



UNC  
SCHOOL OF LAW

NORTH CAROLINA  
BANKING INSTITUTE

---

Volume 20 | Issue 1

Article 6

---

3-1-2016

# New Wine Into Old Bottles: Fintech Meets the Bank Regulatory World

John L. Douglas

Follow this and additional works at: <http://scholarship.law.unc.edu/ncbi>



Part of the [Banking and Finance Law Commons](#)

---

## Recommended Citation

John L. Douglas, *New Wine Into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. BANKING INST. 17 (2016).

Available at: <http://scholarship.law.unc.edu/ncbi/vol20/iss1/6>

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Banking Institute by an authorized administrator of Carolina Law Scholarship Repository. For more information, please contact [law\\_repository@unc.edu](mailto:law_repository@unc.edu).

# NEW WINE INTO OLD BOTTLES: FINTECH MEETS THE BANK REGULATORY WORLD

JOHN L. DOUGLAS\*

## I. INTRODUCTION

We seem to be in the midst of an extraordinary transformation of the business of banking as technology companies seek inroads into what has traditionally been the core ambit of banking.<sup>1</sup> From marketplace lenders, digital currencies and computerized investment management to novel applications of blockchain technology, new competitors are exploiting legacy inefficiencies in our financial system to provide greater convenience, lower costs and novel services to businesses and individuals.<sup>2</sup>

Global investments in the financial technology (or “fintech”) industry are estimated to have grown from \$4.05 billion in 2013 to \$12.21 billion in 2014, a 201% increase.<sup>3</sup> Banks alone have invested \$2 billion in fintech start-ups since 2010.<sup>4</sup> As a result of the emergence of well-

---

\* Partner, Davis Polk & Wardwell LLP; General Counsel, Federal Deposit Insurance Corporation, 1987–1989. The author expresses his gratitude to the superb contributions of Charles Steele, Reuben Grinberg, Kimberly Chehardy, Jacob Herz, and Hanna Robinson in the preparation of this article.

1. See, e.g., JULIAN SKAN ET AL., *THE FUTURE OF FINTECH AND ABANKING: DIGITALLY DISRUPTED OR REIMAGINED?* 3 (2015); MIKLOS DIETZ ET AL., *CUTTING THROUGH THE FINTECH NOISE: MARKERS OF SUCCESS, IMPERATIVES FOR BANKS* (2015).

2. See, e.g., OLIVER WYMAN ET AL., *THE FINTECH 2.0 PAPER: REBOOTING FINANCIAL SERVICES* 4 (2015) (“Over the last decade, however, a new source of innovation in financial services has emerged from financial technology start-ups (‘fintechs’) and technology companies (‘techcos’). These new firms have been quicker than banks to take advantage of advances in digital technology, developing banking products that are more user-friendly, cost less to deliver and are optimized for digital channels.”).

3. SKAN ET AL., *supra* note 3, at 2 (noting that a “digital revolution in financial services is under way”).

4. Daniel Huang, *Banks and Fintech Firms’ Relationship Status: It’s Complicated*, WALL ST. J. (Nov. 18, 2015), <http://www.wsj.com/articles/banks-and-fintech-firms-relationship-status-its-complicated-1447842603>. Additionally, in 2015, firms such as American Express, Bain Capital, Goldman Sachs, MasterCard, New York Life and the New York Stock Exchange invested \$1 billion in bitcoin related start-ups. These investments are mostly driven by the potential that these firms see in blockchain technology. Jose Pagliery, *Record \$1 billion Invested in Bitcoin So Far*, CNN MONEY (Nov. 3, 2015),

funded fintech firms such as OnDeck,<sup>5</sup> Ripple<sup>6</sup> and Bond Street,<sup>7</sup> legal services providers and consulting firms have taken note. Many prominent law firms have responded to the growth of the fintech sector by emphasizing the strengths of their fintech practice groups.<sup>8</sup> Likewise, large consulting firms have begun to market to these clients through papers, reports and studies on fintech.<sup>9</sup>

The direct challenges to the core business of banking posed by

---

[http://money.cnn.com/2015/11/02/technology/bitcoin-1-billion-invested/?utm\\_source=November+Newsletter&utm\\_campaign=ADCCA&utm\\_medium=email](http://money.cnn.com/2015/11/02/technology/bitcoin-1-billion-invested/?utm_source=November+Newsletter&utm_campaign=ADCCA&utm_medium=email).

5. OnDeck uses big data to determine the creditworthiness of a potential borrower without the use of a loan officer and relies on more accurate information than banks do when underwriting loans. Zeke Faux & Dune Lawrence, *Is OnDeck Capital the Next Generation of Lender or Boiler Room?*, Bloomberg Bus. (Nov. 13, 2014), <http://www.bloomberg.com/bw/articles/2014-11-13/ondeck-ipo-shady-brokers-add-risk-in-high-interest-loans>. OnDeck raised \$180 million from Google Ventures and Goldman Sachs, *id.*, and raised \$200 million in an IPO. Leslie Picker, *On Deck Jumps in Debut After \$200 Million IPO of WebLender*, Bloomberg (Dec. 14, 2014), <http://www.bloomberg.com/news/articles/2014-12-17/on-deck-raises-200-million-pricing-ipo-above-marketed-range>.

6. Ripple uses distributed ledger technology, the same technology that powers bitcoin, in order to improve the settlement time and costs of financial transactions. See Ripple, *Our Company*, <https://ripple.com/company/> (last visited Nov. 17, 2015) (explaining Ripple's business); John Ginovsky, "IoV": Internet of Value, *Banking Exch.* (Aug. 27, 2015), <http://www.bankingexchange.com/payments/online/item/5698-iov-internet-of-value> (explaining Ripple's use of distributed ledger technology). Ripple's investors include venture capital firms such as Google Ventures, IDG Capital Partners and Santander InnoVentures. Ripple, *supra* 7.

7. Bond Street provides loans to small business. Bond Street, *About Us*, <https://bondstreet.com/about.html> (last visited Nov. 17, 2015). In June 2015, Bond Street received \$110 million in funding from Spark Capital and the investment bank Jefferies. Laura Shin, *Bond Street, An Online Small Business Lender, Announces \$110 Million in Funding*, *Forbes* (Jun. 18, 2015), <http://www.forbes.com/sites/laurashin/2015/06/18/6616/>.

8. See generally Davis Polk & Wardwell LLP, *FinTech*, <http://www.davispolk.com/practices/corporate/FinTech/> (last visited Nov. 17, 2015); Cleary Gottlieb Steen & Hamilton LLP, *Financial Technology*, <http://www.cgsh.com/financial-technology/> (last visited Nov. 17, 2015); Wilmer Cutler Pickering Hale and Dorr LLP, *FinTech*, <https://www.wilmerhale.com/fintech/> (last visited Nov. 17, 2015); Reed Smith LLP, *FinTech*, <http://www.reedsmith.com/FinTech-Practices/> (last visited Nov. 17, 2015); Dechert LLP, *FinTech*, <https://www.dechert.com/FinTech/> (last visited Nov. 17, 2015).

9. See Skan et al., *supra* note 2; *Financial Technology Software and Services*, Deloitte, <http://www2.deloitte.com/us/en/pages/risk/solutions/financial-technology-software-and-services.html> (last visited Nov. 17, 2015); *Fintech: Are banks responding appropriately?*, EY, <http://www.ey.com/CN/en/Industries/Financial-Services/Banking—Capital-Markets/EY-fintech-are-banks-responding-appropriately> (last visited Nov. 18, 2015); Wyman et al., *supra* note 3; *PricewaterhouseCoopers, Money is no object: Understanding the Evolving Cryptocurrency Market* (2015), <https://www.pwc.com/us/en/financial-services/publications/assets/pwc-cryptocurrency-evolution.pdf>.

bitcoin-based businesses, such as Coinbase<sup>10</sup> and BitPay,<sup>11</sup> Lending Club and other customer-facing companies have received a great deal of publicity.<sup>12</sup> Yet other fintech companies do not touch the core businesses of accepting and holding deposits, making loans or facilitating payments.<sup>13</sup> Fraud recognition software, biometric identification tools, personal financial applications, pricing models, document management and countless other innovations are transforming the way banks do business.<sup>14</sup>

---

10. Coinbase is a bitcoin wallet that allows users to store their digital currency. About, Coinbase, <https://www.coinbase.com/about> (last visited Nov. 18, 2015).

11. BitPay allows merchants to accept bitcoin as payment and in turn have money deposited in their bank accounts. *Tour*, BITPAY, <https://bitpay.com/tour> (last visited Nov. 17, 2015).

12. See Huang, *supra* note 4 (explaining how banks and fintech start-ups compete for customers, but banks also feel the need to invest in fintech start-ups) Trond Undheim, *Why Banks Fear Bitcoin*, FORTUNE (Nov. 20, 2014), <http://fortune.com/2014/11/20/why-banks-fear-bitcoin/> (arguing that bitcoin will disrupt banking industry because it will force banks to innovate); Peter Rudegeair & Telis Demos, *SoftBank Makes \$1 Billion Fintech Bet with SoFi Investment*, Wall St. J.: MoneyBeat Blog (Sept. 30, 2015), <http://blogs.wsj.com/moneybeat/2015/09/30/softbank-makes-1-billion-fintech-bet-with-sofi-investment/> (“SoFi is one of the larger financial technology, or ‘fintech,’ startups looking to displace banks from various aspects of consumer lending. . . . The SoFi round is the latest example of the money pouring into online lenders, as part of a big bet that banks are vulnerable to nimbler, upstart online competitors . . .”). *But see*, John Carney, *Online Lenders vs. Banks: Who Gets Disrupted*, Wall St. J. (Oct. 8, 2015), <http://www.wsj.com/articles/online-lenders-vs-banks-who-gets-disrupted-1444331083> (“Online lending sites like Lending Club and OnDeck Capital are at the vanguard of so-called fintech companies destined, according to enthusiasts, to disrupt traditional banks. Yet that proposition looks increasingly dubious.”); Joe Mantone, *Are Banks Friends or Foes of Marketplace Lenders?*, SNL Fin. (Sept. 11, 2015), <https://www.snl.com/InteractiveX/ArticleAbstract.aspx?id=33835076> (discussing whether banks may be “long-term partners of online marketplace lenders” or “future competitors that quickly quash the startups”); *Why Fintech Won’t Kill Banks, The Economist Explains* (June 16, 2015), <http://www.economist.com/blogs/economist-explains/2015/06/economist-explains-12> (discussing the impact of fintech on traditional banks).

13. See Douglas W. Arner et al., *The Evolution of FinTech: A New Post-Crisis Paradigm?* 18 (2015), <http://ssrn.com/abstract=2676553> (noting that fintech comprises the following five areas: finance / investment, operations / risk management, payments / infrastructure, data security / monetization, and customer interface).

13. See, e.g., Allan Ripp, *You’ll Never Look at Your ATM the Same Way Again*, THE STREET (Nov. 7, 2015), <http://www.thestreet.com/story/13350569/1/you-ll-never-look-at-your-atm-the-same-way-again.html>; Tarun Wadhwa, *Wells Fargo Wants to Let You Make Million-Dollar Wire Transactions with Your Face and Voice*, FORBES (Nov. 3, 2015), <http://www.forbes.com/sites/tarunwadhwa/2015/11/03/why-wells-fargo-wants-to-let-you-make-million-dollar-wire-transactions-with-your-face-and-voice/>.

14. See, e.g., Allan Ripp, *You’ll Never Look at Your ATM the Same Way Again*, THE STREET (Nov. 7, 2015), <http://www.thestreet.com/story/13350569/1/you-ll-never-look-at-your-atm-the-same-way-again.html>; Tarun Wadhwa, *Wells Fargo Wants to Let You Make Million-Dollar Wire Transactions with Your Face and Voice*, FORBES (Nov. 3, 2015), <http://www.forbes.com/sites/tarunwadhwa/2015/11/03/why-wells-fargo-wants-to-let-you-make-million-dollar-wire-transactions-with-your-face-and-voice/>.

This transformation of the banking business is not new. As technology has evolved, so too has the business of banking.<sup>15</sup> Computerization has reshaped every aspect of banking, from deposit taking to lending.<sup>16</sup> Securitization, derivatives, credit, debit and prepaid cards, remote, mobile and home banking, check imaging and a world of other products and services we now take for granted all developed because technology permitted dramatic shifts in the way traditional banking was conducted.<sup>17</sup>

The entry of nonbank competitors into the field of banking is not new either. Western Union leveraged its telegram business to introduce money transfers in the nineteenth century.<sup>18</sup> Securities firms are active lenders and provide numerous deposit products through their money market funds and other offerings.<sup>19</sup> More recently, PayPal and CheckFreePay have made substantial inroads into online bill payments.<sup>20</sup> Green Dot, InComm and NetSpend are significant providers of prepaid cards, which can serve as convenient substitutes for bank deposits and debit cards for

---

15. See Arner et al., *supra* note 13, at 10–15 (discussing the development of traditional digital financial services).

16. See *id.* at 8–10.

17. See *id.* at 11–12 (“By the beginning of the 21<sup>st</sup> century, both banks’ internal processes, interactions with outsiders and an ever increasing number of their interactions with retail customers had become fully digitized, facts highlighted by the significance of IT spending by the financial services industry.”).

18. WESTERN UNION, OUR RICH HISTORY, <http://corporate.westernunion.com/History.html> (last visited Nov. 10, 2015). Western Union completed the first transcontinental telegraph line across North American in 1861. Ten years later, in 1871, Western Union introduced money transfers. *Id.*

19. Money market funds are a type of mutual fund that provides investors with the option to purchase a pool of securities that generally provides higher rates of return than an interest-bearing bank account. See MONEY MARKET FUNDS, U.S. SEC. & EXCH. COMM’N, <https://www.sec.gov/spotlight/money-market.shtml> (last visited Nov. 19, 2015). Today, money market funds hold more than \$2.9 trillion in assets and invest in government securities, tax-exempt municipal securities and other corporate debt securities. *Id.*

20. Will Edwards, *Fiserv Agrees to Acquire CheckFree for \$4.4 Billion*, BLOOMBERG (Aug. 2, 2007), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=afxJE7EGtkss&refer=home> (noting that CheckFreePay’s electronic systems for online bill paying processes more than 1 billion transactions per year); Hayley Tsukayama, *PayPal Makes Strong Debut on Nasdaq*, WASH. POST (July 20, 2015), [https://www.washingtonpost.com/business/economy/paypal-makes-strong-debut-on-nasdaq/2015/07/20/3d5ab7c6-2f29-11e5-8353-1215475949f4\\_story.html](https://www.washingtonpost.com/business/economy/paypal-makes-strong-debut-on-nasdaq/2015/07/20/3d5ab7c6-2f29-11e5-8353-1215475949f4_story.html) (“After more than 12 years as a part of eBay, PayPal is in a strong position when it comes to several online payment trends. That is because of not only the success of the traditional PayPal service but also its business-focused Braintree branch and the peer-to-peer payments app Venmo.”).

those with little or no access to traditional banks.<sup>21</sup> Lending Club, OnDeck, Funding Circle and other peer-to-peer lenders are matching willing providers of funds to borrowers in an automated fashion, promising less overhead and more efficient execution.<sup>22</sup>

Yet, just as the entry of nonbank competitors using new technologies to capture what has traditionally been the hallowed turf of the banking industry is an oft-repeated story, so, too, is the clash between these new entrants and the labyrinth of laws and regulations governing the business of banking.<sup>23</sup> Is PayPal a bank? Does GreenDot accept deposits? Is CheckFreePay a money transmitter? What license does Lending Club need? Are the loans purchased from peer-to-peer lenders simply loans, or are they securities? These questions were not trivial at the time these companies started, and they are not trivial today for new entrants. And while the PayPals, GreenDots and CheckFreePays of the world seem to have reached a reasonable accommodations with the traditional banking regulatory framework,<sup>24</sup> we are now watching in real time the asking and answering of these questions as they apply to marketplace lenders, bitcoin companies, and other new entrants into what is now commonly known as fintech.

---

21. Todd J. Zywicki, *The Economics and Regulation of Network Branded Prepaid Cards*, 65 FLA. L. REV. 1477, 1479 (2013) (“Prepaid cards are especially important for unbanked Americans as a mechanism for electronic payments and as an alternative to traditional bank accounts.”).

22. See, e.g., Carney, *supra* note 12; Kevin Wack, *OnDeck Swings to Profit as its Marketplace Business Booms*, AM. BANKER, Nov. 2, 2015.

23. See generally Jill Andersen Hill, *Virtual Currencies & Federal Law*, 18 J. CONSUMER & COMM. L. 65 (2014) (discussing application of criminal law, tax law, banking law, securities law and consumer protection law to virtual currencies); Reuben Grinberg, *Bitcoin: An Innovative Alternative Digital Currency*, 4 HASTINGS SCI. & TECH. L.J., 159 (2011) (discussing application of federal law and securities regulation to bitcoin).

24. For example, PayPal is licensed as a money transmitter on a state-by-state basis. For a list of PayPal state licenses, see PAYPAL, PAYPAL STATE LICENSES, <https://www.paypal.com/webapps/mpp/licenses> (last visited Nov. 10, 2015). See also Stacy Forster, *PayPal's Woes Lead to Calls for More Industry Regulation*, WALL ST. J. (Apr. 8, 2002), <http://www.wsj.com/articles/SB1018038560564846640> (noting PayPal's position that it is a “money service” that has traditionally been regulated at the state level). Likewise, GreenDot is a licensed money transmitter in 39 states, Puerto Rico, and Washington, D.C. GREENDOT CORP., 2014 ANNUAL REPORT 7 (Mar. 2, 2015). However, GreenDot also operates a state-chartered Federal Reserve member bank in order to provide certain mobile banking and prepaid card services. *Id.* at 2. Additionally, CheckFreePay operates as a licensed money transmitter in New York. CHECKFREEPAY, TERMS, <https://www.checkfreepay.com/info/terms> (last visited Nov. 19, 2015).

