

4. This affirmation is based upon my personal knowledge of the matter at issue, based upon a review of related Department records, and my conversations with Department personnel.

Supervision and Regulation of Financial Services by the Department

5. In 2011, drawing on lessons learned from the 2008 financial crisis, the New York State Legislature (the “Legislature”) created the Department to implement a comprehensive approach to the regulation of financial products and services in New York.¹ The Superintendent of Financial Services (the “Superintendent”) is the head of the Department. FSL § 202(a).

6. By merging the New York State Banking and Insurance Departments, the Legislature created a single agency that could draw on the extensive experience of the staffs of the Department’s predecessor agencies in regulating and supervising financial products and services and their providers under the New York Banking Law (cited as the “BL”) and Insurance Law. Specifically, the Department regulates and supervises a variety of financial services institutions, including all New York state-chartered banking organizations, such as banks, trust companies, savings banks, and credit unions, as well as branches, agencies, and representative offices of foreign banks. In addition, the Department regulates and supervises such entities as mortgage bankers, brokers, loan originators and servicers, money transmitters, licensed lenders, check cashers, budget

¹ Explaining his vote in favor of legislation creating the Department, Senator James Seward noted: “I’m pleased that the Legislature includes some specific legislative intent recognizing the fact that it is necessary for our regulatory system to be responsive, effective, and innovative in order to compete in this global marketplace. And I see this legislation as being a first step, a big step toward our ultimate goal of transforming and modernizing the regulation of insurance, banking and other financial products in New York State.” NY Senate Transcript, Regular Session (Mar. 29, 2011), available at <http://open.nysenate.gov/transcripts/floor-transcript-032911v1.txt>.

planners, sales finance companies, and all insurance companies and insurance producers that do business in New York.

7. As a complement to the Banking Law and the Insurance Law, the Legislature enacted the Financial Services Law (cited as the “FSL”), which tasked the Department with the regulation and supervision of certain financial products and services and the providers of such products and services. The Legislature declared that the purpose of the Financial Services Law is to “provide for the enforcement of the insurance, banking and financial services laws, under the auspices of a single state agency” that would, among other things, “provide for the regulation of *new* financial services products” and “ensure the continued safety and soundness of New York’s banking, insurance and financial services industries, as well as the prudent conduct of the providers of financial products and services, through responsible regulation and supervision,” “protect the public interest,” and “protect users of banking, insurance, and financial services products and services.” FSL §§ 102(f), (i), (j), and (l) (emphasis added).

8. Similarly, the Financial Services Law’s “Declaration of policy” section states that it “is the intent of the legislature that the superintendent shall supervise the business of, and the persons providing, financial products and services....” FSL § 201(a).

9. To perform this mandate, the Financial Services Law requires that the Department “take such actions as the superintendent believes necessary” to “ensure the continued solvency, safety, soundness and prudent conduct of the providers of financial products and services” and to “protect users of financial products and services....” FSL §§ 201(b)(2) and (7).

10. The Financial Services Law defines a “financial product or service” as “any financial product or financial service offered or provided by any person regulated or required to be regulated by the superintendent pursuant to the banking law or the insurance law or any financial product or service offered or sold to consumers,” subject to certain exceptions.² FSL § 104(a)(2).

11. The Financial Services Law authorizes the superintendent to promulgate “rules and regulations and issue orders and guidance involving financial products and services, not inconsistent with the provisions of” the Financial Services Law, the Banking Law, the Insurance Law, and “any other law in which the superintendent is given authority.” FSL § 302(a).

12. Such regulations may effectuate “any power given to the superintendent” under the Financial Services Law and other enumerated laws; interpret the Financial Services Law and other enumerated laws; and govern “the procedures to be followed in the practice of the department.” FSL §§ 302(a)(1) - (3).

13. As discussed below, the Financial Services Law provided the statutory authority for the regulations challenged by Petitioner, namely Part 200 of Chapter 1 of Title 23 of the New York Codes, Rules and Regulations (“NYCRR”). These regulations set requirements for entities engaging in virtual currency business activity involving New York or a New York resident (the “Virtual Currency Regulation”). *See generally* 23 NYCRR Part 200.

