



Texas Department of Banking

April 24, 2018

Presented to:

House Investment and Financial Services

CRYPTOCURRENCY



TEXAS DEPARTMENT OF BANKING

★ Dedicated to Excellence in Texas Banking ★

SUPERVISORY MEMORANDUM – 1037

DATE: April 3, 2014

TO: All Virtual Currency Companies Operating or Desiring to Operate in Texas

FROM: Charles G. Cooper, Banking Commissioner

SUBJECT: Regulatory Treatment of Virtual Currencies Under the Texas Money Services Act

Purpose

Virtual currencies have proliferated in recent years and, particularly with the advent of cryptocurrencies like Bitcoin, have raised novel questions in relation to money transmission and currency exchange. This supervisory memorandum outlines the policy of the Texas Department of Banking (Department) with regard to virtual currencies. This policy expresses the Department's interpretation of the Texas Money Services Act,¹ and the application of its interpretation to various activities involving virtual currencies. While the popularity of Bitcoin has sparked new discourse on the nature of money and transferability of value, this memorandum seeks only to establish the regulatory treatment of virtual currencies under existing statutory definitions.

Types of Virtual Currency

In broad terms, a virtual currency is an electronic medium of exchange typically used to purchase goods and services from certain merchants or to exchange for other currencies, either virtual or sovereign.² As of the date of this memorandum the Department is not aware of any virtual currency that has legal tender status in any jurisdiction, nor of any virtual currency issued by a governmental central bank. As such, virtual currencies exist outside established financial institution systems. There are many different virtual currency schemes, and it is not easy to classify all of them, but for purposes of this memorandum, they can generally be divided into two basic types: centralized and decentralized.

Centralized virtual currencies are created and issued by a specified source. They rely on an entity with some form of authority or control over the currency. Typically, the authority behind a

centralized virtual currency is also the creator. Centralized virtual currencies can be further divided into subclassifications that quickly become too complex to apply a universal policy. Some can be purchased with sovereign currency, but cannot be exchanged back to sovereign currency; some can be converted back to sovereign currency; some are used only for purchase of goods and services from a closed universe of merchants, while others may have a theoretically open universe of merchants. Some centralized currencies are backed by the issuer with sovereign currency or precious metals, and therefore derive intrinsic value.

In contrast, decentralized virtual currencies are not created or issued by a particular person or entity, have no administrator, and have no central repository. Thus far, decentralized currencies are all cryptocurrencies such as Bitcoin, Litecoin, Peercoin, Namecoin, and so on. A cryptocurrency is based on a cryptographic protocol that manages the creation of new units of the currency through a peer-to-peer network. The creation of cryptocurrency happens through a process called mining that basically involves running an application on a computer that performs proof-of-work calculations. When the computer performs a sufficient amount of these calculations, the cryptocurrency's underlying protocol essentially generates a new unit of the currency that can be delivered to the miner's wallet. Because users' wallets act as the connection points of the cryptocurrency's peer-to-peer network, transfers of cryptocurrency are made directly from wallet to wallet, without any intermediary, whereas transmissions of sovereign currencies must be made through one or more intermediaries such as a financial institution or money transmitter.

One important characteristic of cryptocurrency is its lack of intrinsic value. A unit of cryptocurrency does not represent a claim on a commodity, and is not convertible by law. And unlike fiat currencies, there is no governmental authority or central bank establishing its value through law or regulation. Its value is only what a buyer is willing to pay for it. Most cryptocurrencies are traded on third party exchange sites, where the exchange rates with sovereign currencies are determined by averaging the transactions that occur. Some experts consider cryptocurrency to be a new asset class that is neither currency nor commodity, but possessing characteristics of both, as well as characteristics of neither.

Analysis

Currency Exchange

Exchanging virtual currency for sovereign currency is not currency exchange under the Texas Finance Code. Finance Code §151.501(b)(1) defines currency for purposes of currency exchange as "the coin and paper money of the United States or any country that is designated as legal tender and circulates and is customarily used and accepted as a medium of exchange in the country of issuance." Because neither centralized virtual currencies nor cryptocurrencies are coin and paper money issued by the government of a country, they cannot be considered currencies under the statute. Therefore absent a legislative change to the statute, no currency exchange license is required in Texas to conduct any type of transaction exchanging virtual with sovereign currencies.