This article provides an overview of what non-regulated technology companies can expect as they seek to provide financial services in the United States. These companies and their investors are walking into a thicket of laws and regulations that ostensibly touch their businesses, and regulators are struggling to determine how these new companies fit into existing legal and regulatory regimes, most of which were designed for a totally different world.<sup>25</sup>

This article will address fintech meeting the world of bank regulation by discussing the issues in a somewhat unique way. First, this article addresses the business of taking deposits, which continues to be an issue for any company that is holding money received from consumers with the understanding that the funds are to be returned to the consumers on demand or otherwise transmitted as they may subsequently direct. Second, this article addresses the issues posed by peer-to-peer or marketplace lenders, which implicate both lending licenses and, in a very important way, the securities laws. Third, this article turns to digital currencies, which provide the platform for addressing money transmission licenses, Bank Secrecy Act (“BSA”) and anti-money laundering (“AML”) concerns, the Office of Foreign Assets Control (“OFAC”) issues and additional securities or commodities law concerns. Fourth, this article addresses the issues associated with third-party outsourcing by banks and those companies providing ongoing services to banking organizations. Lastly, this article discusses the risks that new fintech companies face when launching without a thoughtful consideration of regulatory compliance requirements.

The divisions are not clean and neat. A marketplace lender may have issues with OFAC or BSA requirements, just as a digital currency participant may inadvertently trip over securities law issues (as, indeed, some have). It is hoped that this article will provide a useful context for presenting and understanding these issues.<sup>26</sup>

---

25. There are, of course, very important and closely related issues, which will not be explored in this article. Banking organizations are subject to this thicket of laws and regulations, many of which govern what they can and cannot do. As banks seek to exploit evolving technologies to better serve their customers, they in turn must grapple with how far they can go. Limitations on permissible activities at the bank or holding company levels, the Volcker rule and the limits of the merchant banking authority all provide some constraints on how banks can permissibly explore and exploit the rapidly evolving technology area. That, however, will be an article for another day.

26. *See, e.g.*, BTC Trading, Corp., Exch. Act Release No. 73783 (Dec. 8, 2014)

## II. FINTECH MEETS THE BANK REGULATORY WORLD

### A. *Regulation of the Business of Taking Deposits*

One of the core activities of banks is taking deposits, which is an activity that is limited strictly to banks under federal and state bank statutory and regulatory regimes.<sup>27</sup> Generally, a deposit is defined as including checking and savings accounts and excludes certain investment products such as mutual funds.<sup>28</sup>

A deeper dive into one state's banking laws illustrates how the business of taking deposits is regulated. For example, Georgia law defines a bank as an entity "authorized to engage in the business of receiving deposits withdrawable on demand or deposits withdrawable after stated notice or lapse of time."<sup>29</sup> Georgia law also contains the common and straightforward proposition that essentially only banks are authorized to engage in the business of accepting deposits:

No person or corporation may lawfully engage in this state in the business of banking or receiving money for deposit or transmission or lawfully establish in this state

---

(sanctioning a computer programmer for operating two unregistered online venues that traded securities using virtual currencies).

27. The National Bank Act provides that deposit taking is part of the business of banking and one of the key powers of a bank. 12 U.S.C. § 24 (Seventh) (2008). Similarly, state chartering laws also have provisions that only permit a chartered commercial bank to accept deposits while excluding any other corporations or businesses from doing so. *See, e.g.*, N.Y. BANKING LAW § 96 (McKinney 2015) (providing that only banks may hold consumer deposits); OHIO REV. CODE ANN. § 1109.5(A) (West 2015) (providing that a bank may receive deposits); TEX. FINANCE CODE ANN. § 31.002(4) (West 2015) (defining banking as an activity that involves accepting deposits).

28. Under the FDIC's regulations, a deposit generally includes money held in checking, negotiable order of withdrawal ("NOW"), savings, and money market deposit accounts, and other items such as certificates of deposits, and does not include certain investment products such as annuities, mutual funds, stocks, bonds, government securities, municipal securities and U.S. treasury securities. FED. DEPOSIT INS. CORP., INSURED OR NOT INSURED?, <https://www.fdic.gov/deposit/covered/notinsured.html> (last visited Nov. 17, 2015).

29. GA. CODE ANN. § 7-1-4 (West 2015). *See also* 12 U.S.C. § 1813(a)(2) (2011) (The Federal Deposit Insurance Act defines a State Bank as "any bank, banking association, trust company, savings bank, industrial bank (or similar depository institution which the Board of Directors finds to be operating substantially in the same manner as an industrial bank), or other banking institution which . . . is engaged in the business of receiving deposits, other than trust funds (as defined in this section).").

a place of business for such purpose, except a bank, a national bank, a credit union . . . , a licensee engaged in selling checks . . . , an international banking agency . . . , a building and loan association . . . , or a savings and loan association . . . .<sup>30</sup>

As the Georgia example reflects, accepting funds from the public with a promise to make them available to the depositor brings one squarely within the definition of a bank, while doing so without a banking charter invites (at a minimum) regulatory scrutiny. An entity must either be a bank, and obtain a banking license with the attendant regulation, or look for a permissible exemption from the licensing requirement.

There are a multitude of financial activities that seem so incredibly convenient that we hardly think about the consequences. For example, when we “load” our accounts at PayPal, is PayPal accepting a deposit?<sup>31</sup> If we load or reload a prepaid card, is that a deposit?<sup>32</sup> If we initiate a person-to-person transfer using our phone, and it results in a debit to our bank account or credit card, is the entity holding the funds until delivered holding a deposit?<sup>33</sup> If these funds are deposits, are they insured by the Federal Deposit Insurance Corporation (“FDIC”)?<sup>34</sup> If deposits, are the funds subject to the Federal Reserve’s reserve requirements?<sup>35</sup> If the entity accepting the deposits is a bank, is it subject to

---

30. GA. CODE ANN. § 7-1-241 (West 2015). Some of the state banking laws provide that if an entity is not a bank, it may not accept deposits. *See, e.g.*, CAL. FINANCE CODE § 1044 (West 2015) (providing that a bank may not conduct any business, which includes taking deposits, until approved to do so); TEX. FINANCE CODE ANN. § 31.004 (West 2015) (prohibiting a person other than a depository institution from conducting the business of banking in Texas).

31. For a discussion of the laws regulating the taking of deposits, see *supra* text accompanying notes 27–30.

32. *See id.*

33. *See id.*

34. The Federal Deposit Insurance Act established the FDIC, which is an independent agency that protects the funds depositors place in banks and savings associations. FED. DEPOSIT INS. CORP., UNDERSTANDING DEPOSIT INSURANCE, <https://www.fdic.gov/deposit/deposits/> (last visited Nov. 19, 2015). *See* 18 U.S.C. § 1813(m)(1).

35. *See* FED. RES., RES. REQUIREMENTS, <http://www.federalreserve.gov/monetarypolicy/reservereq.htm#table1> (last visited Nov. 19, 2015) (listing the required amount of funds that a depository institution must hold in reserve against specified deposit liabilities). For example, these funds could be subject to the Federal Reserve Regulations E, 12 C.F.R. § 205 (2015), which governs electronic fund transfers, or Regulation CC, 12 C.F.R. § 229 (2015), which governs the availability of funds and the collection of checks.

branching restrictions?<sup>36</sup> And, if the deposits are accepted at a third-party location (a grocery store, drug store or convenience store), are those locations branches?<sup>37</sup> If Coinbase is holding bitcoins or Microsoft is holding Microsoft points for its users, are they taking deposits in a way that requires them to be licensed as banks?

Of course, once an organization is deemed to be a bank, the full weight of the seemingly endless panoply of banking laws and regulations come crashing down and become applicable.<sup>38</sup> Licensing, capital requirements, community reinvestment obligations, truth in lending, truth in savings, equal credit opportunity and an almost endless list of other statutes and regulations can become part of an organization's life.<sup>39</sup>

These are all wonderful and interesting questions, and at least for now the tentative answer appears to be that, with respect to dollar and other fiat currency-denominated funds, if you properly structure, document and disclose your relationships, you can avoid the banking restrictions.<sup>40</sup> As a general proposition, unless an entity is already a chartered bank, it must place customer funds in another insured depository institution under a structure that indicates that the entity is not the "owner" of the funds, but rather that the funds are being placed on behalf of its customers.<sup>41</sup> If this approach is followed, the entity should be able

---

36. Interstate branching restrictions on national banks ability to branch across state lines are very limited. *See generally* John C. Dugan et al., *Forms of Entry, Operation, Expansion and Supervision of Foreign Banks in the United States*, REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES 18 (2014) (Randall D. Gynn ed., 2014) (discussing the lack of restrictions on the ability of banks to branch across state lines). Some state bank regulatory regimes place restrictions on interstate branching. *See generally* RONALD L. SPIEKER, FUTURE OF BANKING STUDY: BANK BRANCH GROWTH HAS BEEN STEADY—WILL IT CONTINUE? 3 (2004).

37. Often different state banking laws define branch in different ways. *See, e.g.*, N.C. GEN. STAT. § 53C-1-4 (providing the definition of a branch under North Carolina's banking law); TEX. FINANCE CODE ANN. § 31.002 (a)(8)(2015) (providing the definition of a branch under Texas banking law).

38. For a list of federal banking regulations, see BD. OF GOVERNORS OF THE FED. RES. SYSTEM, REGS., <http://www.federalreserve.gov/bankinforeg/reglisting.htm> (last updated July 27, 2015); FED. DEPOSIT INS. CORP., FED. DEPOSIT INS. CORP. LAW, REGS., RELATED ACTS, <https://www.fdic.gov/regulations/laws/rules/2000-50.html> (last updated Sept. 30, 2014).

39. For a list of banking regulations, see *id.*

40. In the United States, banks are subject to both federal and state banking laws. It is possible for fintech firms to not engage in certain activities, such as taking deposits or making loans, in order to avoid being regulated as a bank. *See* Rys Bollen, *infra* note 43 (explaining that if a bitcoin company engages in certain activities such as accepting customer funds and making loans the banking laws in some states may be implicated).

41. For example, PayPal received an advisory opinion from the FDIC in 2002, stating that PayPal may not hold customer funds because it is not a bank. FED. DEPOSIT INS. CORP.

to avoid classification as a bank with all the attendant consequences.<sup>42</sup> Intent and disclosure play a big role in determining banking status, and having an insured depository institution in the chain is very helpful for avoiding that characterization. Additionally, banking agencies have not yet found that bitcoins, gaming points, rewards points or similar digital or virtual currencies should be considered deposits, although they are regulated in other ways, as described in more detail below.<sup>43</sup>

### B. *Peer-to-Peer or Marketplace Lenders*

We have witnessed an explosion in online lenders such as Prosper, Lending Club, and SoFi.<sup>44</sup> As of 2014, peer-to-peer platforms had issued \$5.5 billion of loans in the United States, and it is estimated that the total amount of loans issued through 2025 will exceed \$150 billion.<sup>45</sup>

---

Advisory Opinion, 2002 FDIC Interp. Ltr. LEXIS 40 (Feb. 15, 2002). PayPal's name was later redacted, but news articles at the time confirm that PayPal was the subject of this advisory opinion. See Deborah Bach, *CEO Insists PayPal Will Not Be Declared a Bank*, AM. BANKER, Mar. 19, 2002 (quoting the language from the FDIC's advisory opinion); see also *Feds: PayPal Is Not a Bank*, CNET (May 19, 2002), <http://www.cnet.com/news/feds-paypal-not-a-bank/> (quoting language from the FDIC's advisory opinion). As a result, PayPal began to keep balances left in customer accounts in FDIC-insured bank accounts. *Id.* PayPal discloses on its website that it uses partner banks such as Bank of America, Citibank, HSBC Bank USA, RBS Citizens Bank and Wells Fargo Bank to actually hold its customers' funds. *FDIC-Insured Banks*, PAYPAL, [https://www.paypal.com/cgi-bin/webscr?cmd=p/pop/fdic\\_banks-outside](https://www.paypal.com/cgi-bin/webscr?cmd=p/pop/fdic_banks-outside) (last visited Nov. 16, 2015).

42. In PayPal's case, PayPal was able to avoid being classified as a bank by placing customer funds in a bank. *Feds: PayPal Is Not a Bank*, *supra* note 41.

43. See Rys Bollen, *The Legal Status of Online Currencies: Are Bitcoins the Future?* 31–32 (2013), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2285247](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2285247) (explaining that if a bitcoin company engages in certain activities such as accepting customer funds and making loans then the banking laws in some states may be implicated). At the time this article was written, no state or federal regulator has taken the view that a business that holds bitcoins or other digital currencies for others is taking deposits, although other nonbank regulatory regimes may be implicated, which will be discussed later in this article.

44. See Matt Scully & Tracy Alloway, *People Have Some Interesting Thoughts About Peer-to-Peer Lending*, BLOOMBERG BUS., Oct. 29, 2015, <http://www.bloomberg.com/news/articles/2015-10-29/people-have-some-interesting-thoughts-about-peer-to-peer-lending> (noting that the peer-to-peer lending industry is quickly growing). The U.S. Department of the Treasury ("Treasury") is monitoring this expanding industry. In early 2015, Treasury requested additional information on the industry. In October 2015, at a marketplace lending conference, Treasury noted that it was still analyzing the responses received. Of note, the American Bankers Association and Consumer Bankers Association both highlighted that peer-to-peer lenders face a lighter regulatory burden than banks, noting that "[c]urrently alternative lenders have little regulatory oversight." See *id.*

45. PRICEWATERHOUSECOOPERS, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CONSUMER LENDING INDUSTRY 1 (2015), <http://www.pwc.com/us/en/consumer-finance/publications/assets/peer-to-peer-lending.pdf>.

This amount is still small in comparison to other small business lending; in 2013, there were \$580 billion in outstanding small business loans by some measures.<sup>46</sup> These lending platforms allow borrowers to have their loans approved faster and funds dispersed quicker than if the borrower sought a loan from a traditional bank.<sup>47</sup> Referred to variously as “peer-to-peer” lenders or “marketplace” lenders, these entities match those that need credit with sources of funding.<sup>48</sup> Most of these lenders began by focusing on a single asset class (*e.g.*, individual consumers, small businesses, or student loans).<sup>49</sup> Many of these companies have enjoyed spectacular growth and media hype surrounding their roles in displacing traditional bank lenders.<sup>50</sup>

The peer-to-peer lending model is relatively straightforward. Relying on various sources of data, proprietary algorithms and other technological tools, the lenders market loans to potential borrowers and gather the necessary information to make a credit decision.<sup>51</sup> Once a loan is deemed to have met necessary standards, the lender “sanitizes” the information, making it non-personally identifiable, and transmits the information to potential funding sources.<sup>52</sup> The lender is responsible for documenting and servicing the loans as well as managing all aspects of the repayment process.<sup>53</sup> Some lenders find lendable funds from individuals

---

46. SMALL BUS. ASSOCIATION, SMALL BUSINESS LENDING IN THE UNITED STATES IN 2013 (2013) (defining small business loans as loans of \$1 million or less).

47. *Id.*

48. See Scully & Alloway, *supra* note 44 (noting that the peer-to-peer lending industry is quickly growing).

49. For example, Lending Club focuses on personal and business loans, while SoFi began by offering student loan refinancing. See LENDING CLUB, <https://www.lendingclub.com/> (last visited Nov. 10, 2015). Today, SoFi also offers personal loans and mortgages. See SOFI, <https://www.sofi.com/> (last visited Nov. 10, 2015).

50. See generally Maureen Farrell, *Investors Like Lending Club's Growth*, WALL ST. J. (Aug. 5, 2015), <http://blogs.wsj.com/moneybeat/2015/08/05/investors-like-lending-clubs-growth/>; Zachary Karabell, *The Uberization of Money*, MoneyBeat Blog WALL ST. J. (Nov. 6, 2015), <http://www.wsj.com/articles/the-uberization-of-finance-1446835102>; Scully & Alloway, *supra* note 44.

51. See *From the People, For the People: But will financial democracy work in a downturn?*, ECONOMIST (May 9, 2015), <http://www.economist.com/news/special-report/21650289-will-financial-democracy-work-downturn-people-people>.

52. See *id.* Both Lending Club and Prosper include a privacy note on their websites, stating that they protect the privacy of the borrower and the investors by never revealing a party's actual identity. *How does an online credit marketplace work?*, LENDING CLUB, <https://www.lendingclub.com/public/how-peer-lending-works.action> (last visited Nov. 10, 2015); *Peer-to-Peer Lending Means Everyone Prospers*, PROSPER, [https://www.prosper.com/welcome/how\\_it\\_works.aspx](https://www.prosper.com/welcome/how_it_works.aspx) (last visited Nov. 10, 2015).

53. For example, Lending Club describes the peer-to-peer lending process as follows: (1)

willing to take risks and provide credit, while others look to banks or other institutional investors.<sup>54</sup> Many lenders partner with banks to originate the loan, attempting to take advantage of certain legal protections and immunities that banks enjoy.<sup>55</sup> All lenders attempt to automate the customer acquisition, underwriting and lending process to achieve economies and advantages that traditional banks cannot.<sup>56</sup> Regardless of how they are structured or operated, these marketplace lending companies are a growing force in our financial system.<sup>57</sup>

### 1. Federal Regulation of Consumer Lending

Most federal lending requirements are designed to protect consumers—the Truth in Lending Act,<sup>58</sup> the Equal Credit Opportunity Act,<sup>59</sup> the Fair Housing Act,<sup>60</sup> the Real Estate Settlement Procedures Act (“RESPA”),<sup>61</sup> the Fair Credit Reporting Act,<sup>62</sup> the Gramm-Leach-Bliley Act (“GLBA”) privacy provisions<sup>63</sup>—the list is long and growing, and each new regulation represents a significant compliance obligation.