² For example, a “financial product or service” does not include any financial products or services “regulated under the exclusive jurisdiction of a federal agency or authority”; or “regulated for the purpose of consumer or investor protection by any other state agency, state department or state public authority”; or “where rules or regulations promulgated by the superintendent on such financial product or service would be preempted by federal law.” FSL §§ 104(a)(2)(A)(i)–(iii).

Virtual Currency and the Department's Regulatory Response

14. Perhaps the most well-known virtual currency, Bitcoin, has been described as a “peer-to-peer version of electronic cash” that allows “online payments to be sent directly from one party to another without going through” a “trusted third party.”³

15. More generally, virtual currency is widely acknowledged as a medium of exchange. For example, in 2013, the Financial Crimes Enforcement Network, a bureau of the U.S. Department of the Treasury, defined 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. In particular, virtual currency does not have legal tender status in any jurisdiction.”⁴ Similarly, in 2014, the European Banking Authority defined virtual currency as “a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a ... [fiat currency], but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically.”⁵

16. Notwithstanding virtual currency's early use as a means of making peer-to-peer payments, a variety of third-party service providers have become an integral part of virtual currency activity.

³ Satoshi Nakamoto, “Bitcoin: A Peer-to-Peer Electronic Cash System” (2008), at 1, available at <https://bitcoin.org/bitcoin.pdf>. Virtual currency first gained major public attention following publication of this paper by the pseudonymous Nakamoto in late 2008.

⁴ Financial Crimes Enforcement Network, “Application of FinCEN’s Regulations to Persons Administering, Exchanging, or Using Virtual Currencies” (March 18, 2013), available at https://www.fincen.gov/statutes_regs/guidance/html/FIN-2013-G001.html.

⁵ European Banking Authority, “EBA Opinion on ‘virtual currencies’” (July 4, 2014 – EBA/Op/2014/08), at 5, available at <http://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf>.

17. Some third-party service providers facilitate the exchange, between customers, of government-issued fiat currency (such as U.S. dollars or euros) for virtual currency (such as bitcoins), and of virtual currency for government-issued fiat currency.

18. Some third-party service providers provide “wallet” services that hold a customer’s virtual currency until the customer wants to draw on the “wallet” to effectuate a payment transaction with the virtual currency.

19. Other third-party service providers use virtual currency to transmit funds domestically and internationally outside of the traditional banking system.

20. Such third-party services are directly analogous to established financial services that are regulated under the Banking Law and the Financial Services Law. For example, virtual currency service providers often accept consumer funds – whether in virtual currency, fiat currency, or both – to be sent to another party.

21. Similarly, money transmitters accept, for example, U.S. dollars to be sent to another party, and money transmission has been regulated in New York as a licensed financial service since the 1960s. *See* BL § 641 (“No person shall engage in the business ... of receiving money for transmission or transmitting the same, without a license....”).

22. A primary purpose of such regulation is to protect consumers against the loss of their funds as a result of fraud or mismanagement by the third-party service provider. Virtual currency service providers pose similar risks.

23. For example, Mt. Gox, once the largest Bitcoin exchange service, collapsed in early 2014 after a purported security breach led to the loss of more than \$450 million worth of bitcoins. According to news reports, nearly 90% of the lost bitcoins

belonged to Mt. Gox's customers.⁶ The CEO of Mt. Gox has since been arrested and charged with embezzlement.⁷

24. In addition to the risk of loss to customers, virtual currency business activity has in some cases involved "dark" online marketplaces, including the Silk Road site, where, between 2011 and 2013, illegal drugs and other illicit items and services worth hundreds of millions of dollars were regularly bought and sold using the virtual currency Bitcoin.⁸ For precisely such reasons, the Virtual Currency Regulation is necessary and appropriate to ensure the "prudent conduct of the providers of financial products and services" and "encourage high standards of honesty, transparency, fair business practices and public responsibility." FSL §§ 102(i) and 201(b)(5).

