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BANKING AND FINANCIAL SERVICES UPDATE

FinCEN Publishes Two Administrative Rulings Clarifying Treatment of Companies Engaged in Certain Virtual Currency Activities

Background

On October 27, 2014, the Financial Crimes Enforcement Network ("FinCEN") issued two administrative rulings, FIN-2014-R011 ("Ruling 1") and FIN-2014-R012 ("Ruling 2"). The inquiring company in Ruling 1 ("Company 1") and the inquiring company in Ruling 2 ("Company 2") each requested FinCEN's determination that, if the company were to engage in certain proposed virtual currency activities, FinCEN would not find the company to be a money services business – specifically, a money transmitter – under the Bank Secrecy Act ("BSA").[1] In the alternative, Company 1 and Company 2 each requested that, if the company were determined to be a money transmitter, FinCEN find that the proposed virtual currency activities qualify for exemptions under regulations implemented by FinCEN pursuant to the BSA ("BSA Regulations") that cover (i) money transmission activities that are "integral" to a person's business and (ii) certain payment processing activities. As discussed below, FinCEN found that both Company 1 and Company 2 would be money transmitters if they engaged in their respective proposed activities and would not be eligible for the exemptions.

In both rulings, FinCEN referenced guidance it had issued on March 18, 2013 ("Guidance"),[2] which discussed generally participants in virtual currency activities. Under the Guidance, a person is deemed to be a money transmitter if it is a virtual currency "exchanger," which includes any "person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency." In contrast, the Guidance provides that a person is not deemed to be a money transmitter if it is a virtual currency "user," which is defined as a "person that obtains virtual currency to purchase goods or services."[3] FinCEN found that both Company 1 and Company 2 were virtual currency exchangers and therefore also money transmitters.

Companies engaged in activities involving virtual currencies should assess the impact of these rulings in combination with the previously issued Guidance since any company deemed to be a virtual currency exchanger

[1] The BSA regulations define "money transmitter" to mean any "person that provides money transmission services" or "[a]ny other person engaged in the transfer of funds." 31 CFR § 1010.100(ff)(5)(i). "Money transmission services," in turn, is defined to mean "the acceptance of currency, funds, or other value that substitutes for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means." Id. The BSA regulations also provide that whether a person is a money transmitter is a matter of facts and circumstances, and the BSA regulations identify circumstances under which a person's activities are exempt from the definition of a money transmitter. See 31 CFR § 1010.100(ff)(5)(ii).

[2] FIN-2013-G001.

[3] FinCEN clarified in FIN-2014-R001 that a "user" is a person that obtains virtual currency to purchase goods or services on the user's own behalf.

or otherwise required to register as a money transmitter is required, among other things, to establish an anti-money laundering program and comply with recordkeeping, reporting and transaction monitoring obligations.

The administrative rulings can be found online at:

FIN-2014-R011: http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R011.pdf

FIN-2014-R012: http://www.fincen.gov/news_room/rp/rulings/pdf/FIN-2014-R012.pdf

A summary of the earlier Guidance can be found here: http://www.sidley.com/FinCEN-Issues-Guidance-on-Application-of-Bank-Secrecy-Act-Regulations-to-Virtual-Currencies-03-26-2013/.

The Administrative Rulings

FIN-2014-R011: Company 1 sought to establish (i) a trading system to match offers from Company 1's customers to buy and sell virtual currency for currency of legal tender and (ii) a set of book accounts in which prospective buyers or sellers of one type of currency or the other could deposit funds to cover their exchanges. If a match were found between "buying" and "selling" customers, Company 1 would purchase from the selling customer and sell to the buying customer, without identifying one customer to the other. Company 1 argued that it was not a money transmitter because transmission would occur only if it found a match between "selling" and "buying" customers and did not enable the parties to select each other. In addition to other points addressed by FinCEN (discussed below), FinCEN concluded that:

- An entity is a money transmitter even if it only effects transmissions contingent upon the occurrence of predetermined conditions, such as the condition that it find a match between a buyer and a seller.[4]
- The fact that the buying and selling customers are never identified to one another does not affect the determination as to whether an entity is a money transmitter.[5]

FIN-2014-R012: Company 2 sought to provide virtual currency-based payments to U.S. and non-U.S. merchants that desired to receive payments for goods or services in a currency other than the legal tender of their respective jurisdictions. Company 2 would receive payment from a buyer (or debtor) in legal tender and transfer the equivalent Bitcoin to the seller merchant (or creditor). A customer would use a credit card to pay Company 2, and Company 2 would pay the merchant from Company 2's Bitcoin reserve that Company 2 previously had acquired. Company 2 argued that it was not a money transmitter because it makes payment from its inventory of Bitcoin, rather than funding each individual transaction. In addition to other points addressed by FinCEN (discussed below), FinCEN concluded that:

- The fact that Company 2 uses its cache of Bitcoin to pay the merchant is not relevant to whether it fits within the definition of money transmitter.