---

customers interested in a loan complete and submit an application to LendingClub.com; (2) Lending Club uses online data and technology to assess risk, determine a credit rating and assign interest rates; and (3) investors select the loan in which to invest and earn monthly returns. *How does an online credit marketplace work?*, *supra* note 52. Prosper describes its process as follows: (1) borrowers chose a loan amount and purpose and post a loan listing; (2) investors view the loan listings and invest in listings of interest; and (3) once the process is complete, borrowers make monthly payments and investors receive a portion of the payments. *Peer-to-Peer Lending Means Everyone Prospers*, *supra* note 52. *See also From the People, For the People: But will financial democracy work in a downturn?*, *supra* note 51.

54. *See From the People, For the People: But will financial democracy work in a downturn?*, *supra* note 51 (noting that most of the funding for peer-to-peer lending no longer comes from the general public but instead comes from institutional investors).

55. “Small local lenders in America have turned to peer-to-peer marketplaces to gain exposure to consumer credit; Citigroup said in April that it would lend \$150m through Lending Club.” *Id.*, *see also*, PWC, PEER PRESSURE: HOW PEER-TO-PEER LENDING PLATFORMS ARE TRANSFORMING THE CONSUMER LENDING INDUSTRY 2 (Feb. 2015) (“Banks and institutional investors are buying blocks of P2P loans to add to their portfolios.”).

56. *See generally From the People, For the People: But will financial democracy work in a downturn?*, *supra* note 51; PWC, PEER PRESSURE, *supra* note 55.

57. *From the People, For the People: But will financial democracy work in a downturn?*, *supra* note 51.

58. Truth in Lending Act, 12 C.F.R. § 1026 (2012).

59. Equal Credit Opportunity Act, 12 C.F.R. § 202 (2012).

60. Discriminatory Conduct Under the Fair Housing Act, 24 C.F.R. § 100 (2010).

61. Real Estate Settlement Procedures Act, 24 C.F.R. § 3500 (2010).

62. Fair Credit Reporting Act, 12 C.F.R. § 1022.1 (2012).

63. Privacy of Consumer Financial Information, 16 C.F.R. § 313 (2012).

Many of the statutes are directed to “creditors” (e.g., Truth in Lending) and apply to those engaged in the business of extending credit.<sup>64</sup> Others apply to “financial institutions” (e.g., GLBA-privacy provisions) and entities engaged in activities that are permissible for banks and bank holding companies.<sup>65</sup> It is important to note that applicability of the laws is more often defined by the activities an entity engages in, rather than by an entity’s charter. If an entity extends consumer credit, it is subject to the Truth in Lending Act.<sup>66</sup> If an entity is engaged in an activity a bank or bank holding company may engage in with individuals, it will have GLBA-privacy obligations.<sup>67</sup> Thus, many of these laws and regulations apply to lenders of all types, not just for those defined as “banks” at their founding.

There is very little federal regulation of non-consumer lending. For example, there is no federal interest rate or usury cap,<sup>68</sup> and the Truth in Lending Act does not apply to loans extended primarily for business, commercial or agricultural purposes or credit extended to an entity other than a natural person.<sup>69</sup> The Fair Credit Reporting Act relates to consumer credit, not commercial credit.<sup>70</sup> The provisions of Section 5 of the

---

64. For example, Regulation Z, the regulation implementing the Truth in Lending Act, covers persons and businesses that offer or extend credit (1) to consumers, (2) on a regular basis, (3) payable under a written agreement in more than four installments, and (4) primarily for personal, family or household purposes. 12 C.F.R. § 1026.1(c) (2015).

65. The GLB privacy provisions “govern[] the treatment of nonpublic personal information about consumers by the financial institutions . . . .” Privacy of Consumer Financial Information § 313(a). The scope of the regulation applies to, but is not limited to, “mortgage lenders, ‘pay day’ lenders, finance companies, mortgage brokers, account servicers, check cashers, wire transferors, travel agencies operated in connection with financial services, collection agencies, credit counselors and other financial advisors, tax preparation firms, non-federally insured credit unions, and investment advisors that are not required to register with the Securities and Exchange Commission.” Privacy of Consumer Financial Information § 313(b).

66. See Truth in Lending Act § 1026.1(c) (2012) (noting that generally the Truth in Lending Act applies to “each individual or business that offers or extends credit”).

67. Privacy of Consumer Financial Information § 313.

68. See Nathalie Martin, *Public Opinion and the Limits of State Law: The Case for a Federal Usury Cap*, 34 N. ILL. U. L. REV. 259 (2014) (arguing for a federal interest rate cap of 36%).

69. See Truth in Lending Act § 1026.3(a) (exempting an extension of credit primarily for a business, commercial or agricultural purpose or an extension of credit to other than a natural person from the requirements of the Truth in Lending Act).

70. See Fair Credit Reporting Act § 1022.1(a) (2012) (“This part generally applies to persons that obtain and use information about consumers to determine the consumer’s eligibility for products, services, or employment, share such information among affiliates, and furnish information to consumer reporting agencies.”).

Federal Trade Commission Act, empowering the Federal Trade Commission (“FTC”) to “prevent persons, partnerships, or corporations . . . from using . . . unfair or deceptive acts or practices in or affecting commerce”, have no such limitation, although virtually all FTC enforcement actions are focused on consumer abuses.<sup>71</sup> The Consumer Financial Protection Bureau, established by the Dodd-Frank Act was specifically established, as its name indicates, to protect consumers from abusive, deceptive or unfair financial products.<sup>72</sup>

## 2. State Regulation of Lending

Regulation of lending at the state level is every bit as complicated and difficult as at the federal level, and perhaps more so as there are a multitude of jurisdictions. Traditionally each state has established interest and usury laws and regulations that limit the interest rates and fees that can be charged by lenders.<sup>73</sup>

### A. INTEREST AND USURY LAWS

The concept of protecting consumers from interest is an ancient one, with references in Exodus, Leviticus, and Deuteronomy of the Old

---

71. Section 5(a)(2) of the Federal Trade Commission Act. *See generally* Timothy J. Muris, *The Federal Trade Commission and the Future Development of U.S. Consumer Protection Policy*, COLUM. BUS. L. REV. 359, 386 (2003) (discussing the FTC’s consumer protection role and how it fits into the modern consumer protection regime).

72. Title X of the Dodd-Frank Act, entitled the Consumer Financial Protection Act of 2010, established the Consumer Financial Protection Bureau (“CFPB”). Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub.L. No. 111-203, 124 Stat. 136. The rules implementing Dodd-Frank provide that the purpose of the CFPB is to “seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive.” 12 U.S.C. § 5511(a) (2015).

73. *See* Martin, *supra* note 68, at 263 (“In the U.S., usury laws have historically been the main protection consumers have had against harsh credit practices.”).

Testament.<sup>74</sup> Every state has an interest and usury statute.<sup>75</sup> While there are often various exceptions to the statutes (*e.g.*, commercial loans, loans above a specified amount, or credit card loans), the interest rates prescribed can be quite low, occasionally ranging from five to ten percent.<sup>76</sup>

However, determining which state's interest and usury laws apply can be difficult at times. There is an initial presumption on the part of a state that a loan made to a resident of a state will be subject to that state's particular laws. Choice-of-law provisions in contracts may be helpful in selecting another state's laws to govern a transaction, but typically in the consumer context, the chosen state must bear some substantial relationship to the transaction.<sup>77</sup> Banks may have the ability to choose a state with liberal interest and usury laws by locating their lending decisions in such states, and generally can export their home state's usury limits to other states where they extend loans or issue credit.<sup>78</sup> This allows banks to charge high interest rates on consumer credit card debt because the interest rate can exceed the usury limit of the state where the

---

74. See Thomas Moser, *The Old Testament Anti-Usury Laws Reconsidered: The Myth of Tribal Brotherhood* (1997), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=41844](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=41844) (discussing the development of the anti-usury laws of the Hebrew Bible). While chapter 22:24 of the Book of Exodus prohibits the taking of interest, chapter 25:35 of the Book of Leviticus prohibits the taking of interest from those in economic distress. Interestingly, chapter 23:19–20 of Deuteronomy prohibits the taking of interest from the Jewish community but not from foreigners. *Id.*

75. See Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110, 1114 (2008) (providing an empirical analysis of all fifty states' usury laws).

76. See, *e.g.*, ALA. CODE § 8-8-1 (2015) (providing that the legal rate of interest is 8%); Cal. Const., Art. XV § 1 (2012) (providing that the legal interest rate is 7% to 10% for consumers depending on the type of loan or forbearance); COLO. REV. STA. ANN. § 5-12-101 (West 2015) (providing that the legal rate of interest is 8%); CONN. GEN. STAT. § 37-1 (2015) (providing that the legal rate of interest is 8%); DEL. CODE ANN. tit. 6 § 2301 (providing that the legal interest rate is 5%); D.C. Code Ann. § 28-3302 (West 2015) (providing that the legal rate of interest is 6%); GA. CODE ANN. § 7-4-2 (West 2015) (providing that the legal rate of interest is 7%); 815 ILL. COMP. STAT. § 205/1 (West 2015) (providing that the legal rate of interest is 5%); IOWA CODE § 535.2 (2014) (providing that the legal rate of interest is 5%); ME. REV. STAT. ANN. tit. 9-B § 432 (2015) (providing that the legal rate of interest is 6%); 41 PA. CODE § 202 (2015) (providing that the legal interest rate is 6%).

77. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 cmt. f at 5 (1971) (“When the state of the chosen law has some substantial relationship to the parties or the contract, the parties will be held to have had a reasonable basis for their choice.”).

78. Traditional banks have relied upon the ability to export interest and fees pursuant to 12 U.S.C. § 85 (2015) and 12 U.S.C. § 1831d(a) (2015). Non-bank lenders do not enjoy this privilege. See also BARKLEY CLARK ET AL., COMPLIANCE GUIDE TO PAYMENT SYSTEMS: LAW AND REGULATION § 12.16[2] (2014) (providing a discussion of state usury laws and a bank's ability to export its home state usury limit).

consumer resides.<sup>79</sup> Nonbank lenders have much less flexibility in that regard as they aren't entitled to the benefits of the federal banking statutes, so many have paired with traditional bank lenders.<sup>80</sup> The feasibility of using a bank partner is discussed in section c below.

## B. LENDER LICENSING

Many states also require the licensing of non-bank lenders, particularly providers of consumer credit.<sup>81</sup> Not surprisingly, following problems in the mortgage market during the financial crisis with abusive lending practices, sloppy servicing and rampant defaults, there has been a renewed interest in overseeing those involved in providing residential mortgage credit and assuring uniform regulation, licensing and supervising of entities and individuals in the mortgage lending area.<sup>82</sup>

State laws governing lender licensing outside the mortgage space vary considerably. One of the critical differences relates to the extent and nature of the activities that require licensing.<sup>83</sup> Variables include the loan

---

79. See BARKLEY CLARK ET AL., *supra*, note 79 at § 12.16 (explaining that a national bank that issues credit cards may export interest rates from its home state and charge up to the interest rate allowed for licensed lenders in a state).

80. Interestingly, in a recent case, the U.S. Court of Appeals for the Second Circuit refused to reconsider its decision that restricts marketplace lenders from bypassing state usury laws by pairing with banks in states that have no such rules. *Madden v. Midland Funding, LLC*, 786 F.3d 246, 253–54 (2nd Cir. 2015), petition for cert. filed, 84 U.S.L.W. 675 (U.S. Nov. 10, 2015) (No. 15-610). See *infra*, note 98.

81. For examples of state licensing requirements for providers of consumer credit, see *Regulated Lenders*, TEXAS OFFICE OF CONSUMER CREDIT COMMISSIONER, <http://occc.texas.gov/industry/regulated-lenders> (last visited Nov. 10, 2015) (providing guidance for becoming a regulated lender in Texas); *Consumer Credit Licensing Information*, MISSOURI DIV. OF FINANCE, <http://finance.mo.gov/consumercredit/licensing.php> (last visited Nov. 10, 2015) (providing guidance for consumer credit licensing in Missouri); *Consumer Credit*, IDFP, [http://www.idfpr.com/dfi/ccd/ccd\\_main.asp](http://www.idfpr.com/dfi/ccd/ccd_main.asp) (last visited Nov. 10, 2015) (providing guidance relating to consumer credit licensing and regulation in Illinois).

82. For example, the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (“SAFE Act”) required states to pass legislation within a year of the SAFE Act being adopted that would require the licensing of mortgage loan originators according to national standards and the participation of state agencies on the Nationwide Mortgage Licensing System and Registry (“NMLS”). SAFE Act, 12 U.S.C. §§ 5512, 5581, 15 U.S.C. §§ 1604(a), 1639(b).

83. For example, the Missouri Division of Finance divides its licensing categories into nine different types of activities, ranging from consumer installment lenders to title lenders. *Consumer Credit Licensing Information*, *supra* note 81. The Florida Division of Consumer Finance divides its consumer licensing categories into six different activities, including collection agencies, loan originators, retail installment sales and title loan companies. *Welcome to the Division of Consumer Finance*, FLORIDA OFFICE OF FINANCIAL REGULATION, <http://www.flofr.com/StaticPages/DivisionOfConsumerFinance.htm> (last visited Nov. 12, 2015).

amounts covered by the state statute, the number of loans that may be made within the state without licensing, and so on. Most state licensing schemes require information on the lender, its officers and directors and any significant shareholders or owners of the lender.<sup>84</sup>

In the mortgage lending arena, the licensing requirements are much more uniform due to the Secure and Fair Enforcement for Mortgage Licensing, or SAFE Act, passed in 2011.<sup>85</sup> While it does not supplant state law requirements, the SAFE Act requires federal registration for mortgage loan originators, and piggybacks on the NMLS, a system developed by the Conference of State Bank Supervisors (“CSBS”) and the American Association of Residential Mortgage Regulators for the state licensing and registration of mortgage loan originators.<sup>86</sup> The advent and sanction of the registry have caused the licensing requirements to become much more uniform.<sup>87</sup> These requirements include specific background checks as well as the reporting of other information designed to assure a safe and sound industry.<sup>88</sup> Individual states may have separate requirements. For instance, in North Carolina, mortgage servicers are required to register and be licensed under the North Carolina version of the SAFE Act.<sup>89</sup>

---

84. For example, the Missouri Division of Finance applications typically require the company name, address, hours of operation, contact information, the names and titles of partners or officers if the entity is a partnership or corporation, and whether the requesting entity holds any other consumer credit licenses in the State of Missouri. *See Section 408.500 Small, Small Loan Company Licensing Application Packet*, MISSOURI DIV. OF FIN., <http://finance.mo.gov/Contribute%20Documents/500ApplicationPacket2015.pdf> (last visited Nov. 13, 2015). Virginia requires information on the company, its business activities both in Virginia and out of state, ownership information of each director, senior officer, member, trustee and partner, as well as three business references. *Application for a Consumer Finance License Pursuant to Chapter 15 of Title 5.2 of the Code of Virginia, CCB-4401 (Rev. 05-13)*, COMMONWEALTH OF VA. STATE CORP. COMM’N, <https://www.scc.virginia.gov/publicforms/68/ccb4402.pdf> (last visited Nov. 11, 2015).

85. SAFE Act §§ 5512, 5581.

86. SAFE Act §§ 5512, 5581; *see generally Resource Center, NMLS*, <http://mortgage.nationwidelicencingsystem.org/Pages/default.aspx> (last visited Nov. 12, 2015).

87. Indeed, the SAFE Act specifically states that, among other things, its purpose is to “increase uniformity” and provide “uniform license applications and reporting requirements for State-licensed loan originators.” SAFE Act § 5101.

88. Section 1504(a) requires background checks in connection with an application to any state for licensing and registration as a state-licensed loan originator. The background checks include: (1) fingerprints for submission to the Federal Bureau of Investigation; and (2) a personal history and authorization to obtain (a) an independent credit report and (b) information related to any administrative, civil or criminal finding.

89. North Carolina Secure and Fair Enforcement Mortgage Licensing Act, N.C. Gen.

Without attempting to explore all of the nuances of the interplay between these state regulatory schemes and their applicability to federally-chartered banks (particularly national banks), note that for the purposes of this article, virtually all of the state licensing systems exclude banks from the scope of coverage. The general theory of exemption is that banks are already subject to a system of comprehensive regulation, and there is no need to overlay another regulatory system of licensing and reporting.<sup>90</sup> And while banks are not exempt from interest and usury laws imposed by a state, a well-developed body of case law exists to the effect that a bank is entitled avail itself of the interest and usury laws of the state where it is deemed to make a loan, providing a “locus” that may be difficult for an Internet-based lender without a physical presence to duplicate.<sup>91</sup>

### 3. Bank Partners of Marketplace Lenders

To avoid the state-by-state interest and usury restrictions,<sup>92</sup> or to avoid the state-by-state licensing requirements with their attendant difficulties,<sup>93</sup> nonbank lenders will often partner with regulated banks.<sup>94</sup> The

---

Stat. § 53.244 (2009) (requiring individuals and companies who engage in the mortgage business in North Carolina to be licensed by the Commissioner of Banks).

90. See, e.g., *Watters v. Wachovia Bank*, 550 US 1 (2007) (“In the years since the NBA’s enactment, we have repeatedly made clear that federal control shields national banking from unduly burdensome and duplicative state regulation.”).

91. See 12 U.S.C. § 85 (“Any association may take, receive, reserve, and charge on any loan or discount made, or upon any notes, bills of exchange, or other evidences of debt, interest at the rate allowed by the laws of the State, Territory, or District where the bank is located . . . and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under title 62 of the Revised Statutes.”); see also *Marquette Nat. Bank v. First of Omaha Corp.*, 439 U.S. 299 (1978) (holding that pursuant to 12 U.S.C. § 85 a national bank may charge interest on any loan at the rate allowed by the state in which the bank is located).