Promulgation of 23 NYCRR Part 200

25. On July 23, 2014, pursuant to the New York State Administrative Procedure Act ("SAPA"), the Department published in the New York State Register (the "Register") the proposed virtual currency regulations to be included at 23 NYCRR Part 200. As the Department stated in the Register, the "Purpose" of the proposed Part was to regulate "virtual currency business activity in order to protect New York consumers and

⁶ U.S. customers were among the customers of the Tokyo-based exchange who suffered losses. Carter Dougherty and Grace Huang, "Mt. Gox Seeks Bankruptcy After \$480 Million Bitcoin Loss," Bloomberg, February 28, 2014, available at <http://www.bloomberg.com/news/articles/2014-02-28/mt-gox-exchange-files-for-bankruptcy>.

⁷ Alex Hern, "Mt Gox CEO charged with embezzling £1.7m worth of bitcoin," The Guardian, September 14, 2015, available at <http://www.theguardian.com/technology/2015/sep/14/bitcoin-mt-gox-ceo-mark-karpeles-charged-embezzling>.

⁸ See, e.g., Andy Greenberg, "End Of The Silk Road: FBI Says It's Busted The Web's Biggest Anonymous Drug Black Market," Forbes, October 2, 2013, available at <http://www.forbes.com/sites/andygreenberg/2013/10/02/end-of-the-silk-road-fbi-busts-the-webs-biggest-anonymous-drug-black-market/>.

users and ensure the safety and soundness of New York licensed providers of virtual currency products and services.”⁹

26. That initial publication in the Register was followed by a 90-day public comment period and Department review of those comments. On February 25, 2015, a substantially revised proposed 23 NYCRR Part 200 was published in the Register.¹⁰

27. After an additional 30-day comment period and Department review of those comments, limited additional revisions were made. The final version of 23 NYCRR Part 200 was adopted on June 24, 2015.¹¹

28. To date, the Department has received approximately 26 license applications to engage in virtual currency business activity.¹² One license has been issued pursuant to the Regulation.¹³

29. In addition, approximately 21 applicants are operating in compliance with the virtual currency licensure requirements under the “Transitional Period” provided by 23 NYCRR 200.21.¹⁴

30. On or about August 10, 2015, Chino Ltd. (the “Company”) submitted to the Department an “Application for License to Engage in Virtual Currency Business

⁹ New York State Register, July 23, 2014 at 14, available at <http://docs.dos.ny.gov/info/register/2014/july23/pdf/rulemaking.pdf>.

¹⁰ New York State Register, February 25, 2015 at 17-18, available at <http://docs.dos.ny.gov/info/register/2015/feb25/pdf/rulemaking.pdf>.

¹¹ New York State Register, June 24, 2015 at 7-9, available at <http://docs.dos.ny.gov/info/register/2015/june24/pdf/rulemaking.pdf>.

¹² The applications have varied widely in the forms and completeness of the documentation provided.

¹³ In addition, two New York chartered trust companies have been authorized to engage in virtual currency business activity.

¹⁴ 23 NYCRR 200.21 provides, in part: “A Person already engaged in Virtual Currency Business Activity must apply for a license in accordance with this Part within 45 days of the effective date of this regulation. In doing so, such applicant shall be deemed in compliance with the licensure requirements of this Part until it has been notified by the superintendent that its application has been denied, in which case it shall immediately cease operating in this state and doing business with New York State Residents.”

Activity” under 23 NYCRR Part 200 (the “Application”). According to the Application, the Company is solely owned by Petitioner, its Chief Executive Officer.

31. In a letter to the Company dated January 4, 2016 (the “Letter”), the Department stated that “the submitted Application documentation is exceptionally limited” and “does not contain any description of the Company’s current or proposed business activity”; that, therefore, “the Department is unable to evaluate whether the Company’s current or intended business activity (if any) would be considered Virtual Currency Business Activity that requires licensing”; and that the Application “is herewith being returned to you without further processing by the Department.”

32. The Department has no record of any subsequent correspondence from the Company in regard to the Letter.

23 NYCRR Part 200 Applies Existing Regulatory Concepts to Virtual Currency

33. In adopting the Virtual Currency Regulation, the Department largely applied to virtual currency various regulatory concepts that already exist in the Banking Law or the regulations promulgated thereunder.

