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## Conceptualizing the Regulation of Virtual Currencies and Providers: Friction Points in State and Federal Approaches to Regulating Providers of Payments Execution and Custody Services and Products in the United States

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**CONCEPTUALIZING THE REGULATION OF  
VIRTUAL CURRENCIES AND PROVIDERS:  
FRICTION POINTS IN STATE AND FEDERAL  
APPROACHES TO REGULATING PROVIDERS OF  
PAYMENTS EXECUTION AND CUSTODY  
SERVICES AND PRODUCTS IN THE UNITED  
STATES**

SARAH JANE HUGHES\*

ABSTRACT

This essay evaluates the state of regulation by the United States government and State legislatures of participants in emerging virtual-currency businesses. It points to friction points as both the federal government and the States experiment with their own regulatory authority over virtual-currency businesses and provides a taxonomy of differing approaches to regulating such businesses. The essay takes the position that the States need to act in the near term if they wish to maintain their longstanding role as regulators of non-depository providers of financial products and services—or they risk being preempted by Congress or federal regulatory actions. This essay also suggests that regulating providers of virtual-currency products and services is a course preferable to regulating the products and services themselves.

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#### I. INTRODUCTION

Virtual currencies have been around much longer than current discussions of these technologies, or their regulation, would suggest. Virtual currencies emerged as e-commerce did, taking off in the mid-1990s.<sup>1</sup>

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\* Sarah Jane Hughes is the University Scholar and Fellow in Commercial Law at the Maurer School of Law at Indiana University. She appreciates the opportunity to share this essay with readers of the *Cleveland State Law Review*, and the invitation of Professor Brian Ray and the editors of the *Law Review* to participate in the April 2018 Blockchain Law and Technology Symposium. Professor Hughes wishes readers to be aware that she served as the Reporter for the Uniform Law Commission’s Uniform Regulation of Virtual-Currency Businesses Act (2017), a product of collaboration between Uniform Law Commissioners and many stakeholders, as well as for the Uniform Law Commission’s Uniform Supplemental Commercial Law Act for the Uniform Regulation of Virtual-Currency Businesses Act (2018). As Reporter, she admits she cannot contain her enthusiasm for the Act’s exemptions and “registration” sandbox. Professor Hughes can be reached at [sjhughes@indiana.edu](mailto:sjhughes@indiana.edu). SSRN author page, <http://ssrn.com/author=408848>.

<sup>1</sup> See Ian Grigg, *A Quick History of Cryptocurrencies BBTC – Before Bitcoin*, BITCOINMAGAZINE (Apr. 16, 2014), <https://bitcoinmagazine.com/articles/quick-history-cryptocurrencies-bbtc-bitcoin-1397682630/> (reprinted from [financialcryptography.com](http://financialcryptography.com)). For some additional analysis, see Steven Levy, *E-Money – That’s What I Want*, WIRED (Dec. 1, 1994) [hereinafter *E-Money*], <https://www.wired.com/1994/12/emoney/> (describing early

Virtual currencies did not become part of wider discussions—and the term “the blockchain” was little heard of—until the publication of Satoshi Nakamoto’s famous paper entitled *A Peer-to-Peer Electronic Cash System* in 2009.<sup>2</sup> Nakamoto’s paper introduced us to Bitcoin and the public ledger associated with it, known as “the blockchain.”<sup>3</sup>

Bitcoin and other virtual currencies that followed were seen by some as a means of proofing e-commerce payments against the “double-spending” and counterfeit problems that Internet -based payments without separate verification platforms can pose,<sup>4</sup> and preserving anonymity in payments that are similar to cash.<sup>5</sup>

Since 2009, government interest in regulating virtual currencies, blockchain technologies, and providers of both currencies and services related to them, has grown as the types of transactions and the types of regulatory challenges that certain technologies and providers bring into governments’ scrutiny.<sup>6</sup>

We stand at a friction point in the regulation of virtual currencies, blockchain technologies, providers of virtual-currency, and other blockchain-based products and services—and perhaps all “fintech” or “financial technology” enterprises.<sup>7</sup> This friction point involves what appear to be competing regulatory priorities and approaches rather than one point of disagreement.<sup>8</sup> These competing approaches cover many concerns that emerged as e-commerce developed more than 20 years ago, particularly regarding whether to allow e-commerce to avoid or comply with extant regulatory obligations and, more specifically, how to regulate them. The recurrence of similar issues of how and to what extent governments should regulate this new technology, and which governments and government agencies should play the single lead role or how to parcel out the regulation of virtual currencies, technologies, and providers among governments and agencies with logical and historical connections to the regulation of the issues that virtual currencies and related new technologies, should help inform important regulatory decisions in the near and medium terms.

This essay looks at this regulatory friction through the lens of numerous competing approaches to the regulation of providers of virtual-currency payments and storage

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participants in the e-money marketplaces and the efforts of cryptographic pioneers David Chaum of Digicash and others).

<sup>2</sup> Satoshi Nakamoto, *A Peer-to-Peer Electronic Cash System*, BITCOIN (2008), <https://bitcoin.org/bitcoin.pdf>.

<sup>3</sup> See Nolan Bauerle, *What Is Blockchain Technology*, COINDESK <https://www.coindesk.com/information/what-is-blockchain-technology/> (last visited Oct. 3, 2018). Readers unfamiliar with blockchain technology will find this explanation particularly useful.

<sup>4</sup> See Nakamoto, *supra* note 2, at 1.

<sup>5</sup> See *E-Money*, *supra* note 1. For the original explanation of the privacy feature in Bitcoin, see Nakamoto, *supra* note 2, at 6.

<sup>6</sup> BANK FOR INT’L SETTLEMENTS, CRYPTOCURRENCIES: LOOKING BEHIND THE HYPE (June 17, 2018), <https://www.bis.org/publ/arpdf/ar2018e5.pdf>.

<sup>7</sup> Andrew Norry, *An In-Depth Look at Bitcoin Laws & Future Regulation*, BLOCKONOMI (July 2, 2018), <https://blockonomi.com/bitcoin-regulation/>.

<sup>8</sup> Gareth W. Peters et al., *Trends in Cryptocurrencies and Blockchain Technologies: A Monetary Theory and Regulation Perspective*, 3 EY GLOBAL FIN. SER. INST. 1, 37 (2015).

products and services in the U.S. marketplace in 2018. These include, in reverse chronological order,<sup>9</sup> the July 31, 2018 issuance of the Office of the Comptroller of the Currency's Policy Statement on Fintech Charters,<sup>10</sup> the July 31, 2018 report from the Department of the Treasury entitled "A Financial System That Creates Economic Opportunities—Nonbank Financials, Fintech, and Innovation,"<sup>11</sup> the Bureau of Consumer Financial Protection's July 2018 announcement that it would use its Office of Innovation to explore regulation of virtual currencies with non-domestic regulators,<sup>12</sup> the launch of the State of Arizona's "regulatory sandbox" for fintech companies,<sup>13</sup> amendments to state "money transmitter" regulatory statutes,<sup>14</sup> the Conference of State Bank Supervisors' pilot program for reciprocal licensure,<sup>15</sup> the Uniform Law Commission's Uniform Regulation of Virtual-Currency Businesses Act,<sup>16</sup> and the BitLicense regulation promulgated by the New York State Department of Financial Services in 2015.<sup>17</sup> Additional sources of friction include the approaches that the Securities and Exchange Commission and Commodities Futures Trading

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<sup>9</sup> The analysis presented in later parts of this essay does not proceed on the same reverse chronological basis. Rather, it proceeds with the approaches taken by the States to date and the visions articulated by the Department of the Treasury and Office of the Comptroller of the Currency by classifying the approaches into a rough taxonomy.

<sup>10</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, POLICY STATEMENT ON FINANCIAL TECHNOLOGY COMPANIES' ELIGIBILITY TO APPLY FOR NATIONAL BANK CHARTERS (July 31, 2018) [hereinafter OCC POLICY STATEMENT], <https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf>.

<sup>11</sup> U.S. DEP'T OF TREAS., REPORT: A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES -- NONBANK FINANCIALS, FINTECH, AND INNOVATION (July 31, 2018) [hereinafter 2018 TREAS. FINTECH REPORT], <https://home.treasury.gov/sites/default/files/2018-07/A-Financial-System-that-Creates-Economic-Opportunities---Nonbank-Financi....pdf>.

<sup>12</sup> Press Release, Bur. of Cons. Fin. Prot., BCFP Collaborates with Regulators Around the World to Create Global Financial Innovation Network (Aug. 7, 2018) [hereinafter BCFP Global Network Press Release], <https://www.consumerfinance.gov/about-us/newsroom/bcfp-collaborates-regulators-around-world-create-global-financial-innovation-network/>.

<sup>13</sup> H.R. 2434, 53rd Leg., 2nd Reg. Sess. (Ariz. 2018) [hereinafter Arizona Fintech Bill] (amending Ariz. Rev. Stat. § 41-1491.10, adding Chapter 55 to Ariz. Rev. Stat., amending Ariz. Rev. Stat. § 44-1531.01).

<sup>14</sup> See Justin S. Wales, *State Regulation on Virtual Currency and Blockchain Technologies*, CARLTONFIELDS (June 28, 2018), <https://www.carltonfields.com/insights/publications/2018/state-regulations-on-virtual-currency-and-blockcha>.