92. JAMES SIVON ET AL., *UNDERSTANDING FINTECH AND BANKING LAW: A PRACTICAL GUIDE* 88 (2014).

93. Kevin Tu, *Regulating the New Cashless World*, 65 ALA. L. REV. 77, 86–88, 92 (2013).

94. KEVIN TAYLOR, *FINTECH LAW: A GUIDE TO TECHNOLOGY LAW IN THE FINANCIAL SERVICES INDUSTRY* § 5.III.C.2 (2014). See also W. Scott Frame, *Marketplace Lending’s Role in the Consumer Credit Market*, FED. RESERVE BANK OF ATLANTA: CTR. FOR FIN. INNOVATION AND STABILITY (Sept. 2015), <https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1509> (“Having a partner bank allows the marketplace lender to: (1) purchase the loans without needing to obtain individual state banking/lending licenses; and (2) charge interest rates that are legal in the partner bank’s state but may not be in the borrowers’

bank, typically located in a state with favorable interest rates such as Utah, South Dakota or Delaware, will be the original party to the loan.<sup>95</sup> The nonbank lender will market to the borrower, and using credit standards established by the bank and agreed to by the non-bank lender, will process the loan. The bank itself will make the loan, but the non-bank lender will subsequently purchase the loan, normally within a few days after the loan has closed.<sup>96</sup> Following the purchase, the nonbank lender will service the loan.<sup>97</sup>

This type of arrangement quickly became standard in the marketplace.<sup>98</sup> As the bank was the entity actually extending credit, the fact that a nonbank entity marketed, purchased and serviced the loan after it was made was not sufficient to challenge the lender's right to rely on the protections afforded banks under state laws.<sup>99</sup> Recently, market practice was

---

state.”).

95. W. Scott Frame, *Marketplace Lending's Role in the Consumer Credit Market*, FED. RESERVE BANK OF ATLANTA: CTR. FOR FIN. INNOVATION AND STABILITY (Sept. 2015), <https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1509>. UTAH CODE ANN. § 15-1-1 (providing 10% legal interest rate); S.D. CODIFIED LAWS §§ 54-3-5.1, 54-3-16 (providing 15% legal interest rate); DEL. CODE ANN. tit. 6, § 2301 (West 2015) (providing a 5% plus the Federal Reserve discount rate as of the time the interest is due).

96. Frame, *supra* note 95 (“Once a match occurs between a borrower and investor(s), the loan is actually originated onto the balance sheet of a partner bank. (Both Lending Club and Prosper use WebBank, a Utah-chartered industrial bank.) The partner bank holds loans for a few days before selling them to the marketplace lender, which in turn sells them to investors.”).

97. *Id.* (“After loan origination, marketplace lenders are responsible for servicing, which primarily involves maintaining accounts, processing borrower payments, and distributing funds to investors.”).

98. *Id.* (“Having a partner bank allows the marketplace lender to: (1) purchase the loans without needing to obtain individual state banking/lending licenses; and (2) charge interest rates that are legal in the partner bank's state but may not be in the borrowers' state.”). There was a large body of case law upholding this practice. *See, e.g.*, *Discover Bank v. Vaden*, 489 F.3d 594, 597 (4th Cir. 2007), *rev'd on other grounds* 556 U.S. 49 (2009); *Krispin v. May Department Stores Co.*, 218 F.3d 919 (8th Cir. 2000). As the *Krispin* court noted, “[t]he non-usurious character of a note should not change when the note changes hands.” *Id.* at 924 (quoting *FDIC v. Lattimore Land Corp.*, 656 F.2d 139, 147-149 (5th Cir. Unit B 1981)). However, a recent appellate court opinion unsettled this line of cases, in terms of charging interest rates that are legal in the bank's state, but may not be legal in the borrower's state. In *Madden v. Midland Funding*, a Second Circuit court reversed a district court's decision, finding that the National Bank Act did not preempt the plaintiff's claim under New York State law usury claims and Fair Debt Collection Practices Act because the defendant lender was not a national bank or its subsidiary or affiliate. *Madden v. Midland Funding, LLC*, 786 F.3d 246, 247 (2015), petition for cert. denied, 84 U.S.L.W. \_\_\_ (U.S. May 4, 2015) (No. \_\_\_-\_\_\_).

99. Frame, *supra* note 95 (“Having a partner bank allows the marketplace lender to: (1) purchase the loans without needing to obtain individual state banking/lending licenses; and (2) charge interest rates that are legal in the partner bank's state but may not be in the borrowers' state. Notably, this second benefit of the partner bank model seems to be legally unsettled

challenged by a case brought in West Virginia where a payday lender sought to enforce a loan purchased from a South Carolina bank. There, based upon the facts of the arrangement, the state Attorney General brought suit alleging that the payday lender, not the bank, was the true lender in question. According to the Attorney General's position, the payday lender had issued loans without the proper license and had violated West Virginia's interest and usury laws. Both the trial court and the West Virginia Supreme Court of Appeals sided with the Attorney General, and the Supreme Court recently denied certiorari.<sup>100</sup>

A similar case arose in North Carolina, involving a payday lender affiliated with a lender located on an Indian reservation.<sup>101</sup> Despite the defendants' allegations that the lender was entitled to sovereign immunity and thus North Carolina lacked any power to regulate the conduct of the lender, the court examined the substance of the relationship between the

---

following a recent U.S. Appellate Court opinion.”).

100. *CashCall, Inc. v. Morrissey*, 2014 W. Va. LEXIS 587 (May 30, 2014), cert. denied *CashCall, Inc. v. Morrissey*, 2015 U.S. LEXIS 2991 (U.S., May 4, 2015) (No. 14-894). In *CashCall, Inc. v. Morrissey*, West Virginia's highest court, the Supreme Court of Appeals, considered an appeal of three orders stemming from CashCall's debt collection actions, including state law claims of abusive debt collection and usurious lending. *Id.* at \*1. CashCall, a California consumer finance company, partnered with the First Bank and Trust of Millbank, South Dakota, to issue small unsecured loans at high interest rates to consumers in various states, including West Virginia. *Id.* at \*2. In the initial case, the Attorney General characterized CashCall's practice as a “rent-a-bank scheme” designed to avoid state usury and consumer protection laws. *Id.* at \*5. On appeal, the appeals court upheld the orders issued by the circuit courts, which included a judgment for violations of the West Virginia Credit Protection Act. *Id.* at \*67.

101. *North Carolina v. Western Sky Financial, LLC*, 2015 NCBC LEXIS 87 (Aug. 27, 2015). In *North Carolina v. Western Sky Financial*, the North Carolina superior court considered a complaint against a South Dakota limited liability company operated on the Cheyenne River Indian Reservation and whose sole owner was a member of the Cheyenne River Sioux Tribe, but not an official or representative of the tribe's government. *Id.* at \*1. The Cheyenne River Sioux Tribe did not receive any direct financial benefit from the business of Western Sky Financial, which made consumer loans to residents of North Carolina marketed through the company's website and through television advertising. *Id.* at \*5. The loans ranged in amounts from \$850 to \$10,000 and charged interest rates between 89.68% and 342.86%, with repayment options ranging from 12 to 84 months. *Id.* at \*5. The loan agreements provided that agreement would be governed solely by the laws and jurisdiction of the Cheyenne River Indian Reservation and specifically excluded the application of any U.S. state or federal law. *Id.* at \*7. However, shortly after a loan was approved, Western Sky Financial sold and transferred the loan to WS Funding, LLC, a California limited liability company. *Id.* at \*9. The loan was serviced through a licensed mortgage lender in North Carolina, and in some instances, the loan was sold or transferred to a licensed collection agency in North Carolina for servicing and collection. *Id.* At the time of the loans, North Carolina usury laws provided for a maximum interest rate on North Carolina consumers on a loan of \$25,000 or less of 16% per annum. *Id.* at \*10, \*25–26.

payday lender and the nominal tribal lender and enjoined the defendants from offering, making or collecting loans to or from North Carolina residents.<sup>102</sup> Ultimately, the court found that the loans at issue were made in North Carolina, rather than on the reservation, and that the court had jurisdiction to apply North Carolina usury law.<sup>103</sup>

A third case involves a debt collector that purchased charged-off credit card loans from a national bank.<sup>104</sup> In that case, the Second Circuit Court of Appeals reversed a district court and held that the debt collector was not entitled to rely on the national bank's preemption of New York usury law where the debtor was located.

These cases have a potential to completely overturn the model used by marketplace lenders described above. As noted, the model uses a bank to originate the loan and, it has been thought, permit the marketplace lender as subsequent purchase to rely on the originating bank's ability to export its interest rate and its status as a chartered bank. If those features are lost once the bank sells the loan, the marketplace lender will be faced with state-by-state compliance issues that will create a significant (although not insurmountable) obstacle for the viability of the business model.

These cases highlight that state interest in protecting its citizens is strong, and the risks of litigation are real, especially in light of the creation of the CFPB and the ever-increasing state and federal and regulatory interest in consumer protection.<sup>105</sup> While the decisions may underscore the adage that bad cases make bad law, they also serve as a warning to

---

102. *Id.* at \*49–54.

103. *Id.* at \*25–26.

104. *Madden v. Midland Funding*, a Second Circuit court reversed a district court's decision, finding that the National Bank Act did not preempt the plaintiff's claim under New York State law usury claims and Fair Debt Collection Practices Act because the defendant lender was not a national bank or its subsidiary or affiliate. *Madden v. Midland Funding, LLC*, 786 F.3d 246, 247 (2015), petition for cert. filed, 84 U.S.L.W. 675 (U.S. Nov. 10, 2015) (No. 15-610). The court remanded the case to the district court to decide whether the Delaware choice-of-law clause precluded the plaintiff's claim under state and federal usury laws. *Id.* at 248. In November 2015, the defendants filed a writ of certiorari to the Supreme Court, which was pending at the time this article was written. *Id.*

105. In *North Carolina v. Western Sky Financial*, the superior court stated that North Carolina has an important state interest in "protect[ing] North Carolina resident borrowers through the application of North Carolina interest laws." *Id.* at \*28 (citing N.C. GEN. STAT. § 24-2.1(g)). See also *CashCall, Inc. v. Morrissey*, 2014 W. Va. LEXIS 587 (May 30, 2014), cert. denied *CashCall, Inc. v. Morrissey*, 2015 U.S. LEXIS 2991 (U.S., May 4, 2015) (No. 14-894) (upholding the decision by the lower court to look through the bank making the loan to the nonbank lender for violations of state interest and usury claims).

fintech companies that pushing the envelope can, at time, lead to unfortunate results.

#### 4. Securities Laws Applicable to Online Lenders

As noted above, Internet-based lenders have created online platforms that match investors with capital with consumers seeking credit.<sup>106</sup> Most of the peer-to-peer lenders issue some form of pass-through notes to their funding sources tied to the performance of the underlying loans.<sup>107</sup> The U.S. Securities and Exchange Commission (“SEC”) has determined that the notes issued by these peer-to-peer lenders to their funding sources are securities under the federal securities laws.<sup>108</sup> While some peer-to-peer lenders may sell whole loans or participations in whole loans to their investors in an attempt to avoid this characterization, even these whole loans or participations may be considered securities under the securities laws.<sup>109</sup> Before engaging in such activities, lenders should evaluate the loan purchaser (a sophisticated lender or investor not otherwise principally engaged in the lending business), the method of distribution (a solicitation of a wide number of unrelated investors) and the degree of reliance on the peer-to-peer lender (how much the investor will rely on the lender to service and administer the loans).

If the loans in which lenders participate are considered securities,

---

106. Carney, *supra* note 22.

107. GAO REPORT, PERSON-TO-PERSON LENDING: NEW REGULATORY CHALLENGES COULD EMERGE AS THE INDUSTRY GROWS (July 2011), <http://www.gao.gov/new.items/d11613.pdf> (“On both [the Prosper and LendingClub] platforms, lenders do not make loans directly to borrowers. Rather, lenders purchase payment-dependent notes that correspond to the selected borrower loans. Once lenders choose which loans to fund, WebBank, an FDIC-insured Utah-chartered industrial bank, approves, originates, funds, and disburses the loan proceeds to the corresponding borrowers. . . . In registering with SEC, the companies . . . now retain the promissory notes for borrowers’ loans and sell to lenders corresponding notes, registered as securities, that depend for their payment on borrowers’ repayment of their loans. Lenders do not have a security interest in the loans themselves.”).

108. See Prosper Marketplace, Inc., SEC Order No. 3-13296 (Nov. 24, 2008) (issuing a cease-and-desist order to Prosper, an online lending platform, for violating Sections 5(a) and (c) of the Securities Act).

109. GAO REPORT, *supra* note 108 (“Although officials from Prosper and LendingClub said that they had initially questioned the applicability of federal securities registration requirements to person-to-person lending, both companies ultimately registered securities offerings with SEC.”). As a general matter, whether a loan or a note is a security requires a facts and circumstances analysis, including the economics underlying the transaction. See *Reeves v. Ernst & Young*, 494 U.S. 56 (1990); *Trust Co. of Louisiana v. N.P.P.*, 104 F.3d 1478 (5th Cir. 1997); *Pollack v. Laidlaw Holdings*, 27 F.3d 808 (2d Cir. 1994).

the full panoply of registration requirements or the applicability of exemptions will come into play.<sup>110</sup> It may be possible to structure the sale of the pass-through notes as private placements or offerings under Regulation D,<sup>111</sup> and certain new issuers may be able to take advantage of the crowdfunding exemption in the JOBS Act.<sup>112</sup> Qualification for these provisions is difficult, however, and the liabilities imposed on those who fail to register securities are high.<sup>113</sup>

### C. *Digital Currencies*

Digital currencies have developed as an alternative means of transferring value from one person to another. A digital currency, such as bitcoin, can be defined as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value, but does not have legal tender status in any jurisdiction.”<sup>114</sup> These virtual

---

110. See Prosper Marketplace, Inc., SEC Order No. 3-13296 (issuing a cease-and-desist order to Prosper, an online lending platform, for failing to register its notes under the Securities Act); GAO REPORT, *supra* note 107 (providing background to the full panoply of regulatory challenges facing peer-to-peer lending firms).

111. 17 CFR § 230.501 et seq.

112. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws* COLUM. BUS. L. REV. 1, 7–8 (2012) (discussing the labyrinth of federal regulatory laws surrounding investor protection and capital formation in relation to crowdfunding).

113. *Id.* (“The devil is in the details. Crafting a crowdfunding exemption requires a careful balancing of investor protection and capital formation.”). See also Daniel Forgive, *How to Finish What the JOBS Act Has Started*, FORBES (Dec. 4, 2013), <http://www.forbes.com/sites/realspin/2013/12/04/how-to-finish-what-the-jobs-act-has-started/> (“Currently, due to labyrinthine laws, peer-lenders are unable to disintermediate banks when ‘lending’—they instead purchase loans issued by banks in order to export uniform interest rates nationally. Peer-lenders also face restrictions in their ability to lend to businesses, are required to register securities with the SEC, and are subject to state lending laws. Moreover, although the JOBS Act could be a potential solution for debt-based business investment given certain state and federal law exemptions, there are other key provisions in the law that are inconsistent with debt-based models.”).

114. COMMODITY FUTURES TRADING COMM’N, Order, Coinflip, Inc. d/b/a Derividan, and Francisco Riordan, CFTC Docket No. 15-29, at 2 n.2 (Sept. 17, 2015) [hereinafter CFTC Order, Coinflip Enforcement]. For other definitions of virtual currency, see DEP’T OF TREASURY FIN. CRIMES ENFORCEMENT NETWORK, FIN-2013-G001, GUIDANCE: APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING OR USING VIRTUAL CURRENCIES (Mar. 18, 2013) [hereinafter FINCEN, GUIDANCE ON REGULATION OF VIRTUAL CURRENCY] (defining “virtual currency” as “a medium of exchange that operates like a currency in some environments, but does not have all the attributes of real currency”); N.Y. COMP. CODES R. & REGS. tit. 23, § 200.2 (2015) (defining “virtual currency” as “any type of digital unit that is used as a medium of exchange or a form of digitally stored value. Virtual Currency shall be broadly construed to include digital units of exchange that (i) have a centralized repository or administrator; (ii) are decentralized and have no centralized repository

currencies are “distinct from ‘real’ currencies, which are the coin and paper money of the United States or another country that are designated as legal tender, circulate, and are customarily used and accepted as a medium of exchange in the country of issuance.”<sup>115</sup> A digital currency can function as a medium of exchange insofar as participants are willing to accept it as payment.<sup>116</sup> To some extent, that willingness appears to hinge on the ability to exchange the digital currency for legal tender when and if necessary or desired.

Although digital currencies and participants in the digital currency ecosystem carry enormous risks,<sup>117</sup> many see various existing or potential benefits, and many people are paid in and use digital currencies in their day-to-day lives.<sup>118</sup> Proponents of bitcoin believe the advantages of using bitcoin as an alternative to fiat currency is that bitcoin is faster, cheaper, more secure than the traditional check, wire, ACH or other payment methods, with the added advantage that bitcoins are also protected from inflation.<sup>119</sup> The first participants in this space—*e.g.*, uber libertar-

---

or administrator; or (iii) may be created or obtained by computing or manufacturing effort.”). See also Reuben Grinberg, *The Failure of Mt. Gox and Other Recent Bitcoin Catastrophes: Why Banks Should Care*, DAVIS POLK: CAPITAL AND PRUDENTIAL STANDARDS BLOG (Mar. 7, 2014), <http://blog.usbase13.com/the-failure-of-mt-gox-and-other-recent-bitcoin-catastrophes-why-banks-should-care/> (noting that cryptocurrencies, such as bitcoin, Ripple and Litecoin, “are essentially money in the form of artificial commodities of limited total supply, which are transmittable quickly and without cost over the internet without a financial intermediary”).

115. CFTC Order, Coinflip Enforcement, *supra* note 115, at 2 n.2; see also FINCEN, GUIDANCE ON REGULATION OF VIRTUAL CURRENCY, *supra* note 115 (quoting 31 C.F.R. § 1010.100(m), which defines “real currency” as “the coin and paper money of the United States or of any other country that [i] is designated as legal tender and that [ii] circulates and [iii] is customarily used and accepted as a medium of exchange in the country of issuance”).

116. *Id.* at 2.

