Client Alert.

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Bitcoin Receives Cease and Desist Order Evidencing Increased Regulatory Scrutiny of Virtual Currency

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On May 30, 2013, the California Department of Financial Institutions ("CADFI") issued a cease and desist letter to Bitcoin Foundation, a not-for-profit organization established to standardize, protect, and promote the use and adoption of Bitcoin. CADFI stated in its letter that Bitcoin Foundation "may be engaged in the business of money transmission without having obtained the license or proper authorization required by" California's Money Transmission Act. CADFI's issuance of the letter, the Financial Crimes Enforcement Network's ("FinCEN") recent guidance regarding virtual currencies, and the subsequent asset seizures of prominent Bitcoin exchanges all reflect increased scrutiny of the use of virtual currencies.

CALIFORNIA DEPARTMENT OF FINANCIAL INSTITUTIONS' CEASE AND DESIST ORDER

CADFI's letter notes that Bitcoin Foundation may be in violation of California's money transmitter licensing law (Cal. Fin. Code § 2030), as well as federal statutes that impose penalties for the failure to have a required state money transmission license and the failure to register as a money transmission business. (18 U.S.C. § 1960, 31 U.S.C. § 5330.)

Section 2030 of the California Financial Code prohibits persons from engaging in "the business of money transmission in California without first obtaining a license from the Commissioner of Financial Institutions." A person in violation of this statute may be subject to civil money penalties under § 2151, and possibly criminal prosecution under § 2152. The California Attorney General may also sue under §§ 17200, 17205, and 17206 of the California Business and Professions Code.

In addition, CADFI noted that under 18 U.S.C. § 1960, it is a felony to own, control, or conduct the business of money transmission without the appropriate state license, or without registering with FinCEN. Violations of this section are punishable by "up to 5 years in prison and a $250,000 fine." CADFI stated that this same activity without a license is also a "felony under California law, pursuant to [California] Financial Code § 2152(b)."

CADFI requested that Bitcoin Foundation "advise [it] in writing within [20] days" of the date of the letter regarding the "steps [] taken to comply with [CADFI's] order." In addition, CADFI noted that "[n]othing in [its] letter is intended to affect any legal remedies, criminal or civil, which the State of California or the Commissioner might pursue for past or future violation of [the] laws [cited]."

WHAT IS BITCOIN?

Introduced in 2009, Bitcoin is a virtual currency that is controlled by a software algorithm ("Bitcoin Algorithm") running on the Internet. Both the creation and transfer of Bitcoins is performed by this algorithm. Bitcoins are created by a procedure called "mining," where users provide their computer resources to help the Bitcoin Algorithm process Bitcoin transactions. In exchange, users are compensated with Bitcoins. The Bitcoin Algorithm restricts the total number of Bitcoins to be "mined" to 21 million Bitcoins. Currently, there are approximately 11 million mined Bitcoins that are in circulation.

Like other forms of currency, Bitcoins can be exchanged for goods and services. However, the value of a Bitcoin (how many goods or services can be exchanged for a Bitcoin) is volatile. This volatility is attributable to the fact that, unlike currencies like the U.S. dollar or the Euro, which are issued by their respective governing bodies, Bitcoins are not supported by any sovereign entity. As a result, the value of a Bitcoin is driven and determined by public perception.

Since Bitcoin's inception, the virtual currency has been gaining popularity and acceptance. Currently, several Bitcoin exchanges and payment Web sites allow users to exchange (buy and sell) Bitcoins with popular currencies, such as the U.S. dollar. In addition, some merchants, both online and in person, are beginning to accept Bitcoins as an alternative to traditional currencies for payment. The value of a Bitcoin has fluctuated from about $0.0025 since its inception to a high of about $266 on April 10, 2013. The current value is approximately $78 per Bitcoin.

Why Do Individuals Use Bitcoin?

A major reason why individuals may prefer to use Bitcoin transfers instead of traditional electronic transfers is for anonymity and privacy. Bitcoins are transferred from peer to peer without the need for an intermediary financial institution to process payments. The Bitcoin-transmitting party merely needs to know the receiving party's Bitcoin address to execute a transfer. In contrast, when a traditional payment card is used to make a transaction, there typically are records identifying the transferor, transferee, and the amount transferred. Because Bitcoin transfers do not rely on established payment systems to process transactions, Bitcoin transfers allow the transferor and transferee to remain anonymous.

Concerns Driving Regulatory Interest

In issuing the cease and desist letter to Bitcoin Foundation, CADFI was likely concerned about the same aspects of Bitcoin that attracts its users—anonymity and privacy. Specifically, the concern regarding the anonymous aspects of Bitcoin is its potential for facilitating criminal activity, money laundering, and illegal transactions. On the other hand, by classifying Bitcoin Foundation as a money transmitter and, by extension, classifying the transfer of Bitcoins as transmission of money, CADFI can subject Bitcoin Foundation to the same requirements as traditional money transmitters. The resulting mandatory record keeping could significantly diminish the anonymous aspects of Bitcoin, and in turn diminish the attractiveness of using Bitcoin for the transfer of funds related to criminal activity.

CADFI'S ACTION COMES ON HEELS OF RECENT FINCEN GUIDANCE

On March 18, 2013, FinCEN issued interpretive guidance, entitled "Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies." The guidance is intended by FinCEN to clarify the applicability of the Bank Secrecy Act ("BSA") and its implementing regulations to persons creating, obtaining, distributing, exchanging, accepting, or transmitting virtual currencies. The guidance addresses "convertible" virtual currency, which is described as a type of virtual currency that either has an equivalent value in real currency, or acts as a substitute for real currency.

The guidance defines "users," "administrators," and "exchangers" of convertible virtual currency and explains which of these participants in a virtual currency environment is a Money Services Business ("MSB") for purposes of the BSA and FinCEN's implementing regulations. Under the guidance, an administrator or exchanger that accepts and transmits a convertible virtual currency, or that buys or sells convertible virtual currency for any reason, is a money transmitter under FinCEN's regulations (unless a limitation or exemption from the money transmitter definition applies). The guidance also explains that accepting and transmitting anything of value that substitutes for currency makes a person a money transmitter under the BSA's implementing regulations.

SEIZURES OF ASSETS OF BITCOIN EXCHANGES

Since FinCEN's virtual currency guidance was issued, U.S. regulators have seized assets of several virtual currency exchanges. Notably, on May 14, 2013, one of the world's largest Bitcoin exchanges, Mt. Gox, had its U.S.-based assets seized by U.S. authorities.

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