34. These concepts reflect common requirements imposed across a wide variety of financial services and include, for example: the maintenance of certain books and records; reporting requirements; disclosures to consumers; periodic examination by the Department; maintenance of a surety bond or similar security fund to protect consumers; prior Department approval of changes in control of the licensee; and anti-money laundering requirements.

35. For example, the requirement that entities engaging in Virtual Currency Business Activity maintain books and records sufficient to allow the Superintendent to

determine whether the licensee is complying with applicable laws, rules, and regulations (23 NYCRR 200.12) mirrors requirements that broadly apply to entities providing financial services in New York, including banks and trust companies (BL § 128), money transmitters (BL § 651-b), check cashers (BL § 372), and budget planners (BL § 586).

36. Further, a requirement to maintain a surety bond or similar security fund for the protection of customers applies not only to entities engaging in Virtual Currency Business Activity (23 NYCRR 200.9) but also to other financial service providers, including money transmitters (BL § 643), mortgage bankers and brokers (BL §§ 591 and 591-a), check cashers (3 NYCRR 400.12), and budget planners (BL § 580).

37. Also, the requirement in the Virtual Currency Regulation that a licensee maintain an anti-money laundering program (23 NYCRR 200.15) emulates requirements that apply to money transmitters and check cashers (3 NYCRR Parts 416 and 417), as well as to, for example, New York banks and trust companies and the New York branches of foreign banks (3 NYCRR Parts 115 and 116).

38. Moreover, regulatory requirements to submit certain reports, including reports of financial condition, and to be periodically examined, apply not only to virtual currency licensees (23 NYCRR 200.13 and 200.14) but also to, for example, money transmitters (3 NYCRR 406.7 and 406.10), check cashers (3 NYCRR 400.3, BL § 372-a), and banking organizations (BL §§ 36, 37, 125, 255, *et al.*).

39. Required disclosures to customers (which may include, for example, disclosures of risks and of the terms of transactions, as well as disclosures on receipts) are another type of regulatory requirement that applies not only to virtual currency licensees (23 NYCRR 200.19) but also, for example, to budget planners (BL § 584-a), money

transmitters (3 NYCRR 406.3 and 406.4), and banks and trust companies (3 NYCRR 6.3, 6.8, 9.5, 13.4, *et al.*).

40. In addition, Department approval for a change of control is required not only for virtual currency licensees (23 NYCRR 200.11) but also for money transmitters (BL § 652-a), budget planners (BL § 583-a), check cashers (BL § 370-a), and banks and trust companies (BL § 143-b), among others.

41. The Virtual Currency Regulation not only incorporates existing regulatory concepts that broadly apply to a wide range of financial services providers, but also comports with the legislative intent expressed in the Financial Services Law: to ensure “the prudent conduct of the providers of financial products and services, through responsible regulation and supervision.” FSL § 102(i).

42. In addition, the anti-money laundering requirements listed above are, for example, consistent with the Legislature’s authorization of the Superintendent to “eliminate financial fraud, other criminal abuse and unethical conduct in the [financial] industry.” FSL § 201(b)(6).

43. The examination requirement and the required maintenance of books and records, including records of customer transactions, are also consistent with the Legislature’s authorization of the Superintendent to “encourage high standards of honesty, transparency, fair business practices and public responsibility.” FSL § 201(b)(5).

44. The required disclosures to consumers that are mandated by the Virtual Currency Regulation are also consistent not only with standards of honesty and transparency but also with the Legislature’s authorization of the Superintendent to “educate and protect users of financial products and services and ensure that users are

provided with timely and understandable information to make responsible decisions about financial products and services.” FSL § 201(b)(7).

45. In sum, the Department has not attempted to make illegal, or ban the use of, virtual currencies. Rather, it has applied the same regulatory principles that are applied to many other providers of financial services within New York, and has done so consistent with its legislatively mandated mission, to ensure that virtual currency businesses that deal with New York residents are safely, soundly, and transparently operated and that their users are protected from fraud and other misconduct.