Money Transmission

Because factors distinguishing the various centralized virtual currencies are usually complicated and nuanced, to make money transmission licensing determinations the Department must

¹ Texas Finance Code Chapter 151.

² In this memorandum the term sovereign currency will be used to mean government-issued currencies with legal tender status in the country of issuance. In most of the literature pertaining to virtual currency, the term fiat currency is used to refer to government-issued legal tender. Technically, fiat currency is a subset of government-issued legal tender. Fiat currency has no intrinsic value; its value is established by law. By contrast, commodity-backed currency has intrinsic value insofar as it represents a claim on a commodity such as gold or silver. Here, sovereign currency means both commodity-backed and fiat currency issued by a government and designated as legal tender.

individually analyze centralized virtual currency schemes. Accordingly, this memorandum does not offer generalized guidance on the treatment of centralized virtual currencies by the Money Services Act's money transmission provisions.

On the other hand, money transmission licensing determinations regarding transactions with cryptocurrency turn on the single question of whether cryptocurrencies should be considered "money or monetary value" under the Money Services Act. Under Finance Code §151.301, money transmission is "the receipt of money or monetary value by any means in exchange for a promise to make the money or monetary value available at a later time or different location." Although there is a great amount of discussion over whether cryptocurrencies should be considered money, for purposes of money transmission regulation in Texas the term is defined by statute. Finance Code §151.301(b)(3) provides that "'money' or 'monetary value' means currency or a claim that can be converted into currency through a financial institution, electronic payments network, or other formal or informal payment system." As already stated, a cryptocurrency is not currency as that word is defined in the Money Services Act. A unit of cryptocurrency is also not a claim.³ It does not entitle its owner to anything, and creates no duties or obligations in a person who gives, sells, or transfers it. There is no entity that must honor the value of a cryptocurrency, or exchange any given unit of a cryptocurrency for sovereign currency. For comparison, under federal law U.S. coin and paper currency must be honored for payment of all debts, public charges, taxes, and dues, and the U.S. Treasury Department must redeem it for "lawful money."⁴ But the owner of a unit of a cryptocurrency has no right or guaranteed ability to convert that unit to sovereign currency. The only way to convert a unit of cryptocurrency to sovereign currency is to find a willing buyer. Therefore cryptocurrencies as currently implemented cannot be considered money or monetary value under the Money Services Act.

Statement of Policy

Because cryptocurrency is not money under the Money Services Act, receiving it in exchange for a promise to make it available at a later time or different location is not money transmission. Consequently, absent the involvement of sovereign currency in a transaction, no money transmission can occur. However, when a cryptocurrency transaction does include sovereign currency, it may be money transmission depending on how the sovereign currency is handled. A licensing analysis will be based on the handling of the sovereign currency.

To provide further guidance, the regulatory treatment of some common types of transactions involving cryptocurrency can be determined as follows.

- Exchange of cryptocurrency for sovereign currency between two parties is not money transmission. This is essentially a sale of goods between two parties. The seller gives units of cryptocurrency to the buyer, who pays the seller directly with sovereign currency. The seller does not receive the sovereign currency in exchange for a promise to

make it available at a later time or different location.

- Exchange of one cryptocurrency for another cryptocurrency is not money transmission. Regardless of how many parties are involved, there is no receipt of money, and therefore no money transmission occurs.
- Transfer of cryptocurrency by itself is not money transmission. Because cryptocurrency is not money or monetary value, the receipt of it in exchange for a promise to make it available at a later time or different location is not money transmission. This includes intermediaries who receive cryptocurrency for transfer to a third party, and entities who, akin to depositories, hold cryptocurrency on behalf of customers.
- Exchange of cryptocurrency for sovereign currency through a third party exchanger is generally money transmission. For example, most Bitcoin exchange sites, such as the failed Mt. Gox, facilitate exchanges by acting as an escrow-like intermediary. In a typical transaction, the buyer of cryptocurrency sends sovereign currency to the exchanger who holds the funds until it determines that the terms of the sale have been satisfied before remitting the funds to the seller. Irrespective of its handling of the cryptocurrency, the exchanger conducts money transmission by receiving the buyer's sovereign currency in exchange for a promise to make it available to the seller.
- Exchange of cryptocurrency for sovereign currency through an automated machine is usually but not always money transmission. For example, several companies have begun selling automated machines commonly called "Bitcoin ATMs" that facilitate contemporaneous exchanges of bitcoins for sovereign currency. Most such machines currently available, when operating in their default mode act as an intermediary between a buyer and seller, typically connecting through one of the established exchange sites. When a customer buys or sells bitcoins through a machine configured this way, the operator of the machine receives the buyer's sovereign currency in exchange for a promise to make it available to the seller. However it is worth noting that at least some Bitcoin ATMs can be configured to conduct transactions only between the customer and the machine's operator, with no third parties involved. If the machine never involves a third party, and only facilitates a sale or purchase of Bitcoins by the machine's operator directly with the customer, there is no money transmission because at no time is money received in exchange for a promise to make it available at a later time or different location.

