

CLIENT ALERT

FinCEN Issues Guidance on Convertible Virtual Currencies

May 10, 2019

On May 9, 2019, the U.S. Financial Crimes Enforcement Network (“FinCEN”) issued [guidance](#) (the “Guidance”) on the applicability of FinCEN’s regulations to convertible virtual currencies in certain business models, which summarizes and clarifies existing FinCEN interpretive guidance. The Guidance contains useful information, the new or significant aspects of which are summarized below.

FinCEN reiterated the view of most regulatory agencies that labels applied to convertible virtual currencies, whether it be digital currencies, cryptocurrencies, cryptoassets, or digital assets, does not dictate the required regulatory treatment of those virtual currencies.

Interpreting “Value that Substitutes for Currency”

Under the Bank Secrecy Act (“BSA”), the term “money transmission services” 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.” Virtual currencies often get swept up in the definition because they are “value that substitutes for currency.”

The intent behind the creation of a coin or token does not matter if it is repurposed to substitute for a currency: “FinCEN’s regulation does not limit or qualify the scope of the term ‘value that substitutes for currency.’ It can be created . . . originally for another purpose but then repurposed to be used as a currency substitute by . . . an unincorporated organization, such as a software agency (in decentralized payment systems).” It does not make a difference whether the issuer of the virtual currency or another party repurposes it to become a currency substitute.

The Guidance touched on the applicability of the BSA to collateralized coins or tokens, without naming them specifically: “Money transmission could involve . . . the issuance and subsequent acceptance and transmission of a digital token that evidenced ownership of a certain amount of a commodity, security, or futures contract.” The same issue exists if the commodity, security or futures contract itself is a native digital coin or token that substitutes as currency.

Money Transmission Involving Convertible Virtual Currencies by Foreign Companies

Compliance obligations under the BSA apply equally to domestic and foreign-located money transmitters “doing business in whole or in substantial part within the United States, even if the foreign-located entity has no physical presence in the United States.” This means that any company involved in convertible virtual currencies with active people in the US need to consider compliance requirements under the BSA.

Centralized Exchanges Transferring Convertible Virtual Currencies to “Another Location”

The definition of a “money transmitter” includes “a person that accepts and transmits value that substitutes for currency from one person to another person or to another location.” FinCEN gave as an example of transmission to another location an exchanger who sells convertible virtual currencies, accepts real currency or its equivalent from a person and transmits the convertible virtual currencies to the person’s convertible virtual currency account with the exchanger. The first location is the person’s bank account, and the second location is the person’s account with the exchanger.

Hosted and Unhosted Wallets Involving Transmission of Convertible Virtual Currencies

The Guidance recognizes the difference between hosted wallets, where third parties control the funds in the users’ wallets, and unhosted wallets, where the users control funds in their own wallets. For intermediaries dealing in wallets, FinCEN will consider four criteria to determine the applicability of the BSA to the intermediaries: (a) who owns the value; (b) where the value is stored; (c) whether the owner interacts directly with the payment system where the CVC runs; and (d) whether the person acting as intermediary has total independent control over the value. Considering those criteria, the Guidance concludes that:

- hosted wallet providers are money transmitters;
- unhosted single-signature wallet providers are not money transmitters;
- unhosted single-signature wallet users are not money transmitters as long as they are using the wallet to transact on their own behalf; and
- unhosted multi-signature wallet providers are not money transmitters as long as they do not control sufficient keys to sign and effect transactions without the users and the users interact directly with the blockchain network rather than the wallet provider.

Decentralized Applications Allowing for Convertible Virtual Currencies Money Transmission

The development of a decentralized application (“DApp”) in and of itself does not make the DApp developer a money transmitter. However, where the DApp is used for money transmission, the Guidance is unclear. The definition of money transmitter will apply to “the DApp, the owners/operators of the DApp, or both” when the DApp performs money transmission services. Given the number of ways DApps can be used in money transmission, the application of the broad statement in the Guidance to particular circumstances is unclear.