23 NYCRR Part 200 Exclusions and Exemptions

46. In promulgating the Virtual Currency Regulation, the Department was careful to ensure that it did not exceed the authority granted by the Financial Services Law. This caution is reflected, in part, in what is excluded from the requirements of the Virtual Currency Regulation.

47. The Virtual Currency Regulation defines “Virtual Currency” as “any type of digital unit that is used as a medium of exchange or a form of digitally stored value.” 23 NYCRR 200.2(p).

48. Consistent with the Department’s mandate to regulate only “*financial* products and services” (FSL § 201(a)) (emphasis added), the definition of “Virtual Currency” excludes “digital units” that, among other things, “are used solely within online gaming platforms” and “have no market or application outside of those gaming platforms.” 23 NYCRR 200.2(p)(1). Such digital units, which are wholly confined to the game’s environment, are not part of a *financial* product or service.

49. Also excluded from the definition of “Virtual Currency” are digital units used in a “customer affinity or rewards program,” such as, for example, a frequent flyer program. 23 NYCRR 200.2(p)(2). As with digital units used solely within online gaming platforms, digital units in such customer affinity or rewards programs “cannot be converted into, or redeemed for,” fiat currency or Virtual Currency. 23 NYCRR 200.2(p)(2). Thus, they are not part of a *financial* product or service. They are simply a form of benefit conferred on a customer as part of a merchant transaction.

50. The third and final exclusion from the definition of “Virtual Currency” is for digital units used in “Prepaid Cards,” which are narrowly defined as being issued and redeemable *solely* in fiat currency (e.g., a gift card issued in U.S. dollars). See 23 NYCRR 200.2(p)(3) and 23 NYCRR 200.2(j). “Prepaid Cards” therefore do not involve virtual currency.¹⁵

51. The Virtual Currency Regulation defines licensable “Virtual Currency Business Activity” as the conduct of any of the following activities involving New York or a New York Resident:¹⁶

- a. “receiving Virtual Currency for Transmission or Transmitting Virtual Currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of Virtual Currency”;
- b. “storing, holding, or maintaining custody or control of Virtual Currency on behalf of others”;

¹⁵ Moreover, in some cases such prepaid cards are already regulated by the Department pursuant to the money transmission licensing requirements of BL Article XIII-B.

¹⁶ 23 NYCRR 200.2(h) defines “New York Resident” as “any Person that resides, is located, has a place of business, or is conducting business in New York.”

- c. “buying and selling Virtual Currency as a customer business”;
- d. “performing Exchange Services as a customer business”; or
- e. “controlling, administering, or issuing a Virtual Currency.”

23 NYCRR 200.2(q).

52. To narrow the Virtual Currency Regulation to ensure that it is consistent with the Financial Services Law, 23 NYCRR 200.2(q)(1) excludes from Virtual Currency Business Activity a transaction that “is undertaken for *non-financial* purposes and does not involve the transfer of more than a nominal amount of Virtual Currency” (emphasis added). To further ensure that non-financial activity is *not* regulated, the Virtual Currency Regulation also provides that the “development and dissemination of software in and of itself does not constitute Virtual Currency Business Activity.” 23 NYCRR 200.2(q).

53. Other exclusions and exemptions contained in the Virtual Currency Regulation are consistent with the Legislature’s intent as expressed in the Financial Services Law and with existing regulatory approaches enacted in the Banking Law.

54. For example, the exclusion of persons chartered under the Banking Law from the requirements of the Virtual Currency Regulation – which Petitioner asserts is arbitrary and capricious – emulates the provisions of Banking Law § 641(1), which excludes banks, trust companies, and other entities from the obligation to be licensed as a money transmitter.¹⁷ Nonetheless, chartered entities must still be “approved by the

¹⁷ Chartered banks, trust companies, and other entities excluded from money transmission licensing requirements are already comprehensively regulated under other provisions of law. *See, e.g.*, BL Article III.

superintendent to engage in Virtual Currency Business Activity.” 23 NYCRR 200.3(c)(1).¹⁸

55. Similarly, “merchants and consumers that utilize Virtual Currency solely for the purchase or sale of goods or services or for investment purposes” are also exempt from the Virtual Currency Regulation. 23 NYCRR 200.3(c)(2). For example, a coffee shop that accepts Bitcoin for payment and one of the coffee shop’s customers, who pays with Bitcoin, would be exempt from the Virtual Currency Regulation. For the same reason that merchants or consumers that use cash are not required to be licensed under the Banking Law, merchants and consumers that are merely *users* of virtual currency are not persons engaging in activities requiring licensing under the Financial Services Law.