<sup>15</sup> CONF. OF STATE BANK SUPERVISORS, STATE REGULATORS TAKE FIRST STEP TO STANDARDIZE LICENSING PRACTICES FOR FINTECH PAYMENTS (Feb. 6, 2018), <https://www.csbs.org/state-regulators-take-first-step-standardize-licensing-practices-fintech-payments>.

<sup>16</sup> UNIF. L. COMM'N, UNIFORM REGULATION OF VIRTUAL-CURRENCY BUSINESSES ACT (July 19, 2017), [www.uniformlaws.org](http://www.uniformlaws.org) (final text of the act, the prefatory note, and comments published in October 2017).

<sup>17</sup> 23 N.Y. FIN. SERV. LAW § 200 (2015) (effective Aug. 8, 2015).

Commission have taken, which are not the focus of this essay.<sup>18</sup> Friction in this environment also arises as other nations—such as Malta<sup>19</sup> and Singapore<sup>20</sup>—start to stake out their positions on virtual-currency providers.

The approach preferred by the virtual-currency and blockchain communities may be to have no regulations governing their activities, but that approach is increasingly unrealistic given the volumes of activity by third-party providers of virtual-currency products and services and domestic and global value flows in virtual currencies. This don't-regulate-us approach also is out of sync with the history of regulating payments and currency in the United States—a history back to Colonial Times.<sup>21</sup> Under this don't-regulate-us approach, the United States would fail a core challenge in the Treasury's 2018 Fintech Report—to find ways to harmonize regulation and work together to improve our regulatory marketplace.

Part II of this essay describes these divergent regulatory approaches with a focus on providers of virtual-currency products and services that are exchanges, wallet providers, centralized issuers, and custodians in the United States.<sup>22</sup> This Part does not proceed in the same reverse chronological basis as mentioned in Part I. Rather, it addresses categories of proposed and extant regulatory approaches taken such as federal bank charters, state bank or industrial loan company charters, full licensure in individual states, reciprocal state licensure, regulatory sandboxes and other innovation incentives, and other models, offering readers a preliminary taxonomy of regulatory choices.

Part III explains why start-ups need a safe “location” from which to test products and grow. Consider the two-year permissioned “sandbox” option the State of Arizona adopted on July 1, 2018<sup>23</sup> or the dollar-limited, non-permissioned “registration” option included in the Uniform Law Commission's Uniform Regulation of Virtual-Currency

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<sup>18</sup> The regulation of cryptocurrencies as securities or commodities is the subject of numerous works in progress. *See, e.g.*, Lawrence J. Trautman, *Bitcoin, Virtual Currencies, and the Struggle of Law and Regulation to Keep Pace*, MARQ. L. REV. (forthcoming 2018); Melanie L. Fein, *Bitcoin: How Is It Regulated?* (June 29, 2018) (unpublished manuscript), <https://ssrn.com/abstract=3166894>.

<sup>19</sup> *See, e.g.*, Jimmy Aki, *Malta Approves Favorable Cryptocurrency Bills in Next Step as a Blockchain Island*, BITCOINMAGAZINE (June 29, 2018), <https://bitcoinmagazine.com/articles/malta-passes-favorable-cryptocurrency-laws-next-step-blockchain-island/> (note that the correction explanation suggests that these bills passed only one organ of government and need final approval).

<sup>20</sup> *See* Samburaj Das, *Singapore Mulls New Rules to Safeguard Cryptocurrency, ICO Investors*, CCN.COM (March 1, 2018), <https://www.ccn.com/singapore-explores-new-rules-safeguard-cryptocurrency-investors/> (reporting that Singapore's Monetary Authority is considering bringing cryptocurrency providers under its Payment Services Bill in 2018).

<sup>21</sup> *See* Stephen T. Middlebrook & Sarah Jane Hughes, *Substitutes for Legal Tender: Lessons from History for the Regulation of Virtual Currencies*, in RESEARCH HANDBOOK ON ELECTRONIC COMMERCE LAW 37 (John A. Rothchild ed., Edward Elgar 2016).

<sup>22</sup> This essay does not analyze the potential effects of the Consumer Financial Protection Bureau's final rule, Rules Concerning Prepaid Accounts under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z), 83 Fed. Reg. 6364 (Feb. 13, 2018), codified at 12 C.F.R. Parts 1005 and 1026.

<sup>23</sup> Arizona Fintech Bill, *supra* note 13, at § 41-5602.

Businesses Act (“URVCBA”), but not yet enacted or implemented in any state.<sup>24</sup> The availability of incubators is not contrary to views expressed in the Treasury’s 2018 Fintech Report.<sup>25</sup> These pro-innovation incubator options contrast with states that are focused on amending already non-uniform money-transmitter statutes to include providers of virtual-currency payment products and services.<sup>26</sup> These money-transmitter amendments do not include, at least for now, equivalents of Arizona’s sandbox, the ULC’s full-exemption and “registration” statuses, or the OCC’s special-purpose or full-fledged national bank charters.<sup>27</sup>

Part IV discusses another source of friction, or at least concern, for virtual-currency providers—the risks of being prosecuted under 18 U.S.C. § 1960 for being unlicensed by the states in which they do business or not registered with Treasury’s Financial Crimes Enforcement Network (“FinCEN”). This Part also explains why virtual-currency businesses should ensure that they comply with existing anti-money-laundering (“AML”) and Office of Foreign Asset Controls (“OFAC”) requirements, as well as meeting their state-license compliance responsibilities. Part V offers some conclusions.

## II. FRICTION: COMPETING REGULATORY APPROACHES ADVANCED IN THE UNITED STATES SINCE 2015

A major, if not the major, source of friction in the licensure and regulation of virtual-currency businesses in the United States stems from the rapidly multiplying approaches to these issues at the federal and state levels.<sup>28</sup> This Part of this essay offers readers a taxonomy of regulatory approaches that are being used or may be available to third-party providers of virtual-currency products and services in the United States based on options that appear to be available as of July 31, 2018. It includes analysis of the Treasury’s July 31, 2018 Fintech Report and of the Comptroller’s July 31, 2018 Policy Statement on Financial Technology Companies’ Eligibility to Apply for National Bank Charters, as well as of various state approaches.

### *A. Federal Bank Charters and Special-Purpose National Bank Charters*

On July 31, 2018, the Comptroller of the Currency issued a Policy Statement<sup>29</sup> and a supplement to the Comptroller’s Licensing Manual<sup>30</sup> announcing that it would take

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<sup>24</sup> UNIF. L. COMM’N, *supra* note 16, at § 207.

<sup>25</sup> 2018 TREAS. FINTECH REPORT, *supra* note 11, at 66–68, 167–69 (respectively, praising states as laboratories for innovation and advocating flexible regulatory regimes with options other than approval and disapproval, and “meaningful experimentation in the real world, subject to appropriate limitations”).

<sup>26</sup> For discussion of specific states’ approaches, see *infra* Part II. Additional analysis is offered in Trautman, *supra* note 18, at 42–48.

<sup>27</sup> OCC POLICY STATEMENT, *supra* note 10.

<sup>28</sup> Mark Burge, *Apple Pay, Bitcoin, and Consumers: The ABCs of Future Public Payments Law*, 67 HASTING L. J. 1493, 1493 (2016).

<sup>29</sup> OCC POLICY STATEMENT, *supra* note 10.

<sup>30</sup> OCC, COMPTROLLER’S LICENSING MANUAL SUPPLEMENT: CONSIDERING CHARTER APPLICATIONS FROM FINANCIAL TECHNOLOGY COMPANIES (2018),

applications for charters under its National Bank Act<sup>31</sup> authority. The options specifically include “special purpose national bank charters” and full national bank charters. The announcement<sup>32</sup> suggests that applicant must be engaged in “the business of banking.”<sup>33</sup> The announcement also explained that “the business of banking” includes three functions—taking deposits, paying checks, and lending money.<sup>34</sup>

Entities that “take deposits” will need to obtain federal deposit insurance from the Federal Deposit Insurance Corporation in addition to their OCC charters before they can commence business.<sup>35</sup> Entities that pay checks or lend money, or both, without taking deposits have not been required to hold bank charters or to have federal deposit insurance. These entities have been regulated by the states as check cashers<sup>36</sup> or licensed lenders<sup>37</sup> unless they held “special purpose bank charters.”<sup>38</sup>

“Special purpose banks” were limited to trust banks, banker’s banks, and credit card banks<sup>39</sup> until the Comptroller began to explore chartering fintech companies as special purpose banks in 2016.<sup>40</sup> The Comptroller’s July 31, 2018 Policy Statement continued to cite the existing regulation codified at 12 C.F.R. § 5.20 for the scope of potential authority for new fintech special-purpose banks.<sup>41</sup> In a now-dismissed

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<https://www.occ.treas.gov/publications/publications-by-type/licensing-manuals/file-pub-lm-considering-charter-applications-fintech.pdf>.

<sup>31</sup> National Bank Act, 12 U.S.C. §§ 1–16 (1988).

<sup>32</sup> Press Release, Office of the Comptroller of the Currency, OCC begins Accepting National Bank Charter Applications from Financial Technology Companies (July 31, 2018) [hereinafter NR 2018-74], <https://www.occ.gov/news-issuances/news-releases/2018/nr-occ-2018-74.html>.

<sup>33</sup> *Id.*; 12 U.S.C. §§ 21, 26 (1982).