[4] FinCEN stated that the "fact that such a transmission sometimes may not occur in your business model if no match is found does not remove the Company from the scope of the regulations for those transactions that do occur."

[5] FinCEN concluded that Company 1 would engage in two money transmission transactions: one between Company 1 and the buyer of the virtual currency, and another between Company 1 and the seller.

Analysis

Virtual Currency Exchanger. FinCEN determined that both Company 1 and Company 2 were virtual currency exchangers, and therefore required to register as money transmitters. Company 1 argued that it would be a "user" rather than an "exchanger" because "a true virtual currency exchange would have its own reserve of virtual currency and dollars that it would buy and sell in order to fund exchanges with its users." In contrast, Company 2 had taken the opposite position by arguing that it would not be an exchanger because it would maintain a Bitcoin reserve from which it would pay its merchants rather than acquiring Bitcoin for each transaction.

FinCEN disagreed with both Company 1 and Company 2 and stated in both rulings that an "exchanger will be subject to the same obligations under FinCEN regulations regardless of whether the exchanger acts as a broker (attempting to match two (mostly) simultaneous and offsetting transactions involving the acceptance of one type of currency and the transmission of another) or as a dealer (transacting from its own reserve in either convertible virtual currency or real currency)."

"Integral" Exemption. The BSA Regulations provide an exemption to the definition of "money transmitter" for money transmission that is "integral" to the person's sale of goods or provision of services. [6] FinCEN repeated in both rulings that an entity must satisfy three conditions to qualify for this exemption:

- The money transmission component must be part of the provision of goods or services distinct from money transmission itself.
- The exemption can only be claimed by the person that is engaged in the provision of goods or services distinct from money transmission.
- The money transmission component must be integral (that is, necessary) for the provision of the goods and services.

Both Company 1 and Company 2 were ineligible for this exemption since FinCEN noted in each case that "[s]uch money transmission is the sole purpose of the Company's System, and is not a necessary part of another, non-money transmission service being provided by the Company." The important point for persons engaged in virtual currency activities to consider is that the provision or exchange of virtual currency is not a bona fide good or service for purposes of this exemption.

"Payment Processor" Exemption. The BSA Regulations also provide an exemption for entities that act as a "payment processor."[7] FinCEN referenced previous guidance[8] in which it stated that an entity must satisfy four conditions to qualify for this exemption:

- The entity providing the service must facilitate the purchase of goods or services, or the payment of bills for goods or services (other than money transmission itself).

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[6] 31 CFR § 1010.100(ff)(5)(ii)(F) provides an exemption to the definition of "money transmitter" for any entity that "[a]ccepts and transmits funds only integral to the sale of goods or the provision of services, other than money transmission services, by the person who is accepting and transmitting the funds."

[7] 31 CFR § 1010.100(ff)(5)(ii)(B) provides an exemption to the definition of "money transmitter" for any entity that "[a]cts as a payment processor to facilitate the purchase of, or payment of a bill for, a good or service through a clearance and settlement system by agreement with the creditor or seller[.]"

[8] See FIN-2013-R002 ("Whether a Company that Offers a Payment Mechanism Based on Payable-Through Drafts to its Commercial Customers is a Money Transmitter")

- The entity must operate through clearance and settlement systems that admit only financial institutions regulated under the BSA.
- The entity must provide the service pursuant to a formal agreement.
- The entity's agreement must be at a minimum with the seller or creditor that provided the goods or services and receives the funds.

FinCEN concluded that both Company 1 and Company 2 were ineligible for this exemption. In Ruling 1, FinCEN explained that Company 1 failed to satisfy two conditions: First, Company 1's customers were not receiving payment "as a seller or creditor from a buyer or debtor for the provision of non-money transmission related goods or services . . . ." In fact, FinCEN explicitly noted that it "does not consider providing virtual currency for real currency or vice versa as a non-money transmission related service . . . ." Second, Company 1 was not operating through a clearing and settlement system that only admits BSA-regulated financial institutions as members.

In Ruling 2, FinCEN similarly determined that Company 2 failed to operate through clearing and settlement systems that only admit BSA-regulated financial institutions since the payment of Bitcoin to the merchants would take place outside such a system, either to a merchant-owned virtual currency wallet or to a larger exchange that admits both financial and non-financial institution members. (In contrast, the real currency payments from customers to Company 2 would take place on a credit card network and therefore would satisfy this requirement.)

As noted in the discussion regarding the "integral" exemption above, it is important for companies engaged in virtual currency activities to recognize that FinCEN does not recognize the exchange of virtual currency as a non-money transmission related service.

If you have any questions regarding this update, please contact the Sidley lawyer with whom you usually work or

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