A cryptocurrency business that conducts money transmission must comply with all applicable licensing provisions of Finance Code Chapter 151 and of Title 7, Texas Administrative Code, Chapter 33. In addition, several considerations should be highlighted. First, because a money transmitter conducting virtual currency transactions conducts business through the Internet, the minimum net worth requirement under Finance Code §151.307 is \$500,000.⁵ Be advised that the Commissioner may increase the required net worth up to a maximum of \$1,000,000 based on the factors set out in §151.307(b). Second, a license holder may not include virtual currency assets in calculations for its permissible investments under Finance Code §151.309. Lastly, pursuant to Finance Code §151.203(a)(3) the Commissioner requires that license applicants who handle

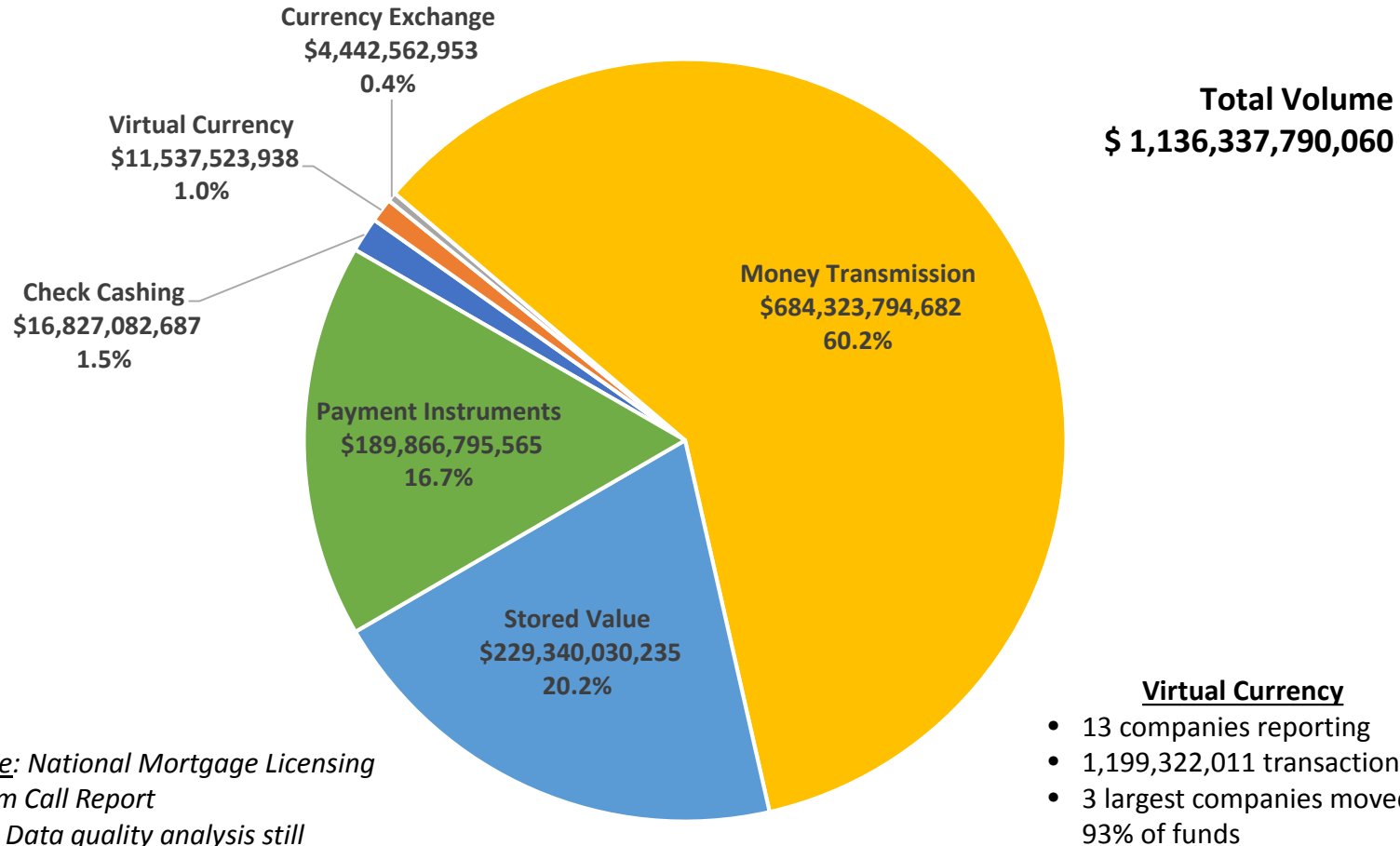
³ The legal definition of a claim can essentially be stated as a right enforceable by a court. See Black's Law Dictionary 264 (8th ed. 2004).

