

Navigating the BSA Hurdles of Virtual Currency Clients



June 2019

Agenda

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- Blockchain Behind the Scenes
- Responsibilities of an MSB
- Players in the VC World
- Most Well-Known VCs and VCEs
- Banking a VCE
- Know Your VCE Customer/Member
- Managing the Risks
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Definitions

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Definitions – Real vs. Virtual Currency (VC)

- Real currency – The coin and paper money of the United States or of any other country that is designated as legal tender, that circulates, and is customarily used and accepted as a medium of exchange in the country of issuance.

31 CFR § 1010.100(m)

- Virtual currency – 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.

Definitions – Virtual Currency Exchanges (VCEs)

- In the U.S., VCEs must be registered with the Financial Crimes Enforcement Network (FinCEN) as a money services business (MSB), unless they qualify under an exemption.
- There are specific state requirements for MSBs as well.
- They function similarly to banks or securities investment companies.
- Clients have accounts or “digital wallets” with the exchange where they can sell, buy, and hold virtual currency (VC).

Definitions – Money Services Businesses (MSBs)

- An MSB is generally any person offering check cashing; foreign currency exchange services; or selling money orders, traveler's checks or prepaid access (formerly stored value) products for an amount greater than \$1,000 per person, per day, in one or more transactions.
- A person who engages as a business in the transfer of funds is an MSB as a money transmitter, regardless of the amount of money transmission activity.

Blockchain Behind the Scenes

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Blockchain Basics

SO WHAT ARE BLOCKCHAINS?

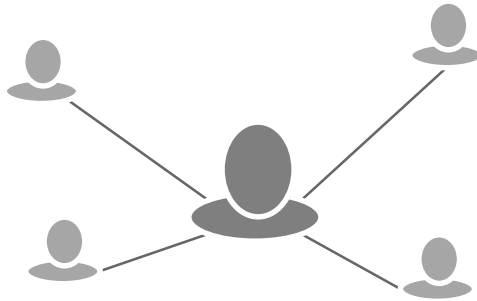
- Distributed, immutable databases
- Invented by Bitcoin (Satoshi Nakamoto)
- Technological infrastructure
- Resilient due to network power and cryptographic integrity
- Trust shifting
- Money, digital assets, identity & more

BLOCKCHAINS ARE NETWORKS...



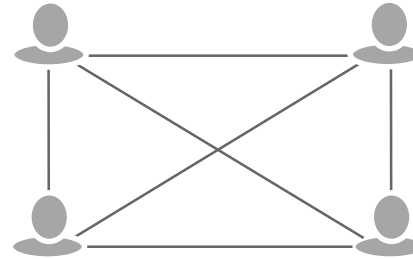
A New Type of Ledger

Traditional ledger



- One party has centralized control over the ledger
- A traditional ledger is only as trustworthy as the centralized party

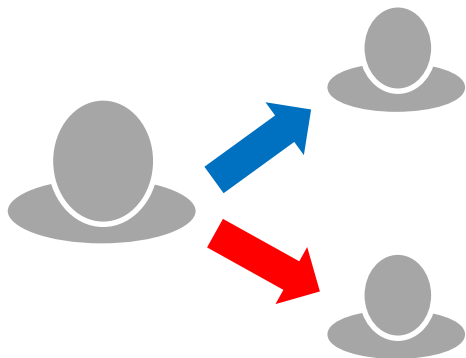
Distributed ledger



- The ledger is distributed to all parties
- The ledger is decentralized, meaning there's no single gatekeeper, or middle-man, to the information
- A trust-minimized system relies on consensus rather than reconciliation

Blockchain Solved the Double-Spend Problem

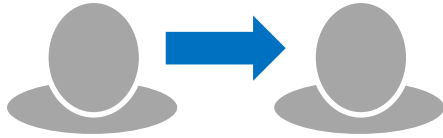
You can't give the same dollar to two people.



Double-spending

- Double-spend is as the name implies: spending the same dollar more than once
- Double-spending is not solved via the blockchain itself, but rather through the confirmation process involved in every transaction
- For non-cash payments, a banking institution acts as the centralized ledger ensuring you can't spend the same dollar twice
- Solving the double-spend problem is arguably the most important solution to a problem that blockchain solved

The Parties Involved (Minus All the Computers)



The transaction

- Any two or more parties involved in the transaction
- Once proposed, the transaction must be verified before being added to the blockchain



The miners

- Have a copy of every verified transaction that ever occurred in the blockchain
- Develop the consensus for every new transaction through a proof-of-work

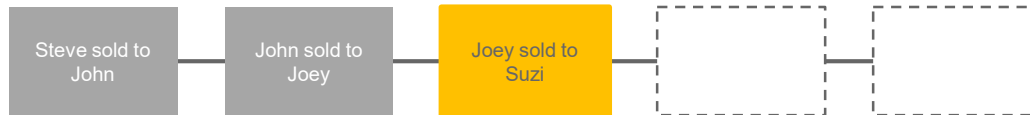
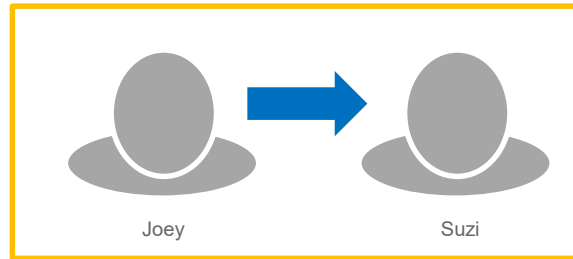
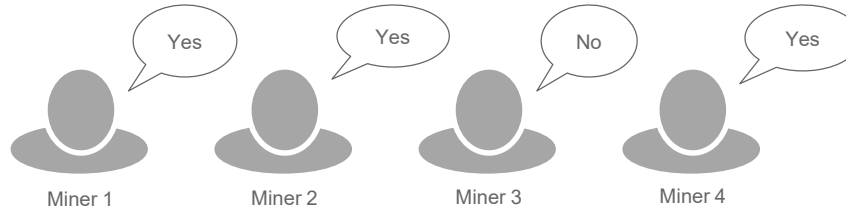


The transactions in the blockchain

- Once the transaction is verified, the transaction is added to the history of every transaction ever recorded
- This history is the foundation for miners to develop a consensus for new transactions

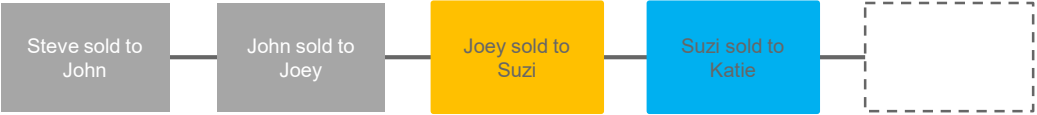
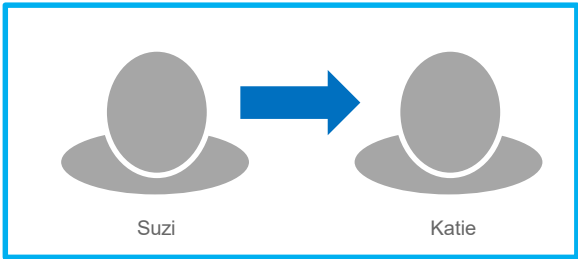