117. Grinberg, *supra* note 23, at 175.

118. See Mary Thompson, *Investing in Digital Currencies: Risks and Rewards*, CNBC (June 20, 2014), <http://www.cnbc.com/2014/06/18/investing-in-digital-currencies-risks-and-rewards.html> (discussing the changing landscape of digital currency and the risks as well as potential benefits for investors); Emily Spaven, *MasterCard: Digital Currency’s Risks Outweigh the Benefits*, COINDESK (June 8, 2015), <http://www.coindesk.com/mastercard-digital-currency-risks-outweigh-the-benefits/> (reporting that MasterCard submitted comments in response to the UK Treasury’s call for information on digital currency in which the payment processor argued that there is a lack of consumer protection in the digital currency space).

119. *Why Use Bitcoin?*, COINDESK, <http://www.coindesk.com/information/why-use-bitcoin/> (last updated Feb. 20, 2014). The inflation protection arises due to the finite number of bitcoins that can be created. Notwithstanding, the value of a bitcoin can fluctuate wildly based upon demand, as with any other commodity.

ians and technologists with little experience in the financial services industry—claimed it was unregulated.<sup>120</sup> However, as consumers have been harmed through malfeasance and negligence (for example, Mt. Gox, at one time the largest bitcoin exchange, failed and lost approximately \$500 million worth of customer bitcoins),<sup>121</sup> regulators have been clarifying how existing regulations apply to this new technology, and businesses have been running into the buzz saw of existing regulatory schemes.<sup>122</sup> In no particular order, this article highlights the most important issues relating to digital currency and its use as money. The distributed ledger technology (often referred to as “blockchain”) powering bitcoin and other digital currencies raises other interesting regulatory issues that are beyond the scope of this article.

### 1. Regulation of the Business of Transmitting Money

Traditionally, money transmission laws might have made one think of the Western Unions or MoneyGrams of the world, which receive funds for the purpose of remitting those funds to third parties, either inside or outside the United States,<sup>123</sup> but advances in technology have permitted the introduction of a myriad of new players in the money transmission space.<sup>124</sup> For example, if after dining out with a friend, my friend and I decide to split the bill, I may cover the entire bill then send a request to my friend for his portion of the bill using the smartphone application Venmo.<sup>125</sup> Digital currencies can provide a method of transferring funds from one person to another that is much less expensive than other methods. However, just because an entity avoids the “bank” definition does not mean that the entity escapes regulation.

---

120. See Thompson, *supra* note 118.

121. Tom Hals, *Failed Bitcoin Exchange Mt. Gox Gets U.S. Bankruptcy Protection*, REUTERS, Jun. 17, 2014, <http://www.reuters.com/article/2014/06/17/us-bitcoin-mtgox-bankruptcy-idUSKBN0ES2WZ20140617#R6ATUFibO3bgQe3B.97>.

122. See generally Grinberg, *supra* note 114; DAVIS POLK VISUAL MEMORANDUM, NEW YORK’S FINAL “BITLICENSE” RULE: OVERVIEW AND CHANGES FROM 2014 PROPOSAL (June 5, 2015), [http://www.davispolk.com/sites/default/files/2015-06-05\\_New\\_Yorks\\_Final\\_BitLicense\\_Rule.pdf](http://www.davispolk.com/sites/default/files/2015-06-05_New_Yorks_Final_BitLicense_Rule.pdf).

123. SIVON, *supra* note 92, 54, 86.

124. See *id.* at 16, 87–88; KEVIN TAYLOR, *supra* note 94, § 5.III.

125. Venmo is a digital wallet, which allows users to pay and request money from other users with whom they connect. *About, VENMO*, <https://help.venmo.com/customer/en/portal/articles/1322558-what-is-venmo-> (last visited Nov. 19, 2015). See also TAYLOR, *supra* note 94, § 5.II.B.

## A. FEDERAL REGULATION OF MONEY TRANSMISSION

On March 18, 2013, the U.S. Department of the Treasury Financial Crimes Enforcement Network (“FinCEN”) issued administrative guidance declaring that a virtual currency would not be deemed a “currency” under regulations implementing the BSA, but that certain virtual currency businesses would nevertheless be money transmitters under the BSA, subject to regulation as money services businesses (“MSB”).<sup>126</sup>

The FinCEN guidance described three types of actors: (i) users, who obtain virtual currency to purchase goods or services; (ii) exchangers, who engage in the business of exchanging virtual currency for real currency, funds or other virtual currency; and (iii) administrators, who engage in the business of issuing virtual currency and have the authority to redeem such virtual currency.<sup>127</sup> While “users” would not be deemed to be “money transmitters,” “exchangers” and “administrators” would be deemed “money transmitters” under the BSA and would be subject to various registration, reporting and recordkeeping requirements as MSBs.<sup>128</sup>

On January 30, 2014 and October 27, 2014, FinCEN issued a series of administrative rulings clarifying the scope of its guidance.<sup>129</sup> These rulings confirmed that a “miner”<sup>130</sup> of virtual currency would not be an MSB as long as the virtual currency was used for the miner’s own purposes, and not for the benefit of another person,<sup>131</sup> and that investing

---

126. FINCEN, GUIDANCE ON REGULATION OF VIRTUAL CURRENCY, *supra* note 115.

127. *Id.*

128. *Id.* This includes the filing of suspicious activity reports (“SARs”), currency transaction reports (“CTRs”), and putting in place know-your-client (“KYC”) and anti-money laundering (“AML”) compliance programs. *See* Rules for Money Services Businesses, 31 C.F.R. § 1022.210 (2011).

129. *See* DEP’T OF TREASURY FINANCIAL CRIMES ENFORCEMENT NETWORK, FIN-2014-R001, GUIDANCE: APPLICATION OF FINCEN’S REGULATIONS TO VIRTUAL CURRENCY MINING OPERATIONS (Jan. 30, 2014) [hereinafter FINCEN, GUIDANCE ON VIRTUAL CURRENCY MINING OPERATIONS] (providing guidance on the application of FinCEN’s regulations to virtual currency mining operations); DEP’T OF TREASURY FINANCIAL CRIMES ENFORCEMENT NETWORK, FIN-2014-R012, GUIDANCE: REQUEST FOR ADMINISTRATIVE RULING ON THE APPLICATION OF FINCEN’S REGULATIONS TO A VIRTUAL CURRENCY PAYMENT SYSTEM, (Oct. 27, 2014) [hereinafter FINCEN, GUIDANCE ON VIRTUAL CURRENCY PAYMENT SYSTEMS] (providing guidance on the application of FinCEN’s regulations to a virtual currency payment system).

130. One “mines” for bitcoins by compiling recent transactions into blocks and trying to solve a computationally difficult problem. The reward for this activity is paid in bitcoins.

131. FINCEN, GUIDANCE ON REGULATION OF VIRTUAL CURRENCY, *supra* note 115.

in virtual currencies for one's own account would not be subject to regulation as an MSB.<sup>132</sup> Conversely, a person operating a platform for the exchange of virtual currencies to real currencies would be subject to regulation as an MSB,<sup>133</sup> as would a person operating a payment system that allows merchants to receive payments in virtual currencies from their customers.<sup>134</sup>

Following its guidance and rulings, on May 5, 2015, FinCEN fined Ripple Labs, a San Francisco-based start-up, \$700,000 for failure to register as an MSB.<sup>135</sup> Ripple Labs had developed its own open-source code for a blockchain separate from the bitcoin blockchain, with its own native currency known as "XRP."<sup>136</sup> The settlement with Ripple stipulated that Ripple had violated the BSA by selling XRP without registering as an MSB or having anti-money laundering ("AML") programs in place.<sup>137</sup>

## B. STATE REGULATION OF MONEY TRANSMISSION

The act of transferring money or value from one person to another also brings into play the state statutes licensing money transmitters.<sup>138</sup> The Georgia prohibition on engaging in the banking business discussed above is again illustrative, for the prohibition includes "receiving money for deposit or transmission," unless one is properly licensed, registered or qualifies for an exemption.<sup>139</sup> Virtually every state regulates money transmitters,<sup>140</sup> and while requirements vary from state to state, they typically include some form of minimum net worth, maintenance of a bond,

---

132. DEP'T OF TREASURY FINANCIAL CRIMES ENFORCEMENT NETWORK, FIN-2014-R002, GUIDANCE: APPLICATION OF FINCEN'S REGULATIONS TO VIRTUAL CURRENCY SOFTWARE DEVELOPMENT AND CERTAIN INVESTMENT ACTIVITY (Jan. 30, 2014).

133. DEP'T OF TREASURY FINANCIAL CRIMES ENFORCEMENT NETWORK, FIN-2014-R011, GUIDANCE: REQUEST FOR ADMINISTRATIVE RULING ON THE APPLICATION OF FINCEN'S REGULATIONS TO A VIRTUAL CURRENCY TRADING PLATFORM (Oct. 27, 2014).

134. FINCEN, GUIDANCE ON VIRTUAL CURRENCY PAYMENT SYSTEMS.

135. Dep't of Treasury Financial Crimes Enforcement Network Assessment of Civil Money Penalty, In the Matter of Ripple Labs Inc., FinCEN Number 2015-05 (May 5, 2015).

136. *Id.*

137. *Id.*

138. SIVON ET AL., *supra* note 92, 85. See also Tu, *supra* note 93, 86-8; Lawrence Trautman, Virtual Currencies; Bitcoin & What Now After Liberty Reserve, Silk Road, and Mt. Gox, 20 RICH. J.L. & TECH. 13 (2014).

139. GA. CODE ANN. § 7-1-241 (West 2015).

140. SIVON ET AL., *supra* note 92, 85. See also Tu, *supra* note 93, at 86-8.

annual audits, examinations by regulators, recordkeeping, AML programs, and a list of permissible investments for funds received and held.<sup>141</sup> Through money transmission licenses, the state can protect the funds of its citizens and help prevent money laundering.<sup>142</sup>

These statutes are clearly triggered when a money transmitter maintains an office or an agent in a state (the agent may also be a money transmitter itself and may require a license), but a physical presence is not necessary to invoke the statute and merely having an internet website that does not block access to a resident in a state may be enough to implicate a state's licensing requirements.<sup>143</sup> Some states are silent on the need for a physical presence, but take the position that receiving funds from residents of the state is sufficient to invoke the statutory requirements.<sup>144</sup> Others are more explicit in their position that a physical presence is not required.<sup>145</sup>

The state money transmitter statutes typically hinge on transmitting "money" or "funds," which are often broad enough to encompass digital currencies.<sup>146</sup> For example, New York law covers "payment instruments,"<sup>147</sup> while Oklahoma law covers the transfer of "the value of the currency or funds."<sup>148</sup>

States appear to be taking different approaches on the regulation of digital currency, with some clarifying that the use of digital currencies to transfer funds from one person to another is within the statute, while

---

141. SIVON ET AL., *supra* note 92.

142. MARIANNE CROWE ET AL., THE U.S. REGULATORY LANDSCAPE FOR MOBILE PAYMENTS 1, 6–7, 9 (July 25, 2012), <https://www.frbatlanta.org/rprf/publications.aspx>. See also SIVON, *supra* note 92.

143. Trautman, *supra* note 138, at 23–6. Moreover, under some state money transmitter laws, if a person in a state can access the website of a business that engages in money transmission in another state, then that business would be considered to be a money transmitter in the state in which the person is accessing the website. See, e.g., N.C. GEN. STAT. § 53-208.3(c)(West 2015) (“[A] person is considered to be engaged in the business of money transmission in this State if that person makes available, from a location inside or outside of this State, an Internet website North Carolina citizens may access in order to enter into those transactions by electronic means.”); W.VA. CODE ANN. § 32A-2-2 (a) (“For purposes of this article, a person is considered to be engaging in those businesses in this state if he or she makes available, from a location inside or outside this state, an internet website West Virginia citizens may access in order to enter into those transactions by electronic means.”).

144. *Id.* at 23–26.

145. *Id.*

146. Tu, *supra* note 93, 86–8.

147. N.Y. BANKING LAW § 641.

148. OKLA. STAT. tit. 6 §1512 (2013).

others seem to be taking the opposite position.<sup>149</sup> For example, in the State of Washington, digital currency is captured by the definition of “money transmission” in its Uniform Money Services Act.<sup>150</sup> However, Texas has issued guidance in which it takes the position that virtual currency is not considered a currency or monetary value under the Texas Money Services Act and therefore receiving virtual currency in exchange for a promise to make it available at a later time or different location is not a money transmission.<sup>151</sup> Kansas has taken the same position as Texas, issuing guidance stating that decentralized digital currencies like bitcoin are not covered by the Kansas Money Transmitter Act because by definition cryptocurrencies are not considered “money” or “monetary value” by the Office of the State Bank Commissioner.<sup>152</sup> Thus, an entity engaged solely in the transmission of cryptocurrencies would not be required to obtain a money transmitting license in the State of Kansas.<sup>153</sup>

States that allow registration under their money transmitting statutes are seeing applications filed by entities that wish to transmit money in digital currency form. One such example is Coinbase, a bitcoin wallet and platform for transacting in bitcoin.<sup>154</sup> Coinbase currently holds licenses in twenty-six U.S. states and territories.<sup>155</sup>

For a company that was founded with the expectation that it would be required to comply with standard AML regimes, compliance with the money transmitter laws of a state is not particularly difficult or onerous. However, for some businesses that expect to be unregulated, and for bitcoin businesses focused on the privacy and anonymity of their customers (*e.g.*, ShapeShift.io), it would be difficult or impossible to

---

149. SIVON ET AL., *supra* note 92, 85–6, 90–1 (“Like federal financial regulators, state regulators have focused attention on the role of virtual currencies in payment and other financial transactions. Not surprisingly, the state responses have not been uniform.”).

150. WASH. STATE DEP’T OF FIN. INST. VIRTUAL CURRENCY REGULATION, <http://www.dfi.wa.gov/documents/money-transmitters/virtual-currency-regulation.pdf> (last visited Nov. 18, 2015).

151. Tex. Dep’t of Banking, Supervisory Memorandum 1037, Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act 2–3 (Apr. 3, 2014), <http://www.dob.texas.gov/public/uploads/files/consumer-information/sm1037.pdf>.

152. Kan. Office of the State Bank Commissioner Guidance Document, MT 2014-01, Regulatory Treatment of Virtual Currencies Under the Kansas Money Transmitter Act 2–3 (June 6, 2014), [http://www.osbckansas.org/mt/guidance/mt2014\\_01\\_virtual\\_currency.pdf](http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf).

153. *Id.*

154. COINBASE, ABOUT, <https://www.coinbase.com/about> (last visited Nov. 18, 2015).

155. COINBASE, LICENSES, <https://www.coinbase.com/legal/licenses> (last visited Nov. 18, 2015).

comply without significant changes to their technology, organizations or business models. More importantly, even a business that wishes to comply with all applicable regulatory requirements may well find that the cumulative effect of dealing with multiple states—and potentially every state—overwhelming.<sup>156</sup>

There is a time and cost component to complying with the varied and occasionally conflicting state laws. An entity attempting to operate on a nationwide basis may find that obtaining necessary state licenses can take one to two years or more. In addition, licensing and compliance may cost millions of dollars in legal, consulting, and other fees, not to mention the opportunity cost of having management's focus diverted away from building the business.<sup>157</sup> Many entities may strive to work around this issue by attempting to limit or preclude customers from a particularly difficult or onerous jurisdiction.<sup>158</sup> Other institutions try to side-step these issues by becoming an agent of an already registered money transmitter. However, few if any of the licensed money transmitters have been interested in allowing the bitcoin businesses to become their agents. Given the risks of the use of digital currencies in money laundering and other criminal activities, the licensed money transmitters likely fear that the activities of the bitcoin businesses will imperil their licenses and relationships with regulators. Unfortunately, some digital currency companies appear to prefer to operate until such time as a particular state might object, believing that it will be acceptable to register and comply after the fact. Experience highlights the risks of such a strategy. Besides being subject to state and federal money transmission and money services business regimes,<sup>159</sup> entities engaged in transmitting money likely must comply with OFAC requirements,<sup>160</sup> consumer protection obligations, as well

---

156. Trautman, *supra* note 138, at 23–6.

157. It took Coinbase two years and \$2 million to complete the application and receive licenses to be a money transmitter laws in 26 states. Michael del Castillo, Fred Wilson: Oppressive Bitcoin Regulation Could Make Silicon Valley the 'Next Wall Street', N.Y. BUS. J. (Apr. 24, 2015), <http://www.bizjournals.com/newyork/news/2015/04/24/fred-wilson-silicon-valley-next-wall-street.html>; COINBASE, LICENSES, <https://www.coinbase.com/legal/licenses> (last visited Nov. 24, 2015).

158. Tu, *supra* note 93, 112 (“The costs of evaluating whether compliance is necessary, the actual costs of becoming licensed and otherwise satisfying the regulatory requirements, and the risks of operating without a license may all act as a deterrent to those who wish to develop payment innovations.”).