<sup>34</sup> NR 2018-74, *supra* note 32; 12 C.F.R. § 5.20(e)(1)(i) (2015). It may become important to remember that physical locations at which a bank performs all three functions constitutes a “branch,” a status that implicates other considerations under § 36(j) of the National Bank Act. 12 U.S.C. § 36(j) (2000).

<sup>35</sup> 12 U.S.C. § 1811 (2006).

<sup>36</sup> See UNIF. L. COMM’N, CURRENT STATE REGULATION OF NONDEPOSITORY PROVIDERS OF FINANCIAL SERVICES (“NDPS”), <http://www.uniformlaws.org/shared/docs/money%20services/ndpnbfi.pdf> (last visited Oct. 5, 2018).

<sup>37</sup> *Id.*

<sup>38</sup> 12 C.F.R. § 5.20(e)(1)(i).

<sup>39</sup> NR 2018-74, *supra* note 32; 12 U.S.C. §§ 1841(c)(2)(D) and (F) (2010). For a more complete statement of the history and scope of these provisions, see Conference of State Bank Supervisors v. OCC, 313 F. Supp. 3d 285, 291–94 (D.D.C. 2018).

<sup>40</sup> Thomas J. Curry, Comptroller of the Currency, Address at the Georgetown University Law Center: Special Purpose National Bank Charters for Fintech Companies (Dec. 2, 2016), <https://www.occ.treas.gov/news-issuances/speeches/2016/pub-speech-2016-152.pdf>; OCC, EXPLORING SPECIAL PURPOSE NATIONAL BANK CHARTERS FOR FINTECH COMPANIES (2016), <https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf>.

<sup>41</sup> OCC POLICY STATEMENT, *supra* note 10.

challenge to the Comptroller's 2017 plans to charter fintech companies,<sup>42</sup> the Conference of State Bank Supervisors argued that these traditional types of special-purpose banks are the only types of special-purpose charters the Comptroller may grant.<sup>43</sup>

All fintech charter applicants, the announcement explained, "will be supervised like similarly situated national banks,"<sup>44</sup> will need to hold capital, demonstrate liquidity, to make financial inclusion commitments appropriate to their business plans,<sup>45</sup> to submit "acceptable contingency" plans for "significant financial stress that could threaten the viability of the bank,"<sup>46</sup> and should expect to be subject to "heightened supervision initially, similar to other de novo banks."<sup>47</sup>

The Comptroller's announcement has energized some participants in the virtual-currency community to imagine that they could obtain nationwide authority without the necessity of obtaining licenses as money transmitters or money services businesses in all jurisdictions that require them. As the Complaint filed by the CSBS notes, such charters free charter-holders from many state laws beyond those requiring state licensure.<sup>48</sup>

The prospect of special-purpose bank charters likely tantalizes virtual-currency companies as well as those in the broader range of fintech companies. However, the OCC's July 31, 2018 Policy Statement suggests that it will impose high standards and will look favorably on applicants that "[have] a reasonable chance of success, will be operated in a safe and sound manner, will treat customers fairly, and will comply with applicable laws and regulations."<sup>49</sup> The Policy Statement also explained that the OCC will not approve "proposals that include financial products and services that have predatory, unfair, or deceptive features or that pose risk to consumer protection[.]"<sup>50</sup> Thus, it is clear that the OCC will not be chartering every applicant for a special-purpose bank charter. Indeed, the OCC's proposed special-purpose bank charters require advance permission.<sup>51</sup> Given the high hurdles in the criteria explained above, this appears to be intended only for applicants with substantial capital and the ability to manage the application process.

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<sup>42</sup> *Conference of State Bank Supervisors*, 313 F. Supp. 3d at 301–02 (dismissing case on lack of standing grounds). The challenge brought by the New York State Department of Financial Services was dismissed on December 20, 2017. *Vullo v. OCC*, No. 17 Civ. 3574 (NRB), 2017 WL 6512245, at \*10 (S.D.N.Y. Dec. 12, 2017).

<sup>43</sup> Complaint for Declaratory and Injunctive Relief at ¶¶ 6, 31–46, *Conference of State Bank Supervisors v. OCC*, 313 F. Supp. 3d 285 (D.D.C. 2018) (No. 1:17-CV-00763).

<sup>44</sup> NR 2018-74, *supra* note 32.

<sup>45</sup> *Id.*

<sup>46</sup> *Id.*

<sup>47</sup> *Id.*

<sup>48</sup> Complaint for Declaratory and Injunctive Relief, *supra* note 43, at ¶ 11.

<sup>49</sup> OCC POLICY STATEMENT, *supra* note 10, at 3.

<sup>50</sup> *Id.* at 3–4.

<sup>51</sup> See 12 U.S.C. § 27(a) (1988) (certificate of authorization before commencing banking).

*B. State Bank Charters or Industrial Loan Company Charters*

States also charter banks and industrial loan companies (“ILCs”).<sup>52</sup> State-chartered banks need advance approval before they open for business from both the state’s chartering authority and the Federal Deposit Insurance Corporation.<sup>53</sup> State-chartered banks are subject to the same limitations on their ownership—to preserve the separation of banking and commerce observed in the United States at least since the Banking Act of 1933<sup>54</sup> and the Securities Act of 1933.<sup>55</sup> Thus, state-chartered banks are in the advance-permission, high-hurdle situations such as federally chartered banks with limitations on their ownership.

Industrial loan companies have powers like those enjoyed by state-chartered banks; they also need advance state approvals and FDIC approval.<sup>56</sup> However, an important difference is that owners of ILC applicants are not subject to the federal Bank Holding Company Act.<sup>57</sup> Thus, commercial firms can apply for industrial-loan company charters and some have. In 2017, for example, two fintech companies applied for ILC permissions: Social Finance (known as “SoFi Bank”) and Square, Inc.<sup>58</sup> Square’s ILC application with Utah remains active, but Square withdrew its FDIC application “temporarily” in June 2018.<sup>59</sup>

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<sup>52</sup> U.S. GOV’T ACCOUNTABILITY OFF., GAO-08-751, INDUSTRIAL LOAN CORPORATIONS (2005).

<sup>53</sup> *How Can I Start a Bank?*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, [https://www.federalreserve.gov/faqs/banking\\_12779.htm](https://www.federalreserve.gov/faqs/banking_12779.htm) (last updated Aug. 2, 2013).

<sup>54</sup> Glass-Steagall Act of 1933, Pub. L. 73-66, 48 Stat. 162 (1933) (also known as the Banking Act of 1933).

<sup>55</sup> Securities Act of 1933, Pub. L. 73-22, 48 Stat. 74 (1933), codified at 15 U.S.C. § 77(a) (1994).

<sup>56</sup> For a comprehensive review of the FDIC’s authority to supervise industrial loan companies, see Mindy West, *The FDIC’s Supervision of Industrial Loan Companies: A Historical Perspective*, FED. DEP. INS. CORP. (2004), <https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisummer04-article1.pdf>.

<sup>57</sup> Bank Holding Company Act, 12 U.S.C. §§ 1841–1852 (1994); West, *supra* note 56.

<sup>58</sup> See *Application Status*, UTAH DEP’T OF FIN. INSTS., <https://dfi.utah.gov/general-information/application-status/> (last updated Nov. 30, 2017); Cinar Oney, *Fintech Industrial Banks and Beyond: How Banking Innovations Affect the Federal Safety Net*, 23 FORDHAM J. CORP & FIN. L. 541 (2018). For more discussion, see, Kevin Petrasic et al., *Fintech Companies and Bank Charters: Options and Considerations for 2018*, WHITE & CASE (Jan. 10, 2018), <https://www.whitecase.com/publications/alert/fintech-companies-and-bank-charters-options-and-considerations-2018>.

<sup>59</sup> See Michelle Price, *Payments Processor Square Inc. Withdraws Banking Application: Statement*, REUTERS (July 5, 2018), <https://www.reuters.com/article/us-square-fdic-license/payments-processor-square-inc-withdraws-banking-license-application-statement-idUSKBN1JV2XG>.

*C. States Offering Only Pre-Approved Full Licensure to Non-Bank Providers Including Virtual-Currency Businesses*

States require licenses prior to engaging in certain types of financial services activities, particularly when their counter-parties are consumers.<sup>60</sup> Lending money is one such financial service that requires a license from all states.<sup>61</sup> The range of services includes mortgage-lending, automobile financing, and other small-dollar loan products.<sup>62</sup> Another service for which states generally require licensure is traditionally known as “money transmission.”<sup>63</sup> This category includes sending money from one consumer to another or from one location to another without engaging a bank to complete the transaction and “payment processing,” a term that covers credit-and-debit-card processing for merchants and payroll services.<sup>64</sup> All states, except Montana, have statutes governing “money transmission.”<sup>65</sup> These types of state laws normally exclude depository institutions—banks and credit unions—from their scope.<sup>66</sup>

State license applications are also relatively costly and time-consuming. For example, the Texas Department of Banking requires a non-refundable application fee of \$10,000 for money transmission licenses (\$5,000 for currency-exchange-only applications).<sup>67</sup> In addition, the Texas Department of Banking requires surety bonds for money transmission ranging from \$300,000 to \$2 million, or a deposit or letter-of-credit substitute, and net worth ranging from \$100,000 (for four or fewer locations in Texas) to a minimum for five or more locations of \$500,000.<sup>68</sup> The time required to get a license varies, but there are reports of periods of one to two years.<sup>69</sup> Application processes have generated complaints from stakeholders in the past.<sup>70</sup> The press release

<sup>60</sup> Jo Ann S. Barefoot, *Disrupting Fintech Law*, 18 FINTECH L. REP. 1, 18 (2015).

