Lex Mundi Blockchain White Paper Series

Financial Institutions and the Drive to Leverage Cryptocurrency

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Partnering with Cryptocurrency Currency Companies

On December 4, 2018, the New York Department of Financial Services announced that it had authorized Signature Bank, a New York chartered bank, to offer commercial payments through a new blockchain-based platform known as Signet.[1] The platform, offered in conjunction with a fintech company called trueDigital Holdings, LLC, enables commercial clients to conduct real-time payments with US dollar settlement through use of a private blockchain and proprietary cryptocurrency (also called Signet). Amounts held in the Signet platform are FDIC insured.

Blockchain is top of mind for many financial institution executives. As an Accenture survey reported, nine out of ten bank executives stated that their institution is exploring blockchain technology.[2] That focus is unsurprising, given recently global regulatory interest in developing faster and more efficient payments.

Regulators in the US and abroad have zeroed in on the need to speed clearing and settlement of both consumer and commercial payments, and the financial services industry has responded.[3] From industry-owned solutions (such as the UK's Faster Payments Service, The Clearing House's Real-Time Payments service, and Australia's New Payments Platform) to solutions owned by central banks, financial institutions worldwide are pursuing initiatives to cut payment processing time and make real-time consumer and commercial payments available.

Banks have been particularly interested in blockchain-based payment solutions. However, it is important for financial institutions that are considering partnering with, providing services to, or investing in cryptocurrency currency companies to proceed with caution: U.S. cryptocurrency companies still face an uncertain regulatory picture.

The Sticky Subject of Regulatory Uncertainty

Before discussing those regulatory risks, it is important to distinguish between cryptocurrency activities and blockchain solutions. While most cryptocurrencies are blockchain-based, many blockchain companies are not in the cryptocurrency or payments space. For example, blockchain solutions can be used for supply-chain management, maintaining records of ownership of digital assets, and registering rare goods. Further, not all blockchain payment solutions utilize a cryptocurrency. From a regulatory perspective, cryptocurrencies present a significantly higher risk than do non-cryptocurrency blockchain payment solutions or other types of blockchain-based products.

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[1] "DFS Continues to Lead Responsible Innovation in New York's FinTech Industry with New Virtual Currency Approval for Commercial Banking Transactions," Press Release, New York Department of Financial Institutions, *available at* https://www.dfs.ny.gov/about/press/pr1812041.htm.

[2] https://www.accenture.com/us-en/insight-blockchain-technology-how-banks-building-real-time

[3] The Board of Governors of the Federal Reserve System, for example, established a Faster Payments Task Force in 2015. *See* https://fedpaymentsimprovement.org/faster-payments/ for more information regarding the Task Force and its activities.

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Cryptocurrency Activities

The first U.S. federal regulatory efforts focused on the use of cryptocurrencies as money. The U.S. Financial Crimes Enforcement Network (FinCEN) was the first federal agency, in March of 2013, to issue guidance on the regulatory treatment of cryptocurrencies, stating that activities that would constitute money transmission if conducted with fiat currency will constitute money transmission if conducted with cryptocurrency, and thus that administrators or exchangers of cryptocurrencies may be required to register as money-services businesses and comply with the attendant obligations under the Bank Secrecy Act.[4] Several states relied on the same reasoning to state that their money-transmitter regulations applied to cryptocurrency activities, while the state of New York adopted a bespoke "Bitlicense" regulation specifically governing cryptocurrency businesses.[5] Other state regulators have determined that their money transmitter regulations do not extend to activities involving cryptocurrency because it does not qualify as "money" under their regulatory regime.[6]

Other federal regulators have approach cryptocurrencies not as currencies, but as other types of assets. The Commodities Futures Trading Commission has determined that cryptocurrencies are commodities and thus within its jurisdiction – a position with which at least one federal judge has agreed.[7] In addition, the Securities Exchange Commission has aggressively pursued initial coin offerings and other cryptocurrency activities it deems to constitute offerings of securities, and the Internal Revenue Service has stated that cryptocurrency is treated as property for taxation purposes.[8] Finally, the Consumer Financial Protection Bureau has, to date, remained silent regarding whether Regulation E, which provides consumer protections relating to certain types of electronic fund transfers, extends to cryptocurrency transactions.[9] The result? Regulatory uncertainty for financial institutions that are considering partnering with cryptocurrency companies to offer payment solutions to their customers.