159. Bank Secrecy Act; 31 U.S.C. §§ 5311–5330 (2001); *see also* TAYLOR, *supra* note 94, § 5.II.B, § 5.III.D.1.

160. SIVON, *supra* note 92, at 63; *see infra* notes 178–198 and accompanying text.

as the CFPB's Remittance Rule.<sup>161</sup>

### C. BITLICENSES AND DIGITAL CURRENCY-SPECIFIC STATE REGIMES

Because many of the money transmitter statutes neither squarely cover digital currencies nor provide the degree of regulatory oversight desired, the New York Department of Financial Services has established a "BitLicense" regime.<sup>162</sup> The regime requires that those involved in "Virtual Currency Business Activity" in or involving the state of New York must apply for a license and adhere to the substantive requirements of the regime.<sup>163</sup> The BitLicense regime can be described as "money transmitter plus" because, in addition to imposing requirements similar to those imposed by money transmitter regulation, the BitLicense regime also imposes requirements tailored to the unique nature of the virtual currency business, such as cybersecurity and special suspicious activity reports ("SARs").<sup>164</sup>

Virtual Currency Business Activity includes: (1) receiving virtual currency for transmission or transmitting virtual currency; (2) storing, holding or maintaining custody or control of virtual currency for others;

---

161. Electronic Fund Transfers (Regulation E), 12 C.F.R. § 1005 (2012); TAYLOR, *supra* note 94, § 5.II.B.

162. N.Y. LAWS § 200.3. *See also* Speech, Superintendent Lawsky's Remarks at the BITS Emerging Payments Forum (June 3, 2015), <http://www.dfs.ny.gov/about/speeches/sp1506031.htm> ("The first instinct among some at NYDFS was to shoehorn these new digital currency firms into our old money transmission rules. However, state money transmission rules date back to the civil war—when there was barely mass communication, let alone an Internet. And it became increasingly clear to us that such an approach simply would not work."); Davis Polk Client Memorandum, New York's Final "BitLicense" Rule: Overview and Changes from 2014 Proposal (June 5, 2015), [http://www.davispolk.com/sites/default/files/2015-06-05\\_New\\_Yorks\\_Final\\_BitLicense\\_Rule.pdf](http://www.davispolk.com/sites/default/files/2015-06-05_New_Yorks_Final_BitLicense_Rule.pdf) (providing summary of changes from and clarifications to the July 2014 proposal); SIVON ET AL., *supra* note 92, 85–86, 90–91 (2014) ("Like federal financial regulators, state regulators have focused attention on the role of virtual currencies in payment and other financial transactions . . . The New York Department of Financial Services (NYDFS) has been in the forefront of state efforts to regulate virtual currencies.").

163. N.Y. LAWS § 200.3. *See also* SIVON ET AL., *supra* note 92, 85–86, 90–91 (2014) ("Like federal financial regulators, state regulators have focused attention on the role of virtual currencies in payment and other financial transactions. . . . The New York Department of Financial Services (NYDFS) has been in the forefront of state efforts to regulate virtual currencies."); Speech, Superintendent Lawsky's Remarks at the BITS Emerging Payments Forum (June 3, 2015), <http://www.dfs.ny.gov/about/speeches/sp1506031.htm>.

164. *See* Davis Polk Client Memorandum, New York's Final "BitLicense" Rule, *supra* note 162, at 5 (providing summary of requirements).

(3) buying or selling virtual currency as a customer business; (4) performing exchange services; and (5) controlling, administering or issuing a virtual currency.<sup>165</sup> While certainly broad, the licensing regime would exclude mere merchants and consumers, the development of software, digital currency “miners,” and nonfinancial uses of digital currencies.<sup>166</sup> The regime imposes disclosure, recordkeeping, and fraud prevention obligations, books and records requirements, AML and know your customer requirements, certain actions designed to safeguard assets and customer funds, security obligations and the like.<sup>167</sup>

The Conference of State Bank Supervisors has issued a model framework that largely mirrors the New York framework.<sup>168</sup> The Uniform Law Commission is also in the process of drafting a statute that “will create an appropriate licensing regime for virtual currency transactions,”<sup>169</sup> and has released a draft of its proposed regulations.<sup>170</sup> While, as of the date of this article, no state other than New York has adopted a

---

165. N.Y. LAWS § 200.3; Superintendent Benjamin M. Lawsky, Remarks at the BITS Emerging Payments Forum, *supra* note 163; Davis Polk, New York’s Final “BitLicense” Rule, *supra* note 162, at 11.

166. N.Y. LAWS § 200.3; Davis Polk, New York’s Final “BitLicense” Rule, *supra* note 162, at 11.

167. N.Y. LAWS § 200.15–200.20. *See also* Davis Polk, New York’s Final “BitLicense” Rule, *supra* note 162, at 29–48 (discussing safeguarding assets, cyber security programs, anti-money laundering and exam, reports and oversight of BitLicense regime).

168. CONFERENCE OF STATE BANK SUPERVISORS, STATE REGULATORY REQUIREMENTS FOR VIRTUAL CURRENCY ACTIVITIES: CSBS MODULE REGULATORY FRAMEWORK (Sept. 15, 2015), <https://www.csbs.org/regulatory/ep/Documents/CSBS-Model-Regulatory-Framework%28September%2015%202015%29.pdf>.

169. ULC UPDATES, UPDATE ON DRAFTING COMMITTEE ON REGULATION OF VIRTUAL CURRENCIES (Oct. 16, 2015), <https://uniformlaws.wordpress.com/2015/10/16/update-on-drafting-committee-on-regulation-of-virtual-currencies/>.

“Because the draft act is contemplated as a licensing regime, the format of the first draft followed in many ways the format of the Uniform Money Services Act (promulgated by the ULC in 2000), and also followed the draft framework recently put forth by CSBS (Conference of State Bank Supervisors) as a starting point. The draft also borrowed definition language from the U.S. Treasury Department’s Financial Crimes Enforcement Network (‘FinCEN’), and, to a lesser extent, from the final ‘Bitlicense’ regulation that has been promulgated by the New York State Department of Financial Services. The present draft includes licensing requirements, reciprocity and use of licensing systems, requirements for financial strength and stability, provisions aimed at cybersecurity, and provisions on the books and records, supervision and enforcement, compliance with other laws, and consumer (or more broadly ‘user’) protections including disclosure, and substantive provisions such as a dispute resolution procedure.” *Id.*

170. NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, DRAFT REGULATION OF VIRTUAL CURRENCIES ACT (2015), [http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/2015oct\\_RVCA\\_Mtg%20Draft.pdf](http://www.uniformlaws.org/shared/docs/regulation%20of%20virtual%20currencies/2015oct_RVCA_Mtg%20Draft.pdf).

virtual currency-specific regime,<sup>171</sup> it is exciting to consider that a model statute may pave the way for reciprocity, allowing an entity licensed under one state statute to also do business in another state without applying for a virtual currency-specific license in that state if both states' statutes are based on the model.

While reciprocity does not currently exist under the BitLicense regime, at least one bitcoin firm that obtained a New York trust charter (as opposed to a BitLicense) is claiming reciprocity in all fifty states.<sup>172</sup> On May 7, 2015, itBit, a bitcoin exchange, became the first virtual currency company to be chartered as a limited purpose trust in New York permitted to engage in virtual currency activity.<sup>173</sup> On the day itBit received its license, it announced it would open for business in all fifty states, arguing that it had been organized under New York banking law, which has reciprocity throughout the United States.<sup>174</sup> However, neither New York nor any other state has confirmed that itBit will receive reciprocity, although no state has begun enforcement actions against it.<sup>175</sup> Notably, the spokesman for the California Department of Business Oversight stated: “[w]e’re not prepared to agree that ItBit . . . can conduct

---

171. Recently, California considered adopting a BitLicense regime—largely based on New York’s—but the bill failed to pass in the legislature prior to the September 11, 2015 deadline. *See generally* California Bitcoin Bill Dies in the Legislature, Blockchain Agenda (Sept. 16, 2015), <http://insidebitcoins.com/news/california-bitcoin-bill-dies-in-the-legislature/34864>; Bitcoin, the California Legislature, and the Future of Cryptocurrency Regulation, DCE Brief (Oct. 13, 2015), <http://dcebrief.com/bitcoin-the-california-legislature-and-the-future-of-cryptocurrency-regulation/>.

172. Davis Polk, New York’s Final “BitLicense” Rule, *supra* note 162, at 3.

173. *Id.*

174. *Id.* Forty-five states have signed the CSBS’s Nationwide Cooperative Agreement for Supervision and Examination of Multi-State Trust Institutions. CSBS, NATIONWIDE COOPERATIVE AGREEMENT, <https://www.csbs.org/regulatory/Cooperative-Agreements/Pages/42signedStates.aspx> (last visited Nov. 23, 2015). If a state is a signatory to this agreement then it allows trust banks organized under those states’ laws to engage in trust activities in the other states that have also signed the agreement. *See* CSBS, NATIONWIDE COOPERATIVE AGREEMENT FOR SUPERVISION AND EXAMINATION OF MULTI-STATE TRUST INSTITUTIONS, [https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide\\_agrmnt\\_multi-state\\_trust\\_op.pdf](https://www.csbs.org/regulatory/Cooperative-Agreements/Documents/nationwide_agrmnt_multi-state_trust_op.pdf) (last visited Nov. 23, 2015). Additionally, the NY DFS issued Gemini, a bitcoin exchange founded by the Winklevoss twins, a trust license in October 2015. Press Release, N.Y. Dep’t of Fin. Serv., NYDFS Grants Charter to “Gemini” Bitcoin Exchange Founded by Cameron and Tyler Winklevoss (Oct. 5, 2015), <http://www.dfs.ny.gov/about/press/pr1510051.htm>; *see also* Paul Vigna, Winklevoss Twin’s Gemini Exchange Gets Trust License-Bitbeat, WALL ST. J. (Oct. 5, 2015), <http://blogs.wsj.com/moneybeat/2015/10/05/bitbeat-winklevoss-twins-gemini-exchange-gets-trust-license/> (discussing the grant of a charter under New York Banking Law to Gemini to operate as a virtual currency exchange).

175. *Id.*

exchange transactions with Californians under its New York certificate.<sup>176</sup> It should be noted that institutions licensed to engage in virtual currency activities through a New York trust charter, such as itBit, still must comply with the substantive requirements of the BitLicense regime.<sup>177</sup>

## 2. OFAC

As is familiar to bankers, the U.S. government uses economic and trade sanctions to advance its foreign policy and national security interests and objectives.<sup>178</sup> Sanctions may be imposed against countries or geographic areas and all organizations, individuals and entities (“Persons”) within those areas, or against designated Persons or governments, wherever located.<sup>179</sup> OFAC is the primary federal agency administering and enforcing U.S. economic sanction programs.<sup>180</sup> There are a number of federal statutes currently in effect which authorize the executive branch to restrict or otherwise regulate commercial and other contacts between U.S. Persons<sup>181</sup> and sanctioned parties.<sup>182</sup> Each of these statutes

---

176. *Id.*

177. *Id.*

178. U.S. DEP’T OF TREASURY, OFAC FAQs: GENERAL QUESTIONS, [http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq\\_general.aspx](http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_general.aspx) (last visited Nov. 12, 2015) (“[S]anctions can be either comprehensive or selective, using the blocking of assets and trade restrictions to accomplish foreign policy and national security goals.”).

179. *Id.*

180. U.S. DEP’T OF TREASURY, ABOUT, <http://www.treasury.gov/about/organizational-structure/offices/Pages/Office-of-Foreign-Assets-Control.aspx> (last visited Nov. 13, 2014). In addition, OFAC and the U.S. State Department administer certain “secondary” sanctions targeting non-U.S. Persons located in non-Target Countries that engage in certain activities involving Iran or Russia. *See* Paul J. Sanders, Will U.S. Sanctions Disrupt Iran-Russia Economic Ties?, *US NEWS* (Aug. 24, 2015), <http://www.usnews.com/news/articles/2015/08/24/will-us-sanctions-disrupt-iran-russia-economic-ties>.

181. “U.S. Persons” include: citizens of the United States, wherever located; permanent resident aliens (i.e., “green card” holders), wherever located; all entities organized in the United States (including their foreign branches); and all Persons actually located in the United States. 31 C.F.R. § 560.314 (2015).

182. These include the Trading with the Enemy Act, 50 U.S.C. §§ 1-44 (2012), the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-1706 (2007) (“IEEPA”), the United Nations Participation Act, 22 U.S.C. § 287c (2010) (which provides the executive branch with the authority to implement mandatory provisions of United Nations Security Council Resolutions), and a number of regulations which impose a variety of sanctions and restrictions on contacts with specific countries, such as Cuba and Iran. *See, e.g.*, 31 C.F.R. § 515 et seq. (2015) (providing sanctions and restrictions on contracts with Cuba); 31 C.F.R. § 561 et seq. (2015) (providing sanctions that relate to financial transactions with Iran).

has civil and criminal penalties and many of them overlap.<sup>183</sup>

While U.S. economic sanctions compliance generally applies to all U.S. Persons, the financial sector is subject to a higher level of scrutiny by OFAC and an aggressive level of enforcement.<sup>184</sup> As technology companies enter this space, they will invite the enhanced scrutiny leveled on the banking and financial sectors. As noted, a variety of statutes authorize the president and the executive branch to impose sanctions against a variety of individuals, entities and nations.<sup>185</sup> These sanction programs are ordered by the president by way of executive order as authorized by one of the underlying statutes.<sup>186</sup> OFAC then issues regulations that interpret and implement the terms of presidential executive orders.<sup>187</sup>

Under regulations administered by OFAC, U.S. Persons are generally prohibited from engaging in transactions, directly or indirectly, with those Persons and countries or territories targeted by U.S. sanctions (“Target Countries”), unless the transactions are exempt or licensed by OFAC.<sup>188</sup> U.S. Persons are also generally prohibited from “facilitating”

---

183. See BENJAMIN WOOD, ET AL., OFAC ENFORCEMENT OF U.S. INTERNATIONAL ECONOMIC SANCTIONS § 9:4 (May 2015) (discussing civil and criminal enforcement of OFAC’s regulations).

184. OFAC does not regulate banks, but requires banks to comply with the laws that it administers. See U.S. DEP’T OF TREASURY, OFAC FAQs: SANCTIONS COMPLIANCE, [http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq\\_compliance.aspx](http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx) (last visited Nov. 13, 2015). The Federal Financial Institutions Examination Council (“FFIEC”) provides examination guidelines at banks. See FFIEC, BANK SECRECY ACT ANTI-MONEY LAUNDERING EXAMINATION MANUAL: OFFICE OF FOREIGN ASSETS CONTROL, [http://www.ffiec.gov/bsa\\_aml\\_infobase/pages\\_manual/olm\\_037.htm](http://www.ffiec.gov/bsa_aml_infobase/pages_manual/olm_037.htm) (last visited Nov. 12, 2015). Additionally, the United States government has brought many recent prosecutions against large banks for violations of trade sanctions. See, e.g., Roy C. Smith & Ingo Walter, Getting Serious About Sanctions-Busting Banks, WALL ST. J. (June 26, 2014), <http://www.wsj.com/articles/roy-smith-and-ingo-walter-getting-serious-about-sanctions-busting-banks-1403823813> (discussing the recent prosecution of BNP Paribas for violating trade sanctions with Iran and Sudan); Christopher M. Matthews, Deutsche Bank to Pay \$258 Million in Fines for Violating U.S. Sanctions, WALL ST. J. (Nov. 4, 2015), <http://www.wsj.com/articles/deutsche-bank-to-pay-258-million-in-fines-for-violating-u-s-sanctions-1446661556>.

185. WOOD ET AL., *supra* note 183, § 9:1 (discussing regulatory authority of the president to order OFAC to promulgate and administer sanctions).

186. See *id.*

187. See *id.*

188. U.S. DEP’T OF TREASURY, OFAC FAQs: GENERAL QUESTIONS, *supra* note 178. There is a recent exception to the traditional practice pursuant to which sanctions broadly prohibit all transactions with sanctioned parties. In 2014, OFAC designed and implemented a new type of sanctions, called “sectoral sanctions,” in response to Russia’s military actions in Ukraine. The sectoral sanctions, which to date have been imposed only in the Russia/Ukraine context, prohibit only limited and very specific types of business dealings with sanctioned parties, in contrast to sweeping prohibitions on all types of dealings. See U.S. DEP’T OF TREASURY, OFAC FAQs: OTHER SANCTIONS PROGRAMS, <http://www.treasury.gov/resource->

or assisting actions of non-U.S. Persons, which could not be directly performed by U.S. Persons due to U.S. sanctions restrictions.<sup>189</sup> This prohibition on facilitating or assisting applies to the U.S. Person, even though the non-U.S. Person is otherwise outside the scope of the OFAC proscriptions.

Currently, the Target Countries are the Crimea region of Ukraine, Cuba, Iran, Sudan, Syria, and, for certain transactions, North Korea.<sup>190</sup> The governments of Cuba, Iran, Sudan, and Syria, including their political subdivisions, agencies and instrumentalities, and entities they own or control directly or indirectly, are blocked.<sup>191</sup> In most cases, Persons located, organized or residing in a Target Country are also considered “Target Persons.”<sup>192</sup> These Target Countries and Target Persons are subject to various trade embargoes that ban imports and/or exports of goods and services (including financial services) and technology into the United States, from the United States, or by U.S. Persons.<sup>193</sup>

OFAC also administers “list-based” sanctions that are imposed on Persons designated under various programs for certain activities, primarily those involved in narcotics, terrorism, proliferation of weapons of mass destruction, and piracy.<sup>194</sup> The names of Persons designated under

---

center/faqs/Sanctions/Pages/faq\_other.aspx#ukraine (last visited Nov. 12, 2015); U.S. DEP’T OF STATE, UKRAINE AND RUSSIA SANCTIONS, <http://www.state.gov/e/eb/tfs/spi/ukrainerrussia/> (last visited Nov. 12, 2015). The nature and scope of the sectoral sanctions are beyond the scope of this article.

189. See WOOD, *supra* note 183, § 9:2.1 (discussing the ban against facilitation by U.S. Persons in the context of U.S. trade sanctions against Sudan).

190. See Exec. Order No. 13685, 79 FR 77357 (Dec. 19, 2014) (executive order blocking certain persons and prohibiting certain transactions with respect to the Crimea Region of Ukraine); 31 CFR §§ 515, 560, 538, 542, 510 (2015).

191. In the definition of the government of these countries, the sanction regimes include the political subdivisions of the Target Countries’ governments. See, e.g., 31 C.F.R. § 515.337 (2015) (broadly defining the government of Cuba as including political subdivisions of the Government of Cuba); 31 C.F.R. § 560.304 (2015) (defining Government of Iran as including “any political subdivision, or instrumentality. . . person owned or controlled, directly or indirectly” by the government of Iran); 31 C.F.R. § 538.305 (2015) (defining the Government of Sudan as including political subdivisions, agencies, or instrumentalities of the Government of Sudan); 31 C.F.R. § 542.305 (2015) (defining the Government of Syria as including political subdivisions, agencies, or instrumentalities of the government of Syria).