<sup>61</sup> *Id.*

<sup>62</sup> See *Types of Loans: What Are The Differences?*, VALUEPENGUIN <https://www.valuepenguin.com/loans/types-of-loans> (last visited Oct. 13, 2018).

<sup>63</sup> Nizan Geslevich Packin & Yafit Lev-Aretz, *Big Data and Social Netbanks: Are You Ready To Replace Your Bank?*, 53 HOUS. L. REV. 1211, 1250 (2016).

<sup>64</sup> See *id.* at 1252.

<sup>65</sup> See THOMAS BROWN, CAL. STATE ASSEMB., COMM. ON BANKING & FIN., 50-STATE SURVEY: MONEY TRANSMITTER LICENSING REQUIREMENTS (2013).

<sup>66</sup> See N.C. GEN. STAT. § 53-208.42(7) (2016) (stating the definition of a “depository institution”); see § 53-208.44 (explaining the exemptions for persons required to have a money transmitter license to engage in business in North Carolina).

<sup>67</sup> See TEX. DEP’T OF BANKING, GENERAL APPLICATION REQUIREMENTS, <http://www.dob.texas.gov/applications-forms-publications/general-application-requirements> (last updated Sept. 2017).

<sup>68</sup> *Id.*

<sup>69</sup> Faisal Khan, *How Difficult Is It to Get a Money Transmitter License for Texas?*, QUORA (Jan. 12, 2016), <https://www.quora.com/How-difficult-is-it-to-get-a-money-transmitter-license-for-Texas>.

<sup>70</sup> See THOMAS BROWN, *supra* note 65; see generally Bloomberg Law, *Money Transmitter: Licensing Guidance*, [https://www.bloomberglaw.com/product/bankfinance/page/bf\\_money\\_transmitter\\_guidance](https://www.bloomberglaw.com/product/bankfinance/page/bf_money_transmitter_guidance) (last visited Sept. 27, 2018).

announcing the State of Arizona's new "regulatory sandbox," described in a later subpart of this essay, stated:

Currently, it can take a startup several months and tens of thousands of dollars in fees, compliance costs, and legal expenses to navigate the regulatory maze in just one state. This slow-moving and expensive process is unacceptable in an industry like fintech that is rapidly changing and developing.<sup>71</sup>

Licensure requirements in the United States vary a great deal. Some states amended their money transmission statutes to reach providers of virtual-currency products and services.<sup>72</sup> For example, North Carolina amended its statutory definition of "money transmission" in 2016<sup>73</sup> to include "maintaining control of virtual currency on behalf of others," and to define "virtual currency."<sup>74</sup> Washington State similarly amended its Money Services Act to include virtual currency.<sup>75</sup> Washington also excludes banks and credit unions from its statute.<sup>76</sup> Other states have not regulated virtual-currency providers yet, for example, South Carolina.<sup>77</sup>

Like bank and ILC charter holders, state money transmission and money services statutes take an all-or-nothing approach to regulating virtual-currency providers.<sup>78</sup> If the business activity meets the statutory definition, then the business must have a license before it offers its products or services to the public.<sup>79</sup> Unlicensed activity is met with the prospect of criminal prosecutions and penalties.<sup>80</sup>

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<sup>71</sup> Press Release, Ariz. Att'y Gen., Ariz. Becomes First State in U.S. to Offer Fintech Regulatory Sandbox (Mar. 23, 2018) [hereinafter Arizona AG Regulatory Sandbox Press Release], <https://www.azag.gov/press-release/arizona-becomes-first-state-us-offer-fintech-regulatory-sandbox>.

<sup>72</sup> Dale A. Werts & Tedrick A. Housh III, *Blockchain and Cryptocurrency: State Law Roundup*, LATHROP GAGE (July 9, 2018), <https://www.lathropgage.com/newsletter-239.html>.

<sup>73</sup> N.C. GEN. STAT., § 53.208.42(13) (2016).

<sup>74</sup> *Id.* § 53.208.42(20).

<sup>75</sup> WASH. REV. CODE ANN. § 19.230 (2017). For a listing of virtual-currency licensees in Washington State, see DEP'T OF FIN. INSTS., LICENSEE LIST – VIRTUAL CURRENCY, <http://www.dfi.wa.gov/sites/default/files/documents/virtual-currency-licensee-list.pdf> (last updated Sept. 5, 2018).

<sup>76</sup> WASH. REV. CODE ANN. § 19.230.020 (2017).

<sup>77</sup> Heather Morton, *Cryptocurrency 2018 Legislation*, NAT'L CONF. OF ST. LEGISLATURES (July 5, 2018), <http://www.ncsl.org/research/financial-services-and-commerce/cryptocurrency-2018-legislation.aspx>.

<sup>78</sup> See PETER VAN VALKENBURGH, THE NEED FOR A FEDERAL ALTERNATIVE TO STATE MONEY TRANSMISSION LICENSING 3 (2018).

<sup>79</sup> WASH. REV. CODE ANN. § 19.230.030; *id.* § 19.230.010(17)–(19).

<sup>80</sup> See, e.g., WASH. REV. CODE ANN. § 19.230.300 (criminal penalties); N.C. GEN. STAT. § 53-208.58(c) (2016) (criminal penalties for engaging in business without first obtaining a license).

*D. Efforts to Increase Reciprocal Recognition of Licenses Issued by Other States Including a Pilot Reciprocity Program to Increase Harmonization of Licensing, Regulations, and Examinations*

Efforts to reduce barriers between and among state licensure requirements since 2016 have come in two forms: enhanced coordination in licensing and supervision and proposed legislation that specifically encourages reciprocal licensure.<sup>81</sup> Both forms use the CSBS' Nationwide Mortgage Licensing System.<sup>82</sup> This subpart of this essay looks at both approaches as alternatives to federal preemption of state regulations relating to virtual-currency business licensure, regulation, and examination—preemption that might come in new legislation or by virtue of holding federal fintech charters.

1. Enhanced Coordination in Licensure and Supervision—the CSBS Vision 2020 Approach

In its May 2017 Vision 2020 announcement, the CSBS set forth a goal that “[b]y 2020, state regulators will adopt an integrated, 50-state licensing and supervisory system, leveraging technology and smart regulatory policy to transform the interaction between industry, regulators and consumers.”<sup>83</sup> In February 2018, the CSBS launched a pilot program to increase harmonization of licensing and other regulatory requirements and examinations of non-depository providers of consumer financial services licensed by states, including agreements by seven states to accept licensing findings of other states.<sup>84</sup>

The CSBS issued a report on its efforts in June 2018.<sup>85</sup> That report identified “common goals shared between regulators and the industry that will help guide improvements to the state supervisory process.”<sup>86</sup> These included efforts to “support innovation and startups, enable national scale, strengthen the financial system, and uphold important consumer protections.”<sup>87</sup> In August 2018, the CSBS issued an

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<sup>81</sup> CONF. OF STATE BANK SUPERVISORS, STATE REGULATORS NATIONWIDE ADOPT SINGLE EXAM FOR MORTGAGE LICENSING (Aug. 8, 2018), <https://www.csbs.org/state-regulators-nationwide-adopt-single-exam-mortgage-licensing>.

<sup>82</sup> *Id.*

<sup>83</sup> CONF. OF STATE BANK SUPERVISORS, VISION 2020 FOR FINTECH AND NON-BANK REGULATION (May 10, 2017), <https://www.csbs.org/csbs-announces-vision-2020-fintech-and-non-bank-regulation>.

<sup>84</sup> CONF. OF STATE BANK SUPERVISORS, STATE REGULATORS TAKE FIRST STEP TO STANDARDIZE LICENSING PRACTICES FOR FINTECH PAYMENTS (Feb. 6, 2018), <https://www.csbs.org/state-regulators-take-first-step-standardize-licensing-practices-fintech-payments> (participating states include Georgia, Illinois, Kansas, Massachusetts, Tennessee, Texas and Washington).

<sup>85</sup> CONF. OF STATE BANK SUPERVISORS, VISION 2020 FOR FINTECH AND NON-BANK REGULATION (June 7, 2018) [hereinafter JUNE 2018 CSBS VISION REPORT], <https://www.csbs.org/vision2020>.

<sup>86</sup> *Id.* at 3.

<sup>87</sup> *Id.*

additional update reporting on progress and describing its next steps.<sup>88</sup> In the August 2018 report, the CSBS announced that 84 percent of the states were using the NMLS for money transmitter licensing.<sup>89</sup>

Strong participation in the NMLS by states that require licenses for money transmission and money services businesses is certainly a huge step forward in streamlining the license application processes for fintech and other non-bank businesses. The NMLS or other methods to share information from license applications, as forward-thinking as the CSBS plans and admirable all-around, do not address two significant issues: (1) the variations of coverage in state laws governing virtual-currency businesses and (2) the attendant risks of being prosecuted as an unlicensed provider by a state whose money transmission or money services laws cover virtual-currency services as money transmission or money services, or, more significantly, for a failure to hold a license and to register with the Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") as a "money services business" for which liability under 18 U.S.C. § 1960 does not have a scienter requirement.<sup>90</sup>

Only a uniform law that is enacted by many states or federal preemption in a new chartering or licensing system will address the risks that arise from non-uniform state coverage requirements where Section 1960 liability may arise. Nevertheless, until states enact uniform laws governing virtual-currency businesses or a federal regime is in place, CSBS' Vision 2020 is a significant improvement over the status quo ante.

