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BitLicense Regulations Create Groundbreaking Hurdles

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On June 3, 2015, the New York Department of Financial Services released the final version of its framework for regulating digital currency firms — the "BitLicense" regulation. The final regulations are the culmination of nearly two years of fact finding, debate and proposed regulations, and mark a historic development for the regulation of the virtual currency industry.

The first version of proposed regulations was published on July 17, 2014. An extended public comment period elicited over 3,700 public comments, the volume of comments demonstrating the controversial nature of the comprehensive proposed regulations.[1] A second proposed version was published on Feb. 4, 2015 — followed by a second public comment period.[2] The 2015 proposed regulations incorporated a number of changes, although the basic framework remained largely the same. As expected, there is little substantive change between the revised proposed regulations published in February and the final version released on June 3. As New York Superintendent of Financial Services Benjamin Lawsky noted in a speech in which he announced publication of the final regulations, DFS had received only 35 comments on the latest revision.[3]

Although the most prominent virtual currency, bitcoin, traces back half a dozen years, legislative and regulatory responses at the federal and state level have not kept up with technological developments, making the DFS proposals a significant milestone in the evolution of virtual currency regulation. The final regulatory framework adopted by DFS creates rigorous requirements for entities involved in what New York has defined as "virtual currency business activity" with "New York or a New York resident," requirements (and a jurisdictional threshold) that seem certain to shape future innovation in the sector as they will likely facilitate a market in which entities with the most robust financial backing will be best positioned to comply with the numerous mandates of the new regulations.

Final Regulations Announced in Speech by DFS Superintendent Lawsky Highlighting Key Aspects

Lawsky announced the release of the final regulations in remarks at the BITS Emerging Payments Forum in Washington, D.C., on June 3, 2015. In his speech, Lawsky focused on five aspects of the final regulations.[4] First, he clarified that firms will not need prior approval from DFS for minor updates to

software or apps. Rather, approval will only be required for "material" changes to the products or business model of a company.

Second, Lawsky stated that DFS has "no intention of being a regulator of software developers — only financial intermediaries."[5] He noted that this distinction was important because financial firms must accept regulatory scrutiny in exchange for the license from a state to be a fiduciary for customers' funds. Third, firms will not have to file duplicative applications for both a BitLicense and a money transmitter license. The license requirements for each will in many cases overlap, and the DFS will work with firms to have a "'one-stop' application submission" for both of these New York licenses.[6]

Fourth, in another attempt by DFS to avoid duplication of effort, firms that are already required to file suspicious activity reports (SARs) with federal regulators will not be required to file SARs with DFS. Fifth and finally, Lawsky explained that firms would not need to seek DFS approval for every new round of funding. DFS approval will only be required where a new investor is a "control person" — an investor who directs the management of the firm.

Final Regulations Reflect Few Substantive Changes From Revised Regulations Released in February

The final version of the regulations is largely unchanged from the 2015 proposed regulations.[7] Despite continued calls to lighten the compliance burden from virtual currency businesses and other groups associated with the industry, only one section was substantially edited after the revised framework was published.

The most significant modifications are to Section 200.10, Material Change to Business. This section has been revised to incorporate a number of changes and clarifications, largely addressing concerns that approval would be required in order to make routine updates to an app. To that end, the requirement to obtain prior written approval for plans or proposals to introduce new products, services or activities are now limited to only "materially" new products, services or activities.[8]

Several minor definitional changes have been made, but generally the final regulations remain the same as those published in February. As Lawsky discussed in his speech, the regulations were revised to clarify that entities subject to certain federal reporting requirements related to anti-money laundering will not need to file with DFS; however, there is some question concerning the exact nature and extent of reporting that will be required for entities not subject to those federal requirements.

Notably, some of the more onerous requirements, such as the anti-money laundering provisions and cybersecurity requirements, have largely remained the same. In addition, no changes were made to the provisions concerning "conditional licenses" that were introduced in the 2015 proposed regulations to address concerns that the 2014 proposed regulations adopted a "one-size-fits-all" approach given that all qualifying entities would have been required to comply with the same licensing regulations, regardless of size or resources.

The conditional licenses are designed for startups and small businesses that lack the financial and other resources to comply with the full licensing requirements. However, the regulations provide for conditional licenses only in broad terms and give the superintendent wide authority to grant them — pursuant to the regulations, the superintendent in "his or her sole discretion"[9] is authorized to grant a conditional license to an applicant that does not otherwise satisfy all of the regulatory requirements.

The final regulations also retain the exemption from the licensing requirements for those already

chartered under New York banking law, as long as such entities obtain approval from the superintendent to "engage in virtual currency business activity."[10] This exemption would therefore benefit New York-charted banks already regulated by DFS, but out-of-state banks "conducting business in New York"[11] would still be subject to the BitLicense requirements.

Conclusion

The publication of the final BitLicense framework marks the beginning of a new era of regulation of virtual currencies. DFS has responded to the broad debate concerning the appropriate level of governmental involvement in the virtual currency sector to ensure goals such as consumer protection, anti-money laundering and prevention of terrorist financing with a regulatory response that some believe will stifle innovation and favor well-resourced and established entities. It remains to be seen how regulators at the state and federal level will respond to the final regulations.

In response to questions following his speech, Lawsky indicated that he hoped other states would be more willing to allow licensure for firms complying with the BitLicense requirements or would work together with New York as they develop regulations. He also expressed hope that the BitLicense framework would create a "race to the top" leading other virtual currency firms to view those firms that hold a BitLicense as having a competitive advantage. In any case, New York has set high regulatory expectations that will have a significant impact on the future of the virtual currency industry.

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[1] Lee, et al., BitLicense 2.0: New York Moves Closer to Comprehensive Virtual Currency Regulation, Gibson Dunn Client Alert (Feb. 11, 2015), http://www.gibsondunn.com/publications/pages/BitLicense-2-0-New-York-Moves-Closer-to-Comprehensive-Virtual-Currency-Regulation.aspx.

[2] Id.

[3] Benjamin Lawsky, Remarks at the BITS Emerging Payments Forum (June 3, 2015).

[4] Benjamin Lawsky, Remarks at the BITS Emerging Payments Forum — As Prepared for Delivery (June 3, 2015), available at http://www.dfs.ny.gov/about/speeches/sp1506031.htm.

[5] Id.

[6] Id.

[7] See Lee et al., BitLicense 2.0: New York Moves Closer to Comprehensive Virtual Currency Regulation, Gibson Dunn Client Alert (Feb. 11, 2015) (discussing the 2015 proposed regulations in more detail), http://www.gibsondunn.com/publications/pages/BitLicense-2-0-New-York-Moves-Closer-to-Comprehensive-Virtual-Currency-Regulation.aspx.

[8] 23 N.Y. Comp. Codes R. & Regs. § 200.10(a).

[9] 23 N.Y. Comp. Codes R. & Regs. § 200.4(c).

[10] 23 N.Y. Comp. Codes R. & Regs. § 200.3(c)(1).

[11] 23 N.Y. Comp. Codes R. & Regs. § 200.2(i).