⁴ 31 U.S.C. §5103; 12 U.S.C. §411 ("The said notes shall be obligations of the United States and shall be receivable by all national and member banks and Federal Reserve banks and for all taxes, customs, and other public dues. They shall be redeemed in lawful money on demand at the Treasury Department of the United States, in the city of Washington, District of Columbia, or at any Federal Reserve bank.")

⁵ Under §151.307(a), a minimum net worth of \$500,000 is required if a business operates through five or more locations. It has been the Department's policy that license holders operating through the Internet are considered to be in more than five locations. See <http://www.dob.texas.gov/forms/corp-mw01.htm#new>

virtual currencies in the course of their money transmission activities must submit a current third party security audit of their relevant computer systems. Because the new technological paradigm created by cryptocurrencies has brought with it new risks for the consumer, it is incumbent on a license applicant to demonstrate that all virtual currency is secure while controlled by the applicant.

2017 MONEY SERVICE BUSINESSES (MSB) DOLLAR VOLUME - NATIONWIDE



Source: National Mortgage Licensing
System Call Report

Note: Data quality analysis still
underway

ACTION AGAINST FRAUDULENT CRYPTOCURRENCY ENTITY



Charles G. Cooper
Commissioner

TEXAS DEPARTMENT OF BANKING

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PRESS RELEASE

Date: January 5, 2018

CONSUMER ALERT

This Notice is Intended for Texas Residents:

The Texas Department of Banking has become aware of an entity holding itself out to be a bank and soliciting funds online through a cryptocurrency investment scheme. The entity, AriseBank, claims to be a “cryptocurrency bank” with offices in Dallas, Texas, Dubai, AE, and Zug, Switzerland. AriseBank operates several websites including, www.arisebank.com and www.arisecoin.com.

The entity, which also goes by “AriseBank, Ltd”, “AriseBank, Inc.”, “aBank”, “Arise Foundation, LLC”, “AriseCoin Foundation”, or “Dotoji, LLC” is not associated with any known financial institution chartered by a state or federal regulatory agency. No entity by that name has been authorized to do business in Texas. AriseBank leadership includes, among others, Jared Rice Sr., Stanley Ford, and Tony Caldevilla.

Consumers should consider any communication or solicitation involving AriseBank to be an attempt to obtain funds by an unauthorized and unregulated entity. Anyone with information about this purported bank or its website should contact the Department’s Consumer Assistance Activities at consumer.complaints@dob.texas.gov or call toll free (877) 276-5554.

[Department of Banking Media Contact](#)

UNIFORM REGULATION OF VIRTUAL CURRENCY BUSINESS ACT

- ★ Adopted by the National Conference of Commissioners on Uniform State Laws in July of 2018.
- ★ Virtual currency is defined as a digital representation of value that is used as a medium of exchange, unit of account, or store of value and is not legal tender.
- ★ Allows reciprocity agreements between states for licensing.
- ★ Most requirements follow money transmission statutes, i.e. net worth, bonding, permissible investments, criminal background checks, and examinations.
- ★ Regulatory Sandbox Section - A registration (as opposed to full licensing) would be required for the first two years of operations for companies with innovative financial services or products. The maximum annual volume of activity can not exceed \$25,000.