## 2. State Statutory Requirements that Encourage Reciprocal Licensing Agreements

Beyond harmonization of the license application processes that the CSBS Vision 2020 project is advancing, an alternate route is direct recognition of licenses granted by one or more states by other states, a process known as "reciprocity." The ULC's Uniform Regulation of Virtual-Currency Businesses Act responds to two concerns that CSBS identified in today's 50-state licensure requirements impose on entrants to the fintech business marketplace: lack of clarity about whether businesses need licenses in some jurisdictions and duplicative or overlapping license processing requirements.<sup>91</sup>

The ULC offered two alternative ways to achieve reciprocity in Article 2 of the URVCBA.<sup>92</sup> The ULC's URVCBA first encourages the use by states of the Nationwide Multistate Licensing System ("NMLS")<sup>93</sup> to permit reciprocal licensing—an approach not included in CSBS' Vision 2020 Project.<sup>94</sup> In the following excerpt,

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<sup>88</sup> CONF. OF STATE BANK SUPERVISORS, CSBS VISION 2020: PROGRESS UPDATE (Aug. 2, 2018) [hereinafter AUGUST 2018 CSBS PROGRESS UPDATE], <https://www.csbs.org/csbs-vision-2020-progress-update>.

<sup>89</sup> *Id.* (referencing point three of the report).

<sup>90</sup> 18 U.S.C. § 1960 (2016).

<sup>91</sup> See JUNE 2018 CSBS VISION REPORT, *supra* note 85.

<sup>92</sup> UNIF. L. COMM'N, *supra* note 16, at § 203.

<sup>93</sup> CONF. OF STATE BANK SUPERVISORS, NATIONWIDE MULTISTATE LICENSING SYSTEM, <https://www.csbs.org/nationwide-multistate-licensing-system> (last visited Oct. 1, 2018) (explaining that NMLS does not grant or deny licenses).

<sup>94</sup> JUNE 2018 CSBS VISION REPORT, *supra* note 85.

the term “registry” specifically refers to the NMLS because of the definition in the URVCBA’s Section 102(15).<sup>95</sup> Section 203 of the URVCBA provides:

**SECTION 203. LICENSE BY RECIPROCITY.**

**Alternative A**

(a) Instead of an application required by Section 202, a person licensed by another state to conduct virtual-currency business activity in that state may file with the registry an application under this section.

(b) When an application under this section is filed with the registry, the applicant shall notify the department in a record that the applicant has submitted the application to the registry and shall submit to the department:

(1) a certification of license history from the agency responsible for issuing a license in each state in which the applicant has been licensed to conduct virtual-currency business activity;

(2) a nonrefundable reciprocal licensing application fee in the amount [required by law of this state other than this [act] or specified by the department by rule];

(3) documentation demonstrating that the applicant complies with the security and net worth reserve requirements of Section 204; and

(4) a certification signed by an executive officer of the applicant affirming that the applicant will conduct its virtual-currency business activity with or on behalf of a resident in compliance with this [act].

(c) The department may permit conduct of virtual-currency business activity by an applicant that complies with this section.<sup>96</sup>

Comment 4 to URVCBA Section 203 makes clear that the NMLS and Registry is the preferred mechanism for “submission and management of reciprocal licensure applications” under the URVCBA.<sup>97</sup> The unique addition in Section 203 is its position that reciprocal licensure by states is a good approach for the prudential regulation of virtual-currency businesses by the states.

The other option that URVCBA Section 203 suggests is more limited legislative authority for bilateral or multilateral reciprocity based on the assessment by state banking commissioners or departments that other states have licensure requirements comparable to their states’ requirements.<sup>98</sup> For this reason, URVCBA Section 203 includes an alternative way to authorize reciprocity:

**Alternative B**

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<sup>95</sup> UNIF. L. COMM’N, *supra* note 16, at § 102(15).

<sup>96</sup> UNIF. L. COMM’N, *supra* note 16, at § 203 Alternative A.

<sup>97</sup> UNIF. L. COMM’N, *supra* note 16, at § 203 cmt. 4.

<sup>98</sup> UNIF. L. COMM’N, *supra* note 16, at § 203 Alternative B(a)(1).

(a) A person licensed by another state to engage in virtual-currency business activity in that state may engage in virtual-currency business activity with or on behalf of a resident to the same extent as a licensee if:

(1) the department determines that the state in which the person is licensed has in force laws regulating virtual-currency business activity which are substantially similar to, or more protective of rights of users than, this [act];

(2) at least 30 days before the person commences virtual-currency business activity with or on behalf of a resident, the person submits to the department:

(A) notice containing:

(i) a statement that the person will rely on reciprocal licensing;

(ii) a copy of the license to conduct virtual-currency business activity issued by the other state; and

(iii) a certification of license history from the agency responsible for issuing the license to conduct virtual-currency business activity in the other state;

(B) a nonrefundable reciprocal license fee in the amount [required by law of this state other than this [act] or specified by the department by rule];

(C) documentation demonstrating that the applicant complies with the security and net worth reserve requirements of Section 204; and

(D) a certification signed by an executive officer of the applicant affirming that the applicant will conduct its virtual-currency business activity with or on behalf of a resident in compliance with this [act];

(3) subject to subsection (b), the department does not deny the application not later than [15] days after receipt of the items submitted under paragraph (2); and

(4) subject to subsection (b), the applicant does not commence virtual-currency business activity with or on behalf of a resident until at least 31 days after complying with paragraph (2).<sup>99</sup>

The approaches offered in the URVCBA go beyond the scope of CSBS' Vision 2020 project. The URVCBA offers legislative authority for reciprocal licensing; the CSBS approach so far only allows sharing of license application information and investigatory results. These are no small achievements, but far less than legislative

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<sup>99</sup> UNIF. L. COMM'N, *supra* note 16, at § 203 Alternative B.

authority allowing true reciprocity.<sup>100</sup> Still, both the URVCBA and CSBS' Vision 2020 are efforts to reduce friction in the initial licensure and later supervision of virtual-currency businesses.<sup>101</sup>

*E. "Regulatory Sandboxes" Based on Prior Approval to Operate and Other "Sandbox" Options—Arizona, the Bureau of Consumer Financial Protection, and the Uniform Regulation of Virtual-Currency Businesses Act*

"Regulatory sandboxes" allow innovators in fintech, blockchain, and cryptocurrencies the ability to operate with the need for full licensure on a trial basis, but the criteria used to determine eligibility or the need for approval prior to operations may differ.<sup>102</sup> In some foreign nations, a "regulatory sandbox license" is required.<sup>103</sup>

1. Arizona's 2018 Regulatory Sandbox Legislation

Arizona became the first U.S. state to authorize a regulatory sandbox when its governor signed House Bill 2434 on March 23, 2018.<sup>104</sup> The new program was approved for launch on July 1, 2018.<sup>105</sup> Authority for the regulatory sandbox program ends on July 1, 2028.<sup>106</sup>

The legislation offers—on a prior approval basis only—applicants a 24-month period<sup>107</sup> in which a fintech company can engage in transactions with Arizona residents without obtaining full licensure to operate.<sup>108</sup> Other features of Arizona's sandbox program are important to note. First, all customers of the approved companies must be residents of Arizona<sup>109</sup> and the legislation caps the number of customers an approved company may serve.<sup>110</sup> If the company is testing products or services as a money transmitter, as that term is defined in Ariz. Rev. Stat. § 6-1201, the sandbox legislation limits individual transactions per consumer to \$2,500, and aggregate transactions per consumer to not more than \$25,000.<sup>111</sup> The Arizona Attorney General may authorize holders of money transmitter sandbox approvals to deal with as many as 17,500 consumers, with a \$15,000 limit per transaction and an aggregate limit of

<sup>100</sup> JUNE 2018 CSBS VISION REPORT, *supra* note 85.

<sup>101</sup> UNIF. L. COMM'N, *supra* note 16, at § 203; JUNE 2018 CSBS VISION REPORT, *supra* note 85.

<sup>102</sup> U.S. GOV'T ACCOUNTABILITY OFF., *supra* note 52.

<sup>103</sup> See, e.g., BOARD OF INVESTMENT MAURITIUS, REGULATORY SANDBOX LICENSE, [www.investmauritius.com/schemes/rs1.aspx](http://www.investmauritius.com/schemes/rs1.aspx).

<sup>104</sup> Arizona AG Regulatory Sandbox Press Release, *supra* note 71, at 1.

<sup>105</sup> ARIZ. REV. STAT. ANN. §§ 41-5612, 41-3102 (2018).

<sup>106</sup> *Id.*

<sup>107</sup> ARIZ. REV. STAT. ANN. § 41-5605(A)(1) (2018).

<sup>108</sup> ARIZ. REV. STAT. ANN. §41-5601(6); Arizona AG Regulatory Sandbox Press Release, *supra* note 71, at 1.

