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PERSPECTIVE

Bitcoin arrest shows risk of virtual currency

By Judith Alison Lee

Users of the virtual currency bitcoin have been eager to demonstrate that it is a secure and legitimate medium of exchange, not a tool for money laundering and other illegal activities. December and January had delivered good news on that front. Forbes reported that Bank of America became the first major financial institution to assign bitcoin an analyst. In the NBA, the Sacramento Kings became the first professional sports franchise to accept bitcoins in their team shop.

The recent arrest of bitcoin exchanger Charlie Shrem for his alleged role in a money-laundering conspiracy to provide bitcoins to customers of Silk Road, an online narcotics and contraband marketplace that allegedly required its customers to pay using the virtual currency, makes it clear that the federal government is not yet convinced.

Its skepticism was also on display in a November 2013 hearing of the U.S. Senate Committee on Homeland Security and Governmental Affairs on the potential risks of virtual currencies. The committee heard testimony from Jennifer Shasky Calvery, director of the Financial Crimes Enforcement Network (FinCEN), as well as from officials at the Department of Justice and the U.S. Secret Service.

The U.S. Department of the Treasury already subjects virtual currency administrators and exchangers to the anti-money laundering (AML) and counter-terrorist financing (CFT) regulatory regime established by the Bank Secrecy Act (BSA). Virtual currency administrators and exchangers who are U.S. persons must also comply with Office of Foreign Assets Control (OFAC) prohibitions on transacting with Specially Designated Nationals or Blocked Persons (SDNs).

Nonetheless, it is clear that regulators remain concerned by virtual currency's potential for misuse. Each government witness emphasized that, whether subject to federal regulation or not, virtual currency has certain attributes that make it an attractive means of exchange for illicit actors. Specifically, they appear concerned with its capacity to facilitate international transfers of value between relatively anonymous users, unconstrained by transaction limits.

The arrest of Shrem and the closure of

the Silk Road are only the most recent in a string of government enforcement actions in this area. Late last year, DOJ indicted the virtual currency administrator Liberty Reserve and its executives for running a \$6 billion money-laundering operation that served organizations engaged in credit card fraud, identity theft, investment fraud, computer hacking, narcotics trafficking and child pornography.

The BSA is the U.S.'s primary anti-money laundering and counter-terrorist financing regulatory regime. It requires that "money services businesses" (MSBs) register with FinCEN, comply with various record-keeping rules, establish and maintain anti-money laundering programs, and file currency transaction and suspicious activity reports. In 2011, FinCEN published a final rule that revised the definition of a "money services business" to require virtual currency administrators and exchangers to comply with the BSA's regulatory requirements.

One such category is MSBs, which now includes virtual currency administrators and exchangers.

In its Bank Secrecy Act/Anti-Money Laundering Examination Manual, the Federal Financial Institution Examination Council (FFIEC) explained that, in certain circumstances, banks that deal with MSBs "may be exposed to a higher risk for potential money laundering activities." It requires banks to assess the risks of a particular MSB customer and perform due diligence that is proportional to the level of risk it assigns. Because virtual currency allows users to remain relatively anonymous, is accessible all over the world, allows for international transactions, and does not typically have transaction limits, virtual currency administrators and exchangers may prove to be risky customers. Consequently, banks may need to take steps like assessing the adequacy of virtual currency customers' BSA/AML compliance programs and

can undercut the OFAC screening process by keeping banks in the dark about the nature of and parties to the transactions being processed through their accounts.

Because virtual currencies also provide relative anonymity to their users, they pose analogous challenges. To mitigate the risk posed by third-party processors, the government advises that banks learn as much about the processor, its merchants, and its processes for contracting with them as possible. Given the similarity between third-party processors and virtual currency administrators, banks servicing administrator accounts should take similar steps.

Virtual currencies like bitcoin may yet emerge as a secure and government-sanctioned medium of exchange. Although virtual currencies are already subject to the BSA and OFAC regulation, the well-publicized arrest of Shrem and the recent Congressional hearing make clear that federal regulators continue to view virtual currency as a substantial source of AML, CFT and OFAC risk. Their current view is supported by previous guidance, which has warned about the risks inherent in doing business with entities, like virtual currency administrators and exchangers, which allow for international transfers of value between relatively anonymous users, unconstrained by transaction limits. Banks may still elect to do business with virtual currency administrators and exchangers. Until further notice, however, effective compliance with federal regulations requires that those who do so take additional precautions.

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In a 2013 guidance document, FinCEN sought to clarify what types of conduct would turn a handler of virtual currency into an MSB subject to the BSA regulatory regime. The FinCEN guidance divided the virtual currency community into three categories: administrators, exchangers and users. Virtual currency administrators — those who issue units of a virtual currency — and virtual currency exchangers — those who, like Shrem, engage in the business of exchanging virtual currency for cash — are subject to the regulatory regime. Users, or people who merely buy something with virtual currency, are free from regulation.

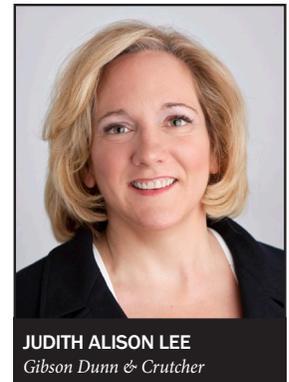
People doing business with virtual currency administrators and exchangers should not assume that federal regulation has eliminated virtual currency's potential for use in illicit activities. After all, Shrem is accused of being a regulated actor who disregarded the BSA's registration, record-keeping and reporting requirements. The government has previously cautioned financial institutions about doing business with certain categories of non-bank financial institutions, despite the fact they are regulated.

requesting additional information about their agents before providing them services.

Another potential source of concern for regulators is the similarity between virtual currency administrators and third-party payment processors. Third-party payment processors contract with merchants to process transactions between the merchant and its customers. Many accomplish this with the use of bank accounts. Because the processor's bank has no direct relationship with the processor's merchants, the "bank is unable to identify and understand the nature and source of the transactions processed" through the account. As a result, using third-party payment processors may be an attractive option for higher-risk merchants who would prefer not to deal directly with a bank.

Third-party payment processors can cause especially acute problems in the OFAC context. OFAC regulations require banks to block the accounts of and prohibit unlicensed trade or financial transactions with specified countries, entities, and individuals. The government considers that third-party payment processors

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