry, seeking information on consumer protection, investment strategies, anti-money laundering compliance, and funding sources, among other issues.[29] DFS also issued a memorandum in which it announced it has been conducting an "inquiry" into virtual currencies to determine the appropriate regulatory framework for the industry.[30] DFS Superintendent Benjamin Lawsky expressed concern that virtual currencies can be used to facilitate "dangerous criminal activity." He stated, "If virtual currencies remain a virtual Wild West for narcotraffickers and other criminals, that would not only threaten our country's national security, but also the very existence of the virtual currency industry as a legitimate business enterprise."[31]

DFS has indicated it intends to conduct an extensive inquiry into virtual currencies. Lawsky stated that DFS may consider issuing new regulatory guidelines for virtual currencies, rather than applying existing rules.[32] He also said, "We believe that—for a number of reasons—putting in place appropriate regulatory safeguards for virtual currencies will be beneficial to the long-term strength of the virtual currency industry."[33] He further stated that DFS is considering measures aimed at implementing "safety and soundness requirements," eliminating the use of illegal activity, and increasing transparency and accountability in order to promote "sustained, long-term investment" in the industry.[34]

CONCLUSION

Given DFS's history of aggressively responding to new regulatory issues, we expect that DFS will remain at the forefront in the coming months in shaping the regulatory framework for the Bitcoin industry.

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ENDNOTES

1 *Jones Day Commentary*, "The Department of Financial Services: New York's Newest Financial Regulator" (December 2012), *available at* http://www.jonesday.com/department__of__financial__services/; *Jones Day Commentary*, "The New York State Department of Financial Services at the One-Year Mark: A New Aggressive Regulator Worth Following" (May 2013), *available at* http://www.jonesday.com/the-new-york-state-department-of-financial-services-at-the-one-year-mark-a-new-aggressive-regulator-worth-following-05-10-2013/.

2 The system, software, and network is typically referred to as "Bitcoin," while the currency itself is labeled "bitcoin." *See* Maria Bustillos, "The Bitcoin Boom," *The New Yorker* (Apr. 2, 2013).

3 *Id.*

4 "The Economist Explains: How Does Bitcoin Work?" *The Economist* (Apr. 11, 2013); Satoshi Nakamoto, "Bitcoin: A Peer-to-Peer Electronic Cash System," at 3, *available at* bitcoin.org/bitcoin.pdf.

5 "The Economist Explains: How Does Bitcoin Work?", *supra* note 4.

6 "The Economist Explains: How Does Bitcoin Work?", *supra* note 4.

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10 Benjamin Wallace, "The Rise and Fall of Bitcoin," *Wired* (Dec. 2011).

11 Chris Gayomali, "Want to Make Money Off Bitcoin Mining? Hint: Don't Mine," *The Week* (Apr. 15, 2013).

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13 Sidel, *supra* note 12.

14 "What is bitcoin?" *CoinDesk: The Voice of Digital Currency*, http://www.coindesk.com/information/what-is-bitcoin/.

15 Chamath Palihapitiya, "Why I Invested in Bitcoin," *Bloomberg* (May 30, 2013).

16 Bustillos, *supra* note 2.

17 The anonymity of Bitcoin transactions is a subject of debate. *See*, e.g., Joshua Brustein, "Bitcoin May Not Be So Anonymous, After All," *BloombergBusinessweek* (Aug. 27, 2013).

18 "What is bitcoin?", *supra* note 14.

19 Kim Zetter, "FBI Fears Bitcoin's Popularity with Criminals," *Wired* (May 9, 2012); Cyrus Sanati, "Bitcoin Looks Primed for Money Laundering," *Fortune* (Dec. 18, 2012); Bustillos, *supra* note 2.

20 Dep't of the Treasury, Fin. Crimes Enforcement Network, FIN-2013-G001 (Mar. 18, 2013).

21 *Id.*

22 FinCEN defines an "administrator" as "a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency." The agency defines an "exchanger" as "a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency." A "user" is a "person that obtains virtual currency to purchase goods or services." *Id.*

23 Jeffrey Sparshott, "Regulator on Bitcoin: Same Rules Apply," *The Wall Street Journal* (Aug. 26, 2013).

24 FinCEN, *Money Services Business (MSB) Suspicious Activity Reporting*, http://fincen.gov/financial__institutions/msb/msbsar.html.

25 Winklevoss Bitcoin Trust Registration Statement, Form S-1 (July 2013) *available at* http://www.sec.gov/Archives/edgar/data/1579346/000119312513279830/d562329ds1.htm).

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27 *SEC v. Shavers*, No. 13-CV-416, 2013 WL 4028182 (E.D. Tex. Aug. 6, 2013).

28 Senate Committee on Homeland Security and Government Affairs, Letter to Janet Napolitano (Aug. 12, 2013), *available at* http://www.hsgac.senate.gov/reports/letters.

29 Sidel, *supra* note 12; Kashmir Hill, "Every Important Person in Bitcoin Just Got Subpoenaed by New York's Financial Regulator," *Forbes* (Aug. 12, 2013).

30 N.Y. State Dep't of Fin. Servs., Notice of Inquiry on Virtual Currencies (Aug. 12, 2013), *available at* www.dfs.ny.gov/about/press2013/memo1308121.pdf.

31 *Id.*

32 *Id.*

33 *Id.*

34 *Id.*