<sup>109</sup> Ariz. Rev. Stat. Title 41, Ch. 55, § 41-5605(B)(1) (2018).

<sup>110</sup> ARIZ. REV. STAT. ANN. § 41-5605(B)(2) (2018) (capping at 10,000 consumers the authority under the sandbox program for participating companies).

<sup>111</sup> ARIZ. REV. STAT. ANN. § 41-5605(B)(4) (2018).

\$50,000 per consumer, if the sandbox applicant demonstrates “adequate financial capitalization, risk management process and management oversight.”<sup>112</sup> The participating companies must comply with Arizona’s Consumer Fraud Act<sup>113</sup> and all statutory limits and caps in Arizona law related to financial transactions.<sup>114</sup> Arizona House Bill 2434 also allows firms to test new products in a regulatory sandbox for which they do not already have permission from the State.<sup>115</sup>

The sandbox will be administered by the Office of Arizona’s Attorney General,<sup>116</sup> not by its traditional regulator of non-depository providers. A key feature is the grant of discretion to the Arizona Attorney General to deny applications.<sup>117</sup> Denials are explicitly not appealable agency actions.<sup>118</sup>

## 2. The Bureau of Consumer Financial Protection’s Global Financial Innovation Network

Another regulatory sandbox may result from the Bureau of Consumer Financial Protection’s Global Financial Innovation Network, which was announced in August 2018.<sup>119</sup> The Bureau announced its global regulator partners, including the United Kingdom’s Financial Conduct Authority, Abu Dhabi Global Markets, Autorité des marchés financiers (Québec), Australian Securities & Investments Commission, Central Bank of Bahrain, Dubai Financial Services Authority Guernsey Financial Services Commission, Hong Kong Monetary Authority, Monetary Authority of Singapore, Ontario Securities Commission, and Consultative Group to Assist the Poor (CGAP).<sup>120</sup> This program is not limited to participants offering virtual-currency products and services.

The BCFP issued a draft document describing aspects of the collaboration in which it expects to participate that, among other things, specifically mentions providing “firms with an environment in which to trial cross-border solutions.”<sup>121</sup> The draft sets forth common objectives found in global regulatory sandbox programs, including: supporting financial innovation and fintech firms offering new products, services, or business models; fostering a financial services system that is “more efficient and manages risks more effectively;” understanding how emerging technologies and business models “interact with the regulatory framework and where it may lead to

<sup>112</sup> ARIZ. REV. STAT. ANN. § 41-5605(C)(1)-(2) (2018).

<sup>113</sup> ARIZ. REV. STAT. ANN. §§ 44-1521-1534 (2018).

<sup>114</sup> ARIZ. REV. STAT. ANN. § 41-5605(B)(3) (2018).

<sup>115</sup> ARIZ. REV. STAT. ANN. § 41-41-5603(D) (2018).

<sup>116</sup> ARIZ. REV. STAT. ANN. § 41-5602 (2018).

<sup>117</sup> ARIZ. REV. STAT. ANN. § 41-5603(J) (2018).

<sup>118</sup> *Id.*

<sup>119</sup> BCFP Global Network Press Release, *supra* note 12.

<sup>120</sup> *Id.* at 2.

<sup>121</sup> *Id.* at 1; BUR. OF CONS. FIN. PROT., GLOBAL FINANCE INNOVATION NETWORK: CONSULTATION DOCUMENT (2018) [hereinafter BCFP CONSULTATION DOCUMENT], [https://files.consumerfinance.gov/f/documents/bcfp\\_global-financial-innovation-network\\_consultation-document.pdf](https://files.consumerfinance.gov/f/documents/bcfp_global-financial-innovation-network_consultation-document.pdf). Comments on the document are due by October 14, 2018. See BCFP Global Network Press Release, *supra* note 12, at 2.

barriers to entry,” promoting “effective competition in the interest of consumers;” and promoting “financial inclusion for consumers.”<sup>122</sup> The document also defines the testing that sandbox firms may engage in as “either on a virtual basis with data sets, or in a love market with real consumers or market participants.”<sup>123</sup>

### 3. Threshold-Based Exemptions from Full-Licensure or Activity Exclusions from Licensure Requirements under the Uniform Law Commission’s Uniform Regulation of Virtual-Currency Businesses Act—Another Key Part of the Uniform Law Commission’s Approach

A different type of regulatory environment or “sandbox” that permits testing of new products and services among virtual-currency businesses is the ULC’s combination of activity exclusions and threshold-basis exemptions from full licensure embedded in its URVCBA.<sup>124</sup> First, the URVCBA defines “virtual-currency business activity” as:

- (A) exchanging, transferring, or storing virtual currency or engaging in virtual-currency administration, whether directly or through an agreement with a virtual-currency control-services vendor;
- (B) holding electronic precious metals or electronic certificates representing interests in precious metals on behalf of another person or issuing shares or electronic certificates representing interests in precious metals; or
- (C) exchanging one or more digital representations of value used within one or more online games, game platforms, or family of games for:
  - (i) virtual currency offered by or on behalf of the same publisher from which the original digital representation of value was received; or
  - (ii) legal tender or bank credit outside the online game, game platform, or family of games offered by or on behalf of the same publisher from which the original digital representation of value was received.<sup>125</sup>

That definition, in turn, depends on the scope of the term “virtual currency,” which is defined as:

- (A) means a digital representation of value that:
  - (i) is used as a medium of exchange, unit of account, or store of value; and
  - (ii) is not legal tender, whether or not denominated in legal tender; and

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<sup>122</sup> BCFP CONSULTATION DOCUMENT, *supra* note 121.

<sup>123</sup> *Id.* at 17.

<sup>124</sup> UNIF. L. COMM’N, *supra* note 16, at § 201.

<sup>125</sup> *Id.* § 102(25).

(B) does not include:

(i) a transaction in which a merchant grants, as part of an affinity or rewards program, value that cannot be taken from or exchanged with the merchant for legal tender, bank credit, or virtual currency; or

(ii) a digital representation of value issued by or on behalf of a publisher and used solely within an online game, game platform, or family of games sold by the same publisher or offered on the same game platform.<sup>126</sup>

Additionally, the URVCBA has two threshold-based exemptions from full licensure.<sup>127</sup> For providers “whose virtual-currency business activity with or on behalf of residents is reasonably expected to be valued, in the aggregate, on an annual basis at \$5,000 or less, measured by the U.S. Dollar equivalent of virtual currency,”<sup>128</sup> the exemption is absolute.<sup>129</sup> For providers whose activity is \$5,000 or less with residents of the enacting state up less than \$35,000 on an annual basis measured in the same manner, the act requires “registration” with the enacting state and compliance with substantive provisions of the act.<sup>130</sup> As Comment 2 to URVCBA Section 103 explains:

This act sets the full-licensure threshold at an annual transaction volume of \$35,000 or more in the U.S. Dollar equivalent with residents of an enacting state. This figure is intended to allow some “in the wild” testing of the products and services in the enacting state. When aggregated with the same threshold in other states that enact this act, this threshold is intended to allow room for market- and function- testing virtual-currency products or services involved on a modest basis in more than one enacting state without first needing to hold a license from each of those states.<sup>131</sup>

Section 207 of the URVCBA sets forth the requirements for those seeking to operate under the “registration” option below full-licensure status only if “registrants” can fulfill the requirements of Subsection 207(a):

**SECTION 207. REGISTRATION IN LIEU OF LICENSE.**

(a) A person whose volume of virtual-currency business activity in U.S. Dollar equivalent of virtual currency will not exceed \$35,000 annually may engage in virtual-currency business activity with or on behalf of a resident under a registration without first obtaining a license under this [act] if the person:

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<sup>126</sup> *Id.* § 102(23).

<sup>127</sup> *Id.* § 207.

<sup>128</sup> *Id.* § 103(b)(8).

<sup>129</sup> *Id.* § 207 cmt. 4.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* § 103 cmt. 2.

- (1) files with the department a notice in the form and medium prescribed by the department of its intention to engage in virtual-currency business activity with or on behalf of a resident;
- (2) provides the information for an investigation under Section 202;
- (3) states the anticipated virtual-currency business activity for its next fiscal quarter;
- (4) pays the department a registration fee in the amount [required by law of this state other than this [act] or specified by the department by rule];
- (5) if required to register with the Financial Crimes Enforcement Network of the United States Department of the Treasury as a money-service business, provides the department evidence of the registration;
- (6) provides evidence that the person has policies and procedures to comply with the Bank Secrecy Act, 31 U.S.C. Section 5311 et seq. [, as amended], and other applicable laws;
- (7) describes the source of funds and credit to be used by the person to conduct virtual-currency business activity with or on behalf of a resident and provides evidence of and agrees to maintain the minimum net worth and reserves required by Section 204 and sufficient unencumbered reserves for winding down operations;
- (8) provides the department with evidence that the person has in place policies and procedures to comply with [Articles] 3, 5, and 6 and other provisions of this [act] designated by the department; and
- (9) provides the department with a copy of its most recent financial statement, whether reviewed or audited.<sup>132</sup>

URVCBA subsection 207(b) also addresses the duration of a registrant's permission to operate without a full license by requiring a license application "before" the registrant's "virtual-currency business activity . . . with or on behalf of residents exceeds \$35,000 annually in U.S. Dollar equivalent of virtual currency[.]"<sup>133</sup> It also allows registrants to operate while their applications for licenses are pending.<sup>134</sup>

Unlike Arizona's provision where the Attorney General must give prior approval of sandbox applications, URVCBA Section 207 does not require any form of advance permission, just registration, as its title suggests.<sup>135</sup> Like Arizona's sandbox law, URVCBA Section 207(c) provides that registrations may be suspended or revoked without prior hearings or opportunity to be heard.<sup>136</sup>

In addition to the dollar-equivalent cap mentioned above, URVCBA Section 207 sets outer limits of registrants' ability to engage with residents of enacting states, *viz.*,

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<sup>132</sup> *Id.* § 207(a).