192. See, e.g., 31 C.F.R. §§ 560.201-07, 304, 306 (2015).

193. U.S. DEP’T OF TREASURY, SANCTIONS PROGRAMS AND COUNTRY INFORMATION, <http://www.treasury.gov/resource-center/sanctions/Programs/Pages/Programs.aspx> (last visited Nov. 13, 2015).

194. See U.S. DEP’T OF TREASURY, RESOURCE CENTER, <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx> (last visited Nov. 12, 2015) (providing a

OFAC's list-based sanction programs are placed on OFAC's List of Specially Designated Nationals and Blocked Persons (the "SDN List").<sup>195</sup>

Banks are familiar with the OFAC regime and all it entails.<sup>196</sup> Using a variety of technology tools, as well as human review where appropriate, financial institutions are generally able to identify potentially prohibited transactions and take steps to block them.<sup>197</sup> There have been, however, some spectacular failures, such as the \$8.9 billion settlement with BNP Paribas for transactions with Iran, Sudan, Burma and Cuba.<sup>198</sup> As a gross generalization, start-up technology companies tend not to be as familiar with sanction requirements. In addition, because the rules regarding engaging in transactions (directly or indirectly) and facilitating transactions are so broad, and given the ease of access to internet-based technologies, having systems to monitor and control access and usage are paramount.<sup>199</sup> The adaptation of bitcoins to finance money laundering and criminal activity serves as a stark warning to those involved in digital

---

searchable list that includes certain designated persons that are involved in narcotics, terrorism, proliferation of weapons of mass destruction and privacy).

195. The SDN List is provided on the U.S. Department of Treasury's webpage. See U.S. DEP'T OF TREASURY, SPECIALLY DESIGNATED NATIONALS LIST (SDN), <http://www.treasury.gov/resource-center/sanctions/SDN-List/Pages/default.aspx> (last visited Nov. 13, 2015).

196. Banks are subject to OFAC regulation and may face civil and criminal sanctions for non-compliance. U.S. DEP'T OF TREASURY, OFAC FAQs: SANCTIONS COMPLIANCE, [http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq\\_compliance.aspx](http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_compliance.aspx) (last visited Nov. 13, 2015).

197. See generally AM. BANKERS ASSOC., "SPECIALLY DESIGNATED WHO?": A PRIMER ON OFAC COMPLIANCE (1996), <http://www.treasury.gov/resource-center/sanctions/Documents/abamag.pdf> (providing an overview of the role of technology and humans in maintaining an OFAC compliance program).

198. Press Release, U.S. Department of the Treasury (June 30, 2014) <https://www.treasury.gov/press-center/press-releases/Pages/jl2447.aspx>. BNP Paribas entered into a \$963 million settlement with OFAC due to allegations that the bank systematically concealed, removed, omitted or obscured references to information about transactions that it had engaged in that violated OFAC's regulations. This was part of a combined \$8.9 billion settlement with various federal and state government agencies, including the Federal Reserve, the New York Department of Financial Services, the US Attorney for the Southern District of New York and the New York County District Attorney's Office. For a number of years, BNP Paribas allegedly processed thousands of transactions, which exceeded \$8 billion, that involved U.S. financial institutions and countries, entities and/or individuals that were prohibited by OFAC's regulations. BNP Paribas supposedly made efforts to hide the identity of the parties of these transactions to conceal that these transactions were being made in contravention of OFAC's regulations. See also <http://www.bnpparibas.com/en/news/press-release/bnp-paribas-announces-comprehensive-settlement-regarding-review-certain-usd-trans>.

199. See WOOD, *supra* note 183, § 9:4 (emphasizing the importance of OFAC compliance and providing the processes that are required for OFAC of compliance).

currencies of the dangers of inadvertently tripping over the OFAC obligations.<sup>200</sup>

### 3. Tax Considerations

The Internal Revenue Service (“IRS”) announced in March 2014 that it would treat virtual currencies, such as bitcoins, as property rather than currency under federal tax law.<sup>201</sup> The tax authorities of some states have announced that they will also treat virtual currencies, such as bitcoins, as property under their tax laws.<sup>202</sup> Thus, purchases and sales of bitcoins, and payments made with bitcoins, can be taxable events.<sup>203</sup> This would include purchases of goods, exchanges of bitcoins for legal tender, wages or other payments made to independent contractors or service providers.<sup>204</sup>

---

200. See DEP’T OF TREASURY, NATIONAL MONEY LAUNDERING RISK ASSESSMENT 62–4 (2015) (providing an overview of the past use of bitcoin to facilitate criminal activity and the risks that bitcoin can facilitate money laundering). There have been a number of high profile criminal cases where it has been alleged that bitcoin has been used to launder money and facilitate criminal activity. See, e.g., Bob Van Voris, Ross Ulbricht Convicted of Running Silk Road as Dread Pirate Roberts, BLOOMBERG BUS. (Feb. 4, 2015), <http://www.bloomberg.com/news/articles/2015-02-04/ross-ulbricht-convicted-of-running-silk-road-as-dread-pirate> (providing that Ross Ulbricht was sentenced to life imprisonment for running the Silk Road, which allowed users to use bitcoins to, among other things, purchase drugs and solicit contract killings); Stan Higgins, U.S. Prosecutors Unseal New Charges Against Bitcoin Exchange Operator, COINDESK (Nov. 10, 2015), <http://www.coindesk.com/us-prosecutors-unseal-new-charges-against-bitcoin-exchange-operator/> (providing that the former operator of Coin.mx was charged with unlawful operation of a money transmitter business and laundering money).

201. I.R.S. Virtual Currency Guidance: Virtual Currency Is Treated as Property for U.S. Federal Tax Purposes, I.R.S. Notice 2014-36 (Mar. 25, 2014) [hereinafter I.R.S. Guidance on Virtual Currency]; General Rules for Property Transactions Apply, I.R.S. Notice 2014-21 (Mar. 25, 2014), <https://www.irs.gov/pub/irs-drop/n-14-21.pdf> [hereinafter I.R.S. General Rules for Virtual Currency].

202. See, e.g., NEW YORK STATE DEPARTMENT OF TAXATION AND FINANCE, TAX DEPARTMENT POLICY ON TRANSACTIONS USING CONVERTIBLE VIRTUAL CURRENCY (Dec. 5, 2014), [https://www.tax.ny.gov/pdf/memos/multitax/m14\\_5c\\_7i\\_17s.pdf](https://www.tax.ny.gov/pdf/memos/multitax/m14_5c_7i_17s.pdf) (providing that for sale taxes purposes convertible virtual currency is intangible property); WASHINGTON STATE DEPARTMENT OF REVENUE, ACCEPTING VIRTUAL CURRENCY AS PAYMENT FOR GOODS OR SERVICES, <http://dor.wa.gov/content/getaformorpublication/publicationbysubject/taxtopics/virtualcurrency.aspx> (last visited Dec. 1, 2015) (providing that tax will apply to virtual currency the same way it applies to the sales of tangible property, digital products, or services provided in exchange for virtual currency).

203. I.R.S. Guidance on Virtual Currency, *supra* note 202; I.R.S. General Rules for Virtual Currency, *supra* note 202. Similarly, when a taxpayer successfully “mines” virtual currency, the fair market value of the virtual currency as of the date of receipt will be included in the taxpayer’s gross income. I.R.S. General Rules for Virtual Currency, *supra* note 202, at 4.

204. I.R.S. Guidance on Virtual Currency, *supra* note 202; I.R.S. General Rules for Virtual

The implications of the treatment of digital currencies as property for users of bitcoin are fascinating. For example, if Sally buys a cup of coffee at Starbucks for \$4.00, but pays for the coffee using a digital currency she acquired at a cost of \$2.00, she has realized a \$2.00 capital gain on the transaction.<sup>205</sup> Even more interesting is that there could not only be a sales tax imposed on Starbucks for the sale of the coffee, Sally could perhaps be deemed to have sold her digital currency for the \$4.00 cup of coffee and owe sales tax on her sale as well. The recordkeeping and compliance costs seem overwhelming (and as a result, are perhaps most often ignored),<sup>206</sup> but this seems to be the logical outgrowth of the IRS position.

#### 4. Securities Laws Issues

While bitcoins themselves are not securities,<sup>207</sup> investment vehicles that hold bitcoins and offer interests in the vehicles are securities.<sup>208</sup> Because of the novel nature of bitcoins and other digital currencies, the SEC has indicated a high interest in investigating fraud and Ponzi schemes involving bitcoins and has even issued an investor warning on the risks of virtual currency-related investments.<sup>209</sup> For example, shares of the Bitcoin Investment Trust were the first publicly quoted securities representing an investment in bitcoin.<sup>210</sup> Additionally, in July 2013, the

---

Currency, *supra* note 202.

205. I.R.S. General Rules for Virtual Currency, *supra* note 202, at 3 (“If the fair market value of property received in exchange for virtual currency exceeds the taxpayer’s adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.”).

206. I.R.S. General Rules for Virtual Currency, *supra* note 202, at 5. According to I.R.S. General Rules for Virtual Currency, the threshold for reporting requirements is for payments using virtual currency with a value of \$600 or more. *Id.* Some fintech start-ups are aimed at assisting customers address their compliance obligations such as Libra, which advertises itself as the “premiere accounting, reporting and tax compliance layer for blockchain technologies.” LIBRA, <http://libratx.com/> (last visited Nov. 18, 2015).

207. See Letter from Mary Jo White, Chair, SEC, to Sen. Thomas R. Carper, Chairman, Committee on Homeland Security and Governmental Affairs (Aug. 30, 2013), at 1 (stating the SEC’s position that “[w]hether a virtual currency is a security under the federal securities laws, and therefore subject to our regulation, is dependent on the particular facts and circumstances at issue.”); see also Grinberg, *supra* note 23, 195.

208. See, e.g., Winklevoss Bitcoin Trust, Registration Statement, No. 333-189752 (Form S-1) (July 1, 2013) (registration statement filing for Winklevoss Bitcoin Trust).

209. SEC Investor Alert, Ponzi Schemes Using Virtual Currencies, SEC Pub. No. 153 (July 1, 2013) [hereinafter SEC Investor Alert, No. 153].

210. GRAYSCALE, OVERVIEW, <http://grayscale.co/bitcoin-investment-trust/> (last visited Nov. 18, 2015). Shares of Bitcoin Investment Trust is traded under the symbol “GBTC” on

Winklevoss Bitcoin Trust filed its S-1 registration statement with the SEC in order to sell shares of its bitcoin exchange-traded fund on NASDAQ under the symbol “COIN.”<sup>211</sup> The S-1 has been amended five times, but the SEC has not yet qualified the prospectus, meaning that no shares in COIN have been publically sold.

Indeed, the SEC has brought a series of enforcement actions regarding bitcoin-related schemes.<sup>212</sup> The first involved a Ponzi scheme, in which the judge levied a fine of more than \$40 million, for violations of Sections 5 and 17(a) of the Securities Act and Section 10(b) of the Exchange Act.<sup>213</sup> The second action resulted in sanctions for operating digital currency exchanges without registering as a broker-dealer or stock exchange.<sup>214</sup> The third action involved a fine and prohibitions from any bitcoin-related securities offerings, as a result of offering unregistered securities in bitcoin ventures.<sup>215</sup> The fourth—but certainly not last—action involved a bitcoin mining company purporting to offer shares of a digital mining operation to investors but did not have the computer power necessary to conduct the mining activity.<sup>216</sup> Thus while digital currencies

---

OTCQX. *Id.*

211. Winklevoss Bitcoin Trust, Registration Statement, *supra* note 208. *See e.g.*, Winklevoss Bitcoin Trust, Amendment No. 1 to Registration Statement, No. 333-189752 (Form S-1/A) (Oct. 8, 2013) (amendment to registration statement filing for Winklevoss Bitcoin Trust); Winklevoss Bitcoin Trust, Amendment No. 2 to Registration Statement, No. 333-189752 (Form S-1/A) (Feb. 19, 2014) (amendment to registration statement filing for Winklevoss Bitcoin Trust); Winklevoss Bitcoin Trust, Amendment No. 3 to Registration Statement, No. 333-189752 (Form S-1/A) (May 8, 2014) (amendment to registration statement filing for Winklevoss Bitcoin Trust).

212. *See* SEC v. Trendon T. Shavers and Bitcoin Savings and Trust, SEC Litigation Release No. 23090 (Sept. 22, 2014), <https://www.sec.gov/litigation/litreleases/2014/lr23090.htm>; BTC Trading, Corp., Exchange Act Release No. 73783 (Dec. 8, 2014); Erik Voorhees, Securities Act Release No. 9592 (June 3, 2014).

213. SEC v. Trendon T. Shavers, SEC Litigation Release No. 23090. In *SEC v. Shavers*, an individual, Trendon Shavers, was found liable for defrauding investors out of more than 700,000 bitcoins by soliciting investments and offering returns to be paid out in bitcoin. *Id.* Mr. Shavers promised up to 7% returns weekly based on his trading bitcoin against the U.S. dollar, when in reality he used the new bitcoins to pay purported returns and to divert funds for his own personal use. *Id.*

214. BTC Trading, Exchange Act Release No. 73783. The SEC sanctioned an individual and his alter ego foreign corporation, an unregistered entity through which he operated unregistered, online, virtual currency-denominated securities exchanges and unregistered broker-dealers. *Id.*

215. Erik Voorhees, Securities Act Release No. 9592. In *Voorhees*, the SEC issued a cease-and-desist order against an individual for conducting unregistered offerings of bitcoin through a bitcoin stock exchange. *Id.*

216. Complaint, SEC v. Homero Joshua Garza, No. 3:15-cv-01760 (D. Conn. Dec 1, 2015).

may not in and of themselves be securities, as companies and individuals seek methods to profit from their popularity, they may run afoul well-established prohibitions under the various securities laws.

#### 4. Commodities Laws

The Commodity Futures Trading Commission (“CFTC”) has jurisdiction over futures involving commodities,<sup>217</sup> and considers bitcoin and other digital currencies to be included in the definition of commodity.<sup>218</sup> In addition, other derivatives, such as swaps, hedges, options, trading platforms and exchanges involving commodities fall squarely within the jurisdiction of the CFTC.<sup>219</sup> The CFTC has granted temporary registrations as swap execution facilities to TeraExchange, LLC<sup>220</sup> and LedgerX,<sup>221</sup> and is considering an application to launch a bitcoin binary options offering.<sup>222</sup> The CFTC recently settled its first enforcement action involving an unregistered bitcoin derivatives trading platform.<sup>223</sup>

---

217. Under Section 1a(9) of the Commodity Exchange Act, the definition of “commodity” includes, among other things, “all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in.” 7 U.S.C. § 1a(9) (2012).

218. CFTC Order, Coinflip Enforcement, *supra* note 115, at 3 (“Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.”).

219. *Id.*

220. CFTC Letter, Notice of Grant of Temporary Registration of TeraExchange, LLC as a Swap Execution Facility Pursuant to Part 37 of the Commission’s Regulations (Sept. 19, 2013), <http://www.cftc.gov/stellent/groups/public/@otherif/documents/ifdocs/teraexchange-ltr091913.pdf>.

221. CFTC Letter No. 15-49, Notice of Grant of Temporary Registration of LedgerX LLC as a Swap Execution Facility Pursuant to Part 37 of the Commission’s Regulations (Sept. 8, 2015), [http://cftc.gov/groups/public/@otherif/documents/ifdocs/lgxsefregltr\\_151008.pdf](http://cftc.gov/groups/public/@otherif/documents/ifdocs/lgxsefregltr_151008.pdf).

222. Diana Ngo, Derivatives Exchange Nadex Awaiting for CFTC Approval to Launch Bitcoin Binary Options, COINTELEGRAPH.COM (Nov. 25, 2014), <http://cointelegraph.com/news/112987/derivatives-exchange-nadex-awaiting-for-cftc-approval-to-launch-bitcoin-binary-options>. “The Bitcoin binary-option contracts will allow the trading of price movements of the cryptocurrency, without the need to hold any Bitcoins.” *Id.*

223. CFTC Order, Coinflip Enforcement, *supra* note 115 (“During the Relevant Period, Coinflip operated a facility for the trading of swaps. However, Coinflip did not register the facility as a swap execution facility or designated contract market. Accordingly, Coinflip violated Section 5h(a)(1) of the Act and Regulation 37.3(a)(1).”). CFTC Order, TeraExchange LLC, CFTC Docket No-15-33 (Sept. 24, 2015) [hereinafter CFTC Order, TeraExchange Enforcement]. *See also* Davis Polk Client Memorandum, CFTC Brings First Bitcoin Enforcement Action, Further Clarifying U.S. Regulatory Landscape for Virtual Currencies (Sept. 28, 2015), [http://www.davispolk.com/sites/default/files/2015\\_09\\_28\\_CFTC\\_Brings\\_First\\_Bitcoin\\_Enforcement\\_Action.pdf](http://www.davispolk.com/sites/default/files/2015_09_28_CFTC_Brings_First_Bitcoin_Enforcement_Action.pdf) (providing analysis of CFTC order finding that Coinflip and its founder violated provisions of the CEA and CFTC regulations governing transactions in

The order in the settled action confirms the CFTC's regulatory treatment of bitcoin (and other "virtual currencies") as "commodities" under the Commodities Exchange Act ("CEA").<sup>224</sup> Based on this characterization, the order applies CEA provisions and CFTC regulations dealing with options and swaps to the trading platform in connection with offering trading of bitcoin options.<sup>225</sup> As is made clear by the order, a wide variety of activities involving virtual currency derivatives, which could include futures, swaps or options referencing virtual currencies, could cause a firm to be subject to registration and regulation by the CFTC and its self-regulatory organization, the National Futures Association ("NFA").<sup>226</sup> In addition to trading platforms that may need to register as swap execution facilities or designated contract markets,<sup>227</sup> firms that provide referral or advisory services with respect to virtual currency derivatives or that operate pooled investment vehicles that trade these derivatives may need to register with the CFTC and the NFA.