Blockchain Solutions

By contrast, blockchain solutions that do not rely on a cryptocurrency or digital currency are lower-risk from a regulatory perspective. Regulators have generally focused on the currency being traded or token being issued, not the underlying technology. New York's Bitlicense regulation, for example, expressly does not apply to use of blockchain technology absent a transfer of cryptocurrency or digital currency.[10] However, financial institutions should be aware that simply implementing a blockchain solution will not eliminate regulatory requirements that apply to the underlying activity for which the solution is used. For example, if sensitive data – such as payment card information or health-related data – will be stored in the blockchain, financial institutions must ensure that the solution will comply with applicable privacy regulations. Given the immutable nature of most blockchains,

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[4] https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf.

[5] *See, e.g.*, Alabama Monetary Transmission Act, Sec. 8-7A-2(8); Hawaii Commissioner of Financial Institutions, "State Warns Consumers on Potential Bit-coin Issues," Feb. 26, 2014 (stating that cryptocurrency activity may constitute money transmission), *available at* http://cca.hawaii.gov/dfi/bitcoin-warning/; 23 N.Y.C.R.R. part 200, *available at* https://www.dfs.ny.gov/legal/regulations/adoptions/dfsp200t.pdf.

[6] *See, e.g.*, Illinois Department of Financial and Professional Regulation, Digital Currency Regulatory Guidance, June 13, 2017, *available at* https://www.idfpr.com/Forms/DFI/CCD/IDFPR%20-%20Digital%20Currency%20Regulatory%20Guidance.pdf; Kansas Office of the State Bank Commissioner, Regulatory Treatment of Virtual Currencies under the Kansas Money Transmitter Act, June 6, 2014, *available at* http://www.osbckansas.org/mt/guidance/mt2014_01_virtual_currency.pdf.

[7] Commodity Futures Trading Commission, CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets, Jan. 4, 2018, *available at* https://www.cftc.gov/sites/default/files/idc/groups/public/%40customerprotection/documents/file/backgrounder_virtualcurrency01.pdf; CFTC v. My Big Coin Pay, Inc., No. 18-10077-RWZ (D. Mass.), Sept. 26, 2018, *available at* https://www.cftc.gov/sites/default/files/2018-10/enfmybigcoinpayincmemorandum092618_0.pdf

[8] The Securities and Exchange Commission maintains a website documenting its cryptocurrency enforcement activities, which is *available at* https://www.sec.gov/ICO. *See* also Internal Revenue Service Notice 2014-21, *available at* https://www.irs.gov/pub/irs-drop/n-14-21.pdf.

[9] The Securities and Exchange Commission maintains a website documenting its cryptocurrency enforcement activities, which is *available at* https://www.sec.gov/ICO. *See* also Internal Revenue Service Notice 2014-21, *available at* https://www.irs.gov/pub/irs-drop/n-14-21.pdf

[10] 23 N.Y.C.R.R. 200.2(q). The Bitlicense regulation reflects that a nominal transfer of some type of token may be necessary due to the typical structure of most blockchain systems.

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it remains to be seen how financial institutions will comply with the European Union's General Data Protection Regulation and its "right to be forgotten" with respect to data stored in blockchains.

Blurred Lines

The line between a cryptocurrency company and a blockchain solution is not, of course, always entirely clear. The Signet platform discussed at the beginning of this article relies on blockchain technology to execute commercial transactions, but also includes a cryptocurrency that can be used within the platform. While national banks are likely exempt from the Bitlicense regulation, Signature Bank was required to obtain approval from the New York Department of Financial Services prior to launching Signet, although as a New York-chartered institution, Signature did not have to obtain a full Bitlicense.[11]

Cryptocurrencies and blockchain-based payment solutions have the potential to enable financial institutions to satisfy regulatory and customer demands for faster, more efficient payments. Given the uncertainty of the current U.S. regulatory environment, however, financial institutions that wish to leverage such solutions should carefully approach prospective partnerships, with particular attention to compliance strategies and management of regulatory change.

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[11] The Bitlicense regulation offers this flexibility to New York-chartered banks only.

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