<sup>133</sup> *Id.* § 207(b).

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* § 207 cmt. 3.

<sup>136</sup> *Id.* § 207(c).

all registrations cease to be effective on the second anniversary of the date of the registration.<sup>137</sup> The other limits imposed follow action by the regulator in charge in the enacting state, *viz.*, actions that deny the registrant's application for a license or that suspend or revoke the registration.<sup>138</sup>

Because the registration option applies for engagement with residents in each enacting state, and until the second anniversary of each registration, the URVCBA affords a broader base of testing products and markets than the Arizona sandbox allows, but the scale of activity under URVCBA Section 207 is likely to involve fewer consumers per state because of the lower dollar-equivalency cap on activity by "registrants."<sup>139</sup>

*F. States that Have Announced Intentions Not to Cover Virtual-Currency Businesses at This Time*

Some states have signaled their intentions not to regulate virtual-currency businesses under existing state money-transmitter or money-services laws, including Illinois, Kansas, New Hampshire, Tennessee, and Texas.<sup>140</sup> One state, Wisconsin, apparently has refused to issue money-transmitter licenses to virtual-currency business providers.<sup>141</sup>

This "non-regulation" approach is one that many providers will like. But, it comes with a potential cost: the fact that a state does not require a license or other approval or registration of providers seeking to engage with residents of that state may keep providers from recognizing that they still have federal compliance obligations under guidance issued by the Department of the Treasury's Financial Crimes Enforcement Network ("FinCEN") under regulations it enforces,<sup>142</sup> and from appreciating their potential liability under 18 U.S.C. § 1960. Additionally, providers in these states will have compliance responsibilities under statutes, regulations, and Executive Orders enforced by the Treasury's Office of Foreign Assets Control.<sup>143</sup> Thus, although the upside is the ability to operate without state compliance responsibilities or application costs, the downside of this "regulatory" approach is that it may create a false sense of non-regulation and cause less attention to federal compliance responsibilities.

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<sup>137</sup> *Id.* § 207(d)(4). Note that Arizona has imposed a comparable, 24-month limit on operations under its sandbox approvals program.

<sup>138</sup> *Id.* § 207(d)(1)–(2).

<sup>139</sup> *See id.* § 207.

<sup>140</sup> *See generally* Wales, *supra* note 14.

<sup>141</sup> *See* State of Wis. Dep't of Fin. Inst., *Sellers of Checks*, <https://www.wdfi.org/fi/ifs/soc/> (last updated Dec. 31, 2017).

<sup>142</sup> Financial Crimes Enforcement Network, 31 C.F.R. §§ 1010.100–1010.980 (effective March 1, 2011) (replacing 31 C.F.R. Part 103).

<sup>143</sup> *See* U.S. DEP'T OF TREAS., OFAC REGULATIONS FOR THE FINANCIAL COMMUNITY (Jan. 24, 2012), <https://www.treasury.gov/resource-center/sanctions/Documents/facbk.pdf> (containing a comprehensive listing of general and country-specific coverage up to early 2012).

*G. States that Have Not yet Regulated Virtual-Currency Providers Under Money-Transmission or Money-Services Regimes or Have not yet Indicated Their Intention to Do So*

The no-action-yet approach covers the largest number of states in the United States. Twenty-seven states have not amended laws or announced their intentions not to include virtual-currency products and services under their existing money-transmission or money-services regulatory regimes as of June 28, 2018. These states include Alaska, Arkansas, California, Florida, Indiana, Iowa, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, Nevada, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, South Dakota, Utah, West Virginia, and Wyoming.<sup>144</sup> In addition, Montana falls into this category primarily because it is the only state without a money-transmission or money-services regulatory statute as of July 31, 2018. The District of Columbia enacted a money-transmission statute in 2018, but it does not specifically cover virtual-currency transactions or providers.<sup>145</sup>

The downside for virtual-currency business providers in these states are the same as described in the previous category—that providers may fail to meet their obligations under FinCEN’s guidance or OFAC-enforced statutes, regulations, and Executive Orders.

### III. CREATING INCUBATION OPPORTUNITIES FOR INNOVATIVE PRODUCTS AND SERVICES

Innovators in the virtual-currency products and services community need environments in which they can test their wares “in the wild.” That is, with real customers. This Part of this essay explains why start-ups need a safe “location” from which to test products and grow, such as the two-year permissioned “sandbox” option in place in the State of Arizona since July 1, 2018<sup>146</sup> and the dollar-limited, non-permissioned “registration” option<sup>147</sup> included in the Uniform Law Commission’s URVCBA that has not been enacted or implemented in any state as of December 1, 2018.

Providers of virtual-currency payments and storage products and services need incubator environments because they may not yet be ready either for full licensure by states or the fintech charters that the OCC plans to offer. A recent policy update from the law firm of Sullivan and Cromwell explains two reasons why the OCC charters may not come to all participants in this marketplace:

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<sup>144</sup> See Wales, *supra* note 14. Readers should thank Mr. Wales for his comprehensive report on the status of state regulations. Note that Mr. Wales cites a report that Oregon may be in the classification of states that require licensure as of June 28, 2018, even if there is no publicly available statute or regulation taking that position. See *id.* (citing *Bitcoin Regulation Roundup Regulator Divide and “Life on Bitcoin,”* PYMNTS.COM (May 29, 2015), <https://www.pymnts.com/in-depth/2015/bitcoin-regulation-roundup-regulator-divide-and-life-on-bitcoin/>).

<sup>145</sup> See Title 10 of the D.C. Code, Chapter 10, § 26: Money Transmissions (2018).

<sup>146</sup> Arizona AG Regulatory Sandbox Press Release, *supra* note 71, at 2.

<sup>147</sup> UNIF. L. COMM’N, *supra* note 16, at § 207.

[I]t is unclear whether a special purpose national bank charter will be a viable option for certain fintech companies, as some startup or early-stage fintech companies may not be able to satisfy many of the baseline supervisory standards, such as those relating to capital, liquidity, and risk management requirements. Even mature fintech companies may conclude that a special purpose charter does not provide enough benefit to justify compliance with a relatively burdensome federal regulatory regime.<sup>148</sup>

Similar factors may keep some startup companies from obtaining full state licenses. For example, since the New York State “BitLicense” regulation became effective on August 8, 2015,<sup>149</sup> only five companies had obtained BitLicenses as of May 25, 2018.<sup>150</sup> Those companies are: Circle, Ripple, Coinbase, BitFlyer, and Genesis Global Trading.<sup>151</sup> The last approval, of Genesis, followed a long period in which Genesis had operated under the “safe harbor” provided to BitLicense applicants who filed license applications before the Regulation’s August 8, 2015 effective date.<sup>152</sup> Presumably, the Department of Financial Services learned a great deal about the operations and financial resilience of those applicants in the more than three years since the BitLicense regulation became effective.

Critics of DFS’s pace of granting BitLicenses continue to charge that the BitLicense regulator favors better-funded applicants over start-ups.<sup>153</sup> Among these may be the capital requirements that the regulation authorizes the Superintendent of the Department of Financial Services to impose.<sup>154</sup> The Superintendent may “consider a variety of factors” when determining the minimum capital it will impose on any licensee, including the composition of its assets and liabilities, its expected volume of activity, the amount of leverage it employs, and the types of products or services it plans to offer.<sup>155</sup> In states such as New York, the amount of the non-refundable

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<sup>148</sup> Sullivan & Crowmell LLP, *Special Purpose National Bank Charters*, (Aug. 3, 2018), <https://www.sullcrom.com/files/upload/SC-Publication-Special-Purpose-Fintech-National-Bank-Charters.pdf>.

<sup>149</sup> 23 N.Y. FIN. SERV. LAW § 200 (2015).

<sup>150</sup> See Jen Wiczner, *Inside New York’s BitLicense Bottleneck: An ‘Absolute Failure?’*, FORTUNE (May 25, 2018), <http://fortune.com/2018/05/25/bitcoin-cryptocurrency-new-york-bitlicense/> (discussing various issues concerning BitLicense applications).

<sup>151</sup> *Id.*

<sup>152</sup> Matthew Leising, *Genesis Global Trading Granted BitLicense in New York State*, BLOOMBERG (May 17, 2018), <https://www.bloomberg.com/news/articles/2018-05-17/genesis-global-trading-granted-bitlicense-in-new-york-state> (discussing licensing of cryptocurrency broker, which had previously operated under BitLicense’s “safe harbor” provision).

<sup>153</sup> Chrisjan Pauw, *BitLicense Approval Shines Fresh Light on New York-Crypto Relationship*, COIN TELEGRAPH (June 1, 2018), <https://cointelegraph.com/news/bitlicense-approval-shines-fresh-light-on-new-york-crypto-relationship> (mentioning how few BitLicenses have been granted and describing an exodus from New York State by several cryptocurrency providers despite the state’s sizeable role in financial services).