In short, any business involved in virtual currency derivatives—including foreign businesses that solicit or provide services to U.S. customers—must consider whether its activities require it to register with the CFTC.<sup>228</sup> The process of registering with the CFTC can be time-consuming and costly, often taking a year or more for registration and costing a

---

commodity options, including provisions requiring trading platforms that offer swaps to register with the CFTC).

224. CFTC Order, Coinflip Enforcement, *supra* note 115 ("Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.").

225. *Id.* ("The definition of a 'commodity' is broad . . . Bitcoin and other virtual currencies are encompassed in the definition and properly defined as commodities.").

226. *Id.*; *see also* Testimony of Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6> ("Derivative contracts based on a virtual currency represent one area within our responsibility . . . Innovation is a vital part of our markets, and it is something that our regulatory framework is designed to encourage. At the same time, our regulatory framework is intended to prevent manipulation and fraud, and to make sure our markets operate with transparency and integrity.").

227. CFTC Order, TeraExchange Enforcement, *supra* note 224, citing 17 C.P.R. § 37.3(a)(1) (2014) ("Regulation 37.3(a)(1) similarly requires that any 'person operating a facility that offers a trading system or platform in which more than one market participant has the ability to execute or trade swaps with more than one other market participant on the system or platform shall register the facility as a swap execution facility under this part or as a designated contract market under part 38 of this chapter.'").

228. *See* Testimony of Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition and Forestry (Dec. 10, 2014), <http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6> ("Derivative contracts based on a virtual currency represent one area within our responsibility. Recently, for example, a SEF registered with us made such a

significant amount of money, sometimes a million dollars or more, to create the necessary infrastructure to ensure compliance with applicable regulatory requirements and to complete the intensive application process.<sup>229</sup> Firms whose virtual currency derivatives activities trigger CFTC registration requirements should take into consideration the time and resources necessary to complete the registration process before offering those services.

*D. Regulation of Entities Providing Services to Banks*

Banks commonly outsource critical functions to third parties.<sup>230</sup> The regulators have adopted the common view that the financial institution is responsible for identifying and controlling any risks arising from the third-party relationship, to the same extent that the institution would if it were to conduct the function itself.<sup>231</sup> Interestingly, although not clearly authorized by statute, the agencies view the Bank Service Corporation Act as giving them the authority to examine third parties that are providing functions for the internal operations of the bank.<sup>232</sup> Indeed, because the agencies take the view that the bank is simply delegating to a third party activities that the bank itself could (and often should) conduct, the agencies have the same authority to examine the third party as

---

contract available. Innovation is a vital part of our markets, and it is something that our regulatory framework is designed to encourage. At the same time, our regulatory framework is intended to prevent manipulation and fraud, and to make sure our markets operate with transparency and integrity. Our responsibilities at the CFTC in this regard are ongoing.”)

229. See NATIONAL FUTURES ASSOCIATION, WHO HAS TO REGISTER, <https://www.nfa.futures.org/nfa-registration/index.HTML> (last visited Nov. 18, 2105) (providing information on who must register and how to register with the CFTC).

230. Taylor, *supra* note 94, § 8.I (“Banks and other financial services companies frequently outsource services required in their businesses.”).

231. Taylor, *supra* note 94, § 8.IV (citing U.S. OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC 2013-29, RISK MANAGEMENT GUIDANCE 1 (Oct. 30, 2013)).

232. FED. FIN. INST. EXAMINATION COUNCIL, SUPERVISION OF TECHNOLOGY SERVICE PROVIDERS 1 (Oct. 2012) (citing 12 U.S.C. §§ 1464(d)(7), 1867(c)). See also OCC, Bulletin 2013-29 (Oct. 30, 2013), <http://www.occ.treas.gov/news-issuances/bulletins/2013/bulletin-2013-29.html#>; FDIC, GUIDANCE FOR MANAGING THIRD-PARTY RISK, <http://www.fdic.gov/news/news/financial/2008/fil08044a.pdf>; BOARD OF GOVERNORS OF THE FED. RESERVE SYS., GUIDANCE ON MANAGING OUTSOURCING RISK (Dec. 5, 2013), <http://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf>; CFPB Bulletin 2012-03 (Apr. 13, 2012), [http://files.consumerfinance.gov/f/201204\\_cfpb\\_bulletin\\_service-providers.pdf](http://files.consumerfinance.gov/f/201204_cfpb_bulletin_service-providers.pdf).

it has to examine the bank itself.<sup>233</sup> The agencies view the bank's management and supervision of these relationships as part of its normal supervisory process, and expect the bank to engage in necessary monitoring and review of the activities.<sup>234</sup>

Bank regulators have provided extensive guidance to banks regarding the management of their third-party vendor relationships.<sup>235</sup> This guidance places significant responsibilities on the banks and highlights the risks they must consider and evaluate, both as they enter into such relationships and as they monitor existing relationships.<sup>236</sup> Vendors should be prepared for this heightened regulatory interest, as it will be reflected in ongoing dealings with the banks.<sup>237</sup>

Accordingly, an entity providing a function or a service to a bank may find regulators knocking on its doors to review policies, procedures, controls, security, internal models, testing results, licenses and the like.<sup>238</sup> For instance, a company providing enhanced verification of customer identities to assist in fraud detection and prevention may find the regulators wanting to look at underlying algorithms or test results for inadvertent bias having potentially disproportionate impacts on protected groups.

Because banks are attractive targets as customers for many fintech companies, these companies need to be aware that they may become subject to bank-like examination and supervision simply by providing services to the banks.

### III. THE RISKS OF RISKING IT

Until recently, it has been the technology sector, rather than the banking industry, that has been the driving force behind the current wave of fintech start-ups. Technologists have led this drive by focusing on ways that technology can enhance the everyday world. The technologists leading the fintech explosion are of the same ilk as those that founded the shared-economy companies Uber and Airbnb. As with those who founded Uber and Airbnb, many of these technologists engaging in the

---

233. *See id.*

234. Taylor, *supra* note 94, § 8.IV.B (2014).

235. *Id.*

236. *Id.*

237. *Id.*

238. *Id.*

fintech industry are risk takers, often having a precarious relationship with regulations and regulators and fitting into three broad categories.<sup>239</sup> The first category includes those that do not have a financial services background and are genuinely unaware of the regulations to which they may be subject. A second category recognizes that regulations exist but make a pragmatic business decision to ignore the applicable regulations prior to launching their new business to avoid regulatory scrutiny at the start. A third category is composed of technologists who intend to violate the law and have no regard for regulators, such as the case with the Silk Road founder.<sup>240</sup> Those who fall within the first two categories, whether intentionally or not, will seek to have their new technology in place and thriving before regulators have even considered how it fits into the existing regulatory regimes.<sup>241</sup> This creates a difficult scenario for regulators, as many of these products will provide substantial advantages to consumers. They will have become accustomed to the advantages of the service and regulatory intervention may frustrate those benefits.<sup>242</sup> For those developing technology to thwart the law, as discussed below, regulators are acting swiftly and aggressively to combat illegal activity in the fintech

---

239. In some cases, tech start-ups took the approach of “act now and ask for forgiveness later.” For example, in the case of Uber, the ride-sharing service, the company is currently facing regulatory backlash throughout the United States and abroad. From its inception, Uber has aggressively moved into different markets with complete disregard for regulation. Only afterwards have those countries, states, and local governments considered how to regulate the service and/or challenged the service. For example, within days of Uber launching in Portland, Oregon, the city issued a cease-and-desist letter notifying the company that it was operating in violation of city law. Malia Spencer, *City Sends Uber Cease-And-Desist Order, Uber Fires Up a Petition*, PORTLAND BUS. J. (Dec. 8, 2014), <http://www.bizjournals.com/portland/blog/techflash/2014/12/city-sends-uber-cess-and-desist-order-uber-fires.html>.

240. During his sentencing hearing, Ross Ulbricht, the founder of Silk Road, stated that he created Silk Road to provide people with privacy and anonymity, thus empowering them. Though not stated, this clearly indicates that Mr. Ulbricht intended to create a universe that avoided the law and applicable regulations. Laurie Segall, *Silk Road's Ross Ulbricht Sentenced to Life*, CNN (May 29, 2015), <http://money.cnn.com/2015/05/29/technology/silk-road-ross-ulbricht-prison-sentence/index.html>.

241. See Andrew Vila & Kevin Gardner, *Bringing Out the Regulatory Wheel Clamps for Uber*, WALL ST. J. (Sep. 27, 2015), <http://www.wsj.com/articles/bringing-out-the-regulatory-wheel-clamps-for-uber-1443385825> (noting that various states are attempting to regulate ride-sharing services); see also, Tom Groenfeldt, *New York State Aims for Sustainable Regulation of Virtual Currencies*, FORBES (Nov. 3, 2014), <http://www.forbes.com/sites/tomgroenfeldt/2014/11/03/new-york-state-aims-for-sustainable-regulation-of-virtual-currencies/> (noting in connection with New York's proposed BitLicense that “[v]irtual currencies are on [New York's] radar screen because we regulate money transmitters like Western Union and Moneygram, but our rules were written long before the Internet or virtual currencies”).

242. Vila & Gardner, *supra* note 241.

world.

As fintech expands and becomes more mainstream, regulation can no longer be avoided by those developing fintech companies and development of compliance infrastructures must be part of the business plan.<sup>243</sup> As compliance programs are developed, fintech start-ups must consider their relationships with their regulators or potential regulators, including the possible long-term effects of avoiding interactions.<sup>244</sup> Not complying with established laws and regulations can lead to criminal actions against the violator, regardless of whether the reason for non-compliance was a lack of awareness or something more nefarious.

For example, in the virtual currency context, authorities are very concerned about money laundering and have brought criminal charges against those administrating and engaging in transactions related to Silk Road and Silk Road 2.0, the online black marketplaces used to facilitate criminal activity that have since been shut down by joint government task forces.<sup>245</sup> Charlie Shrem, the former CEO of BitInstant, was arrested and later sentenced to a two-year prison sentence for allegedly aiding in facilitating criminal activity relating to Silk Road.<sup>246</sup>

Mr. Shrem started BitInstant as a senior at Brooklyn College, made millions, and attracted the attention of wealthy investors.<sup>247</sup> However, it was later discovered that many of BitInstant's customers were using false identities,<sup>248</sup> and BitInstant had not been submitting SARs to regulators even after flagging transactions for fraudulent activity.<sup>249</sup> In some cases, BitInstant was used to unlawfully convert dollars into bitcoin

---

243. See ARNER, *supra* note 13, at 18–21.

244. *Id.*

245. See generally Kim Zetter, *How the Feds Took Down the Silk Road Drug Wonderland*, WIRED (Nov. 18, 2013), <http://www.wired.com/2013/11/silk-road/>; Andy Greenberg, *Feds Seize Silk Road 2 in Major Dark Web Drug Bust*, WIRED (Nov. 6, 2014), <http://www.wired.com/2014/11/feds-seize-silk-road-2/>.

246. Nathaniel Popper, *Charlie Shrem and the Ups and Downs of BitInstant*, COINDESK (May 19, 2015), <http://www.coindesk.com/charlie-shrem-and-the-ups-and-downs-of-bitinstant/>.

247. See Max Raskin, *Meet the Bitcoin Millionaires*, BLOOMBERG BUS. (Apr. 10, 2013), <http://www.bloomberg.com/bw/articles/2013-04-10/meet-the-bitcoin-millionaires>; Popper, *supra* note 247.

248. Popper, *supra* note 247.

249. Kim Zetter, *Bitcoin Exchange CEO Charged with Laundering \$1Million through the Silk Road*, WIRED (Jan. 27, 2014), <http://www.wired.com/2014/01/bitcoin-exchangers-arrested/>.

to fulfill orders for users of Silk Road.<sup>250</sup> After being arrested and charged with conspiracy to commit money laundering and unlicensed money transmission,<sup>251</sup> Mr. Shrem pleaded guilty to operating an unlicensed money transmitting business, money laundering, and willful failure to file SARs with FinCEN<sup>252</sup> and received a two-year prison sentence.<sup>253</sup>

Another recent example of criminal charges being brought against a member of the fintech community is the prosecution of Mark Karpeles, the former head of Mt. Gox, the now-defunct bitcoin exchange.<sup>254</sup> On August 1, 2015, Mr. Karpeles was arrested in Japan in connection with the 2014 disappearance of approximately \$500 million bitcoin following Mt. Gox's bankruptcy filing in February 2014.<sup>255</sup> At that time, Mt. Gox reported that 850,000 bitcoins were stolen due to a software security flaw, but Mr. Karpeles was ultimately charged with embezzling the bitcoins.<sup>256</sup> It was later discovered that Mt. Gox had amateur and inadequate security systems and infrastructure, designed by Karpeles.<sup>257</sup>

Those involved in fintech start-ups, not surprisingly, often express a great amount of optimism when speaking of their companies. Joshua Reich, who co-founded the mobile-banking app Simple, wrote:

---

250. Alex Hern, *Bitcoin Entrepreneur Sentenced to Two Years in Prison*, GUARDIAN (Dec. 22, 2014), <http://www.theguardian.com/technology/2014/dec/22/bitcoin-entrepreneur-sentenced-jail>; Grinberg, Presentation, *supra* note 252, at 9.

251. Kim Zetter, *Bitcoin Exchange CEO Charged with Laundering \$1 Million through the Silk Road*, WIRED (Jan. 27, 2014), <http://www.wired.com/2014/01/bitcoin-exchangers-arrested/>.

252. Reuben Grinberg, Davis Polk Presentation, *Bitcoin: Overview of U.S. Legal Treatment* (Feb. 24, 2015), at 9, <http://bitcoin-reg.com/docs/All%20Payments%20Expo%20%20Presentation%20%2024%202015.pdf>.

253. *Id.*

254. Jessica Elgot, *Ex-Boss of MtGox Bitcoin Exchange Arrested in Japan Over Lost \$390m*, GUARDIAN (Aug. 1, 2015), <http://www.theguardian.com/technology/2015/aug/01/ex-boss-of-mtgox-bitcoin-exchange-arrested-in-japan-over-lost-480m>.

255. *Id.* See also Tom Hals, *Failed bitcoin exchange Mt. Gox gets U.S. Bankruptcy Protection*, REUTERS (Jun. 17, 2014), <http://www.reuters.com/article/2014/06/17/us-bitcoin-mtgox-bankruptcy-idUSKBN0ES2WZ20140617#R6ATUFibO3bgQe3B.97>.

256. *Id.*; French MtGox CEO in Japan Charged with Embezzlement Amid Bitcoin Fraud Investigation, SOUTH CHINA MORNING POST (Sept. 11, 2015), <http://www.scmp.com/news/asia/east-asia/article/1857199/french-mtgox-ceo-japan-charged-embezzlement-amid-bitcoin-fraud>.

257. See Rick Falkvinge, *Security At Mt. Gox Much Worse Than Originally Imaged* (Nov. 24, 2015), <http://falkvinge.net/2014/03/11/just-how-abysmal-was-gox-security-anyway/> (discussing Mt. Gox's poor security infrastructure).

“By not sucking . . . we will win.”<sup>258</sup> However, part of “not sucking” is building a compliance infrastructure at the outset of a new business venture rather than treating regulatory compliance as an afterthought. By understanding and complying with the applicable regulations at the beginning, these fintech start-ups will have a competitive advantage over competitors that do not take such initiatives. Because some of the fintech companies or applications are so novel or complicated, those who choose not to develop a compliance infrastructure at the beginning of their business ventures may find themselves bogged down by regulatory headaches. Investigations or injunctions may effectively halt the business, while regulators struggle to determine how it fits within the regulatory compliance framework. Competitors, particularly the traditional banking organizations, may use the regulatory uncertainty as a weapon as they seek to protect their core businesses. Further, by abiding by existing regulatory schemes or communicating with regulators regarding why those schemes are not applicable, a fintech start-up is creating a dialogue with potential regulators that will benefit the start-up in the long run.<sup>259</sup> Having an open dialogue with a regulator will help establish trust and avoid incurring unnecessary legal fees, as well as potentially providing opportunities for the fintech start-up to influence future policy and regulations.<sup>260</sup>

#### IV. CONCLUSION

Looking back over other periods when potentially disruptive technologies entered the banking space, a relatively common refrain from the regulatory bodies was that they wished to avoid premature regulation, as it might inadvertently stifle development. Perhaps that was simply a reflection of a more relaxed era. Perhaps it was because the technologies, although interesting, seemed uncertain to gain customer acceptance, and much of what went on was quite small and relatively insignificant. Perhaps it was because banks were major participants in the experiments and

---

258. Huang, Banks and Fintech Firms' Relationship Status, *supra* note 4.

259. See Norm Champ, Building Effective Relationships with Regulators, Harvard Law School Forum on Corporate Governance and Financial Regulation, Oct. 22, 2015, <http://corpgov.law.harvard.edu/2015/10/22/building-effective-relationships-with-regulators/> (discussing advantages of having contact with regulators).

260. *Id.*

the regulators felt comfortable with the window they had on the developments in the sector.

That era seems to be a relic of the past. Whatever the reasons, technology firms treading in the banking arena must tread with their eyes open. To the entrepreneur, the financial rewards offered by digital currencies, marketplace or peer-to-peer lending, or other new technologies may seem ripe for the taking, but an unclear legal framework does not equate to a lack of regulatory scrutiny. The success of many fintech firms is tied to the firm's ability not only to be ahead of the technological curve, but also to have the flexibility to adapt to an evolving set of laws and compliance obligations. Several years ago, during due diligence on behalf of a major financial institution of a payments company as a potential acquisition target, the target proudly announced that one of its competitive advantages was the lack of any state licenses for its activities; this allowed it to be nimble and quickly adapt its business to changes in the marketplace. Those days are long over. With digital currencies, the unfavorable association with money laundering and illicit activities perhaps made it quite hard to avoid regulatory involvement. With the online lenders, their success seems to indicate that they will not simply be bit players in the financial world. And with a heightened sensitivity to consumer protection, it would be unrealistic these days to expect much regulatory forbearance.