The Legislature Has Not Sought to Pass Any Virtual Currency Legislation

56. The Legislature has passed no legislation governing virtual currency activity nor taken any action that would suggest any inconsistency between the promulgation of the Virtual Currency Regulation and the Legislature’s intent as expressed in the Financial Services Law.

57. In fact, the Department’s ability to regulate financial products and services is subject to regular legislative review. Specifically, the Financial Services Law requires that the Department “submit a report annually to the governor and to the legislature” containing, among other things, “a general review of the insurance business, banking

¹⁸ Even the requirement that chartered entities obtain prior approval before engaging in “Virtual Currency Business Activity” reflects existing regulatory practice, which includes, among many other requirements, prior-review and approval requirements for new products and services. *See, e.g.*, the Department’s July 10, 2007, “All Institutions Letter Concerning Banking Department Procedures for Review and/or Approval of Certain New Products of Banking Organizations,” available at <http://www.dfs.ny.gov/legal/industry/il070110.htm>.

business, and financial product or service business,” as well as details regarding regulations promulgated under the Financial Services Law. FSL § 207(a)(1) and (14).

58. In its 2013 “Annual Report,” submitted in June 2014, the Department reported that it had “launched a fact-finding inquiry concerning virtual currency, considering whether further regulations, in addition to current money transmission regulations, are necessary.”¹⁹

59. The 2013 Annual Report further stated: “In August [2013], the Department requested information from over 20 virtual currency participants, ranging from service providers to investors. In November [2013], the Department announced notice of its intent to hold public hearings on virtual currencies and the potential issuance of a ‘BitLicense’ [*i.e.*, a virtual currency license]. The Department is continuing its fact finding and exploring potential regulatory frameworks.”²⁰

60. In its 2014 Annual Report, submitted in May 2015, the Department again reported to the Governor and Legislature in regard to virtual currency regulation. Specifically, the Department stated that, following “public hearings that the Department held in January 2014,” the Department proposed a “comprehensive regulatory framework for firms dealing in virtual currency, including Bitcoin. The regulatory framework contains key consumer protection, anti-money laundering compliance, and cyber security rules tailored for virtual currency firms.”²¹

¹⁹ New York State Department of Financial Services, *Annual Report – 2013* at 9, available at http://www.dfs.ny.gov/reportpub/annual/dfs_annualrpt_2013.pdf.

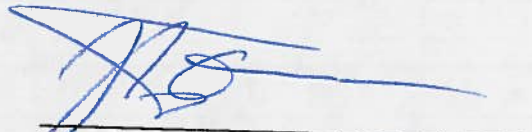
²⁰ New York State Department of Financial Services, *Annual Report – 2013* at 9, available at http://www.dfs.ny.gov/reportpub/annual/dfs_annualrpt_2013.pdf.

²¹ New York State Department of Financial Services, *Annual Report – 2014* at 6, available at http://www.dfs.ny.gov/reportpub/annual/dfs_annualrpt_2014.pdf.

Conclusion

61. In conclusion, the regulations challenged herein are neither unconstitutional nor arbitrary and capricious. The Department has not sought to ban or outlaw the use of virtual currencies or their future application. Instead, consistent with its mission to “ensure the continued safety and soundness of New York’s banking, insurance and financial services industries, as well as the prudent conduct of the providers of financial products and services, through responsible regulation and supervision,” the Department has applied the same regulatory principles to virtual currency products, services and providers that it has applied to other financial products, services and providers in New York. FSL § 102(i). Therefore, there is no merit to this Article 78 proceeding and declaratory judgment action, and the entire action should be dismissed.

Dated: New York, New York
April 22, 2016



Peter C. Dean
General Counsel for Banking
New York State Department of Financial Services