<sup>154</sup> 23 N.Y. FIN. SERV. LAW § 200.8 (2015).

<sup>155</sup> *Id.*

application fees and minimum capital requirements could well be beyond the reach of many potential applicants for full licenses.<sup>156</sup>

A final reason supporting enactment of the URCVBA’s “registration” option—and one in furtherance of Arizona’s sandbox and the “safe harbor” provided to pre-effective-date applicants for BitLicenses—is that the states have long served as testing grounds for new financial products and services.<sup>157</sup> As the Treasury’s 2018 Fintech Report noted:

The United States has a long and complex history of state and federal regulation in financial services. The U.S. banking system began through state charters. In many ways, the state-based system acts as a laboratory of innovation for firms, which should be preserved. In fact, the state model has allowed for numerous nonbank firms to build a local product in a state, and then subsequently expand as the product gained broader market appeal.<sup>158</sup>

The report continued with a final factor favoring having provider- or product-incubation capacity at the state level:

State regulators have greater proximity to their constituents and can be more responsive to the needs and preferences of local consumers than regulators who do not have a local presence.<sup>159</sup>

As this Part suggests, there may be many reasons why creating incubator options—such as Arizona’s sandbox periods, the BitLicense’s “safe harbor” operations, and the “registration” option under Section 207 of the URVCBA—is a good approach to regulating a young, and frequently morphing community of providers of financial services. Additional reasons stem from high application fees required for more mature “money transmitters” or “money services businesses” and from high, ongoing capital requirements. The small-scale testing that the URVCBA allows also can help regulators learn about the marketplace participants and various products and services being offered. Other benefits may attend incubators in the pursuit of information-based economies, such as collaborations among participants.<sup>160</sup>

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<sup>156</sup> DavisPolk, *New York’s Final “BitLicense” Rule: Overview and Changes From July 2014 Proposal* 3 (2015), [https://www.davispolk.com/files/new\\_yorks\\_final\\_bitlicense\\_rule\\_overview\\_changes\\_july\\_2014\\_proposal.pdf](https://www.davispolk.com/files/new_yorks_final_bitlicense_rule_overview_changes_july_2014_proposal.pdf).

<sup>157</sup> See 2018 TREAS. FINTECH REPORT, *supra* note 11, at 13.

<sup>158</sup> *Id.* at 66.

<sup>159</sup> *Id.*

<sup>160</sup> For a recent study of incubators and a literature review, see Hanadi Mubarak Al-Mubarak & Michael Busler, *Challenges and Opportunities of Innovation and Incubators as a Tool for Knowledge-Based Economy*, 6 J. OF INNOVATION & ENTREPRENEURSHIP 1 (Dec. 20, 2017), <https://innovation-entrepreneurship.springeropen.com/track/pdf/10.1186/s13731-017-0075-y>.

There are risks in not providing for sandboxes for fintech innovations. One is that market participants will go elsewhere to regulate, taking intellectual property, talent, and innovations with them.<sup>161</sup> Another is described in the next Part of this essay.

#### IV. LIABILITY UNDER 18 U.S.C. § 1960

Beyond the policy reasons to use incubators or regulatory sandboxes to encourage innovations in products and services, the most significant reason for greater clarity in the regulation of providers of virtual-currency payment and storage products comes from federal anti-money laundering regulations and enforcement authority.<sup>162</sup> The key provision is 18 U.S.C. § 1960, which provides that the knowing conduct, control, management, supervision, ownership, or direction of an unlicensed money transmitting business shall be fined or imprisoned not more than 5 years, or both.<sup>163</sup> To provide more context for why this federal criminal statute is a major reason as to why we need regulatory sandboxes or the URVCBA's "registration" (not licensure) option at this point in the development of virtual-currency payments and storage products and services, subsection (b)(1) of Section 1960 defines the term "unlicensed money transmitting business" as one affecting interstate or foreign commerce "in any manner or degree" and:

(A) is operated without an appropriate money transmitting license in a State where such operation is punishable as a misdemeanor or a felony under State law, whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable;

(B) fails to comply with the money transmitting business registration requirements under section 5330 of title 31, United States Code, or regulations prescribed under such section; or

(C) otherwise involves the transportation or transmission of funds that are known to the defendant to have been derived from a criminal offense or are intended to be used to promote or support unlawful activity.<sup>164</sup>

The key concern stems from subparagraph (A) above—that if one should have had a license to operate a money transmitting business in a State that has prescribed a misdemeanor or felony punishment for failure to hold such a license is vulnerable to prosecution under section 1960, whether they knew about the requirement to have a license.<sup>165</sup> This provision makes it imperative to provide opportunities for innovation without risk of federal prosecution for innocent providers. The second reason—as described in subparagraph (b) above is that failure to register a money transmitting business with FinCEN is a separate ground for liability.<sup>166</sup>

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<sup>161</sup> Ernst & Young, *As FinTech Evolves, Can Financial Services Innovation Be Compliant?* 3 (2017), <https://www.ey.com/Publication/vwLUAssets/ey-the-emergence-and-impact-of-regulatory-sandboxes-in-uk-and-across-apac.pdf>.

<sup>162</sup> 18 U.S.C. § 1860(a) (2016).

<sup>163</sup> *Id.*

<sup>164</sup> 18 U.S.C. § 1960(b)(1)(A)–(C) (2016).

<sup>165</sup> 18 U.S.C. § 1960(b)(1)(A) (2016).

<sup>166</sup> 18 U.S.C. § 1960(b)(1)(B) (2016).

## V. CONCLUDING OBSERVATIONS

A recent survey of providers of virtual-currency products and services revealed which jurisdictions that they perceived as having the best and worst approaches to regulating their businesses.<sup>167</sup> The United States topped the list of the “worst jurisdictions” and Malta topped the list of the “best jurisdictions.”<sup>168</sup> But, what is more telling, is that the top answers for both categories was “none.”<sup>169</sup>

It appears that virtual-currency businesses do not like regulation. They do not like what is happening, or not happening, in the United States. In other times, entities that needed physical locations could more easily avoid regulations they did not like by either not doing business in the jurisdictions whose requirements they do not wish to meet or changing the nature of their products and services to avoid specific regulations.

The regulation of virtual-currency payments- and storage-product providers in the United States shows some friction points and is beginning to offer some solutions, as this essay has tried to explore. We have not yet reached an inflection point in regulating virtual-currency providers.<sup>170</sup> Indeed, the Department of the Treasury’s report suggests that the inflection point is specifically ahead of us. The report embraces a solution to permit “meaningful experimentation in the real world, subject to appropriate limitations.”<sup>171</sup> It also proposes “a unified solution” that would provide equal access to companies in “various stages of the business lifecycle” (e.g., start-ups and incumbents).<sup>172</sup> The Treasury also suggests that the alternative could be a single regulator with power to preempt the other regulators of fintech firms or an additional regulator.<sup>173</sup> The Treasury’s bottom-line message is clear: if the states do not move to more uniformity in regulating providers of virtual-currency products and services in the next few years, the Department will ask Congress to adopt a federal regulatory scheme.<sup>174</sup> Whether or when Congress might do so is anyone’s guess.

With the Treasury’s recently issued challenge to collaborate or be preempted, the states should help create the space for innovation via new approaches to regulating new entrants into these emerging payments and asset-storage businesses. States can do this whether through more widespread enactment of uniform prudential regulatory schemes such as the URVCBA,<sup>175</sup> or other devices that States may authorize their non-

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<sup>167</sup> Nolan Bauerle, *State of Blockchain Q2 2018*, COINDESK RES., <https://www.coindesk.com/research/state-of-blockchain-q2-2018/?slide=96> (last visited Sept. 9, 2018).

<sup>168</sup> *Id.*; see Aki, *supra* note 19. Readers will recall that Malta has not yet fully adopted the laws or regulations that apparently contributed to this favorable position among the virtual-currency marketplace.

<sup>169</sup> Bauerle, *supra* note 167.

<sup>170</sup> 2018 TREAS. FINTECH REPORT, *supra* note 11, at 168.

<sup>171</sup> *Id.*

<sup>172</sup> *Id.*

<sup>173</sup> *Id.* at 169.

<sup>174</sup> *Id.*

<sup>175</sup> See 2018 TREAS. FINTECH REPORT, *supra* note 11, at 67–68 (mentioning specifically the URVCBA as a means of harmonizing state regulation of fintech companies).

bank regulators to try, perhaps through wider use of the NMLS to streamline license applications or other reciprocal license recognition, or sandboxes like that in Arizona.

The Treasury has offered the states a continuing role in our historical dual-regulation of providers of financial services—an approach that has served us well given differences in size, capital strength, business structure, and other features of developing financial services providers and markets.<sup>176</sup> Joint regulation has worked well through many iterations of products and business models, and through market disruptions. The Treasury is signaling that now is the time for the states to step up or to risk losing their ability to control which businesses may conduct transactions within their states' boundaries. As traditional hosts of new financial products and services, the states should step up because regulating *providers of virtual-currency products and services* is more appropriate now than attempting to regulate virtual currencies themselves, and it is more consistent with the States' traditional roles as regulators of non-depository providers of financial products and services.

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<sup>176</sup> See generally 2018 TREAS. FINTECH REPORT, *supra* note 11.