Transactions Involving Anonymizing Services

In the context of using software or services that anonymize transactions in convertible virtual currencies, such as mixers and tumblers, the Guidance distinguishes between software providers and services providers. In short, an anonymizing services provider is a money transmitter with BSA obligations, and an anonymizing software provider is not a money transmitter.

Transactions Involving Anonymous Convertible Virtual Currencies

A money transmitter’s obligations are no different when dealing in anonymous convertible virtual currencies, also known as privacy coins, as when dealing in other convertible virtual currencies. In spirit, the Guidance indicates that money transmitters dealing in privacy coins do so voluntarily and, therefore, voluntarily undertake to remove the anonymity in anonymous convertible virtual currency transactions to collect information necessary to comply with BSA obligations.

Exemption Convertible Virtual Currency Transactions

Decentralized exchanges and peer-to-peer trading platforms that do not facilitate trades as an intermediary are exempt from money transmitter status because they only provide “delivery, communication, or network access services used by a money transmitter to support money transmission services.” If the decentralized exchange or peer-to-peer trading platform does not settle transactions, which traders settle through any wallet that is not hosted by that exchange or platform, even if the exchange or platform provides automatic matching of counterparties, then the exchange or trading platform is not a money transmitter.

The Guidance provides significant analysis into BSA obligations in connection with initial coin offerings (“ICOs”). With respect to sales of coins or tokens in exchange for any value paid instantaneously or at a later date, FinCEN concludes that the seller is a money transmitter because it is the only person authorized to issue and redeem (i.e., permanently retire from circulation) the convertible virtual currency. However, the Guidance ignores certain other possibilities, such as pre-mined convertible virtual currencies that are held in a smart contract and distributed automatically upon receipt of payment. In those ICOs, the seller is neither authorized nor able to redeem the convertible virtual currency. Moreover, the Guidance discusses an exception to the seller being a money transmitter where the sale of the convertible virtual currency is integral to the sale of goods or services different from money transmission, which generally occurs if the sale is for fundraising purposes, unless the coin or token is issued to serve as value that substitutes for currency.

With respect to sales of digital debt or equity instruments, such as security tokens (but also applicable to simple agreements for future tokens), the exchange of the debt or equity instrument for convertible virtual currencies may be money transmitters but will not be money transmitters if they are a domestic or foreign bank or regulated by the Securities and Exchange Commission or the Commodities Futures Trading Commission, which will be the case when selling a debt or equity instrument (or futures).

The development of a DApp, even if financed with the funds from an ICO and to issue convertible virtual currencies or facilitate activities denominated in convertible virtual currencies, does not constitute money transmission. However, a person who uses the DApp, including the developer or investors, to engage in money transmission will qualify as a money transmitter

If the creator of a convertible virtual currency pre-mines that currency and uses it for itself, whether to pay for goods or services or repay obligations, then it will not be subject to FinCEN regulations. But, if the creator pre-mines the convertible virtual currency and uses it to engage in money transmission, then it is subject to FinCEN regulations.

Mining Pools and Cloud Miners

When the leader of a mining pool or the cloud miner transfers convertible virtual currencies to the pool members or contract purchasers to distribute the amount of mining rewards earned, the distribution does not qualify as money transmission under the BSA. However, if the leader of the mining pool or the cloud miner combines its managing and renting services with the service of hosting convertible virtual currency wallets on behalf of the pool members or contract purchasers, then the leader or the cloud miner will fall under FinCEN’s definition of money transmitter.

Conclusion

Although the Guidance is presented as only a consolidation of current FinCEN regulations, administrative rulings and interpretive guidance, it does clarify several important aspects of dealing in convertible virtual currencies that previously were unclear. In general, parties in decentralized transactions, whether over exchanges, peer-to-peer, or involving anonymized software or virtual currencies, will not be money transmitters required to comply with BSA obligations.

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