SANDBOX CONCEPT

MONEY TRANSMISSION BUSINESSES AND FINTECH

- ☆ Texas Department of Banking (DOB) regulates money transmission activities in Texas.
- ☆ There has been tremendous evolution in the money transmission industry from money orders to wallets on our phones.
- ☆ FinTech companies include a variety of businesses including those that have products or services related to money transmission.
- ☆ Regulatory structure can pose challenges to start-up FinTech companies if they want to operate across the U.S. - getting a license in all 50 states.
- ☆ Sandbox programs can provide a means to test innovative products and services and learn and adapt from the experience.

DOB START-UP LICENSE CONCEPT

- ☆ Start-up license for three years for companies with innovative financial services or products in the money service business arena.
- ☆ A sponsor is required for the start-up company which can be a financial institution or licensed money service business. The sponsor would oversee the operations of the start-up company.
- ☆ The maximum volume of activity would be set by rule.
- ☆ Net worth requirement for entry would be lower than a normal money service business license as well as waiver of the requirement to have an audited financial statement. These reduced requirements would be mitigated by a larger bond (double) to provide consumer protections.
- ☆ The sponsor would be responsible for the start-up customer obligations if the start-up was unable to fulfill them.

DOB START-UP LICENSE CONCEPT

(CONTINUED)

- ★ Application process would still require background checks and a Bank Secrecy Act compliance program and officer. However, the start-up can have a less experienced compliance officer if the sponsor is involved in the compliance program.
- ★ Consumer disclosures would be required.
- ★ The start-up would be subject to examinations.

ILLINOIS LEGISLATION HB 5139 FILED FEBRUARY 2018 – REGULATORY SANDBOX

- ☆ New companies with innovative financial services or products could enter the market for a 12-month period which can be extended for six months, if warranted.
- ☆ The industry activities in this bill include banking, money transmission, small loan lending, title insurance, and pawn brokers.
- ☆ The company would submit an application to join the sandbox which describes the financial product or services to be offered.
- ☆ The company cannot transact with more than 5,000 Illinois citizens.
- ☆ Consumer disclosures would note that the sandbox company is not licensed as a money service business.
- ☆ The Division of Financial Institutions under the Department of Financial and Professional Regulation may inspect the books of the sandbox company at any time.

ARIZONA LEGISLATION HB 2434 FILED JANUARY 2018 – REGULATORY SANDBOX

- ☆ Program administrated by the Arizona Attorney General including application reviews, approvals, and determination of records to maintain and periodic reporting.
- ☆ Companies with an innovative product or service could enter the market for a 24-month period which can be extended one year. This bill covers more than financial services.
- ☆ The company would submit an application to join the sandbox which describes the innovative product or services to be offered and risks consumers could face.
- ☆ Cannot transact with more than 10,000 Arizona citizens.
- ☆ For money transmission innovations, cannot exceed \$25,000 in aggregate for any customer.
- ☆ Consumer complaints would be directed to the Attorney General.
- ☆ This bill was passed by the Arizona legislature in March 2018.

OTHER SANDBOX INITIATIVES

- ★ **Singapore** – launched the FinTech and Innovation Group and Financial Sector and Technology Innovation Scheme in 2015 to facilitate the use of technology and innovation to better manage risks, enhance efficiencies and strengthen competitiveness in the financial sector.
- ★ **United Kingdom** – launched the Bank of England’s FinTech Accelerator in 2016 to work in partnership with FinTech firms to enhance central banking.
- ★ **Office of the Comptroller of the Currency** – launched the Offices of Innovation which proposed the special purpose national bank charter for FinTech companies in 2016. The Conference of State Bank Supervisors and the New York State Department of Financial Services have challenged the constitutionality of this charter.
- ★ **Consumer Financial Protection Bureau** – issued a no-action policy statement in 2016 to encourage FinTech companies to reach out to the agency.
- ★ **Conference of State Bank Supervisors** – announced Vision 2020 in May 2017 which is a series of initiatives to modernize state regulation of non-banks, including FinTech firms. Vision 2020 provides for a regulatory system that makes supervision more efficient and recognizes standards across state lines – actions that will better support start-ups and enable national scale while protecting consumers and the financial system.

CONCLUSIONS

- ☆ FinTech products and services can provide benefits to consumers, such as convenience and lower costs.

- ☆ Sandbox programs need:
 - an established test period;
 - definitions for what innovation products and services will include;
 - adequate consumer disclosures;
 - limits on potential consumer losses;
 - anti money laundering programs;
 - safeguards for the protection of consumer personal data; and
 - tailored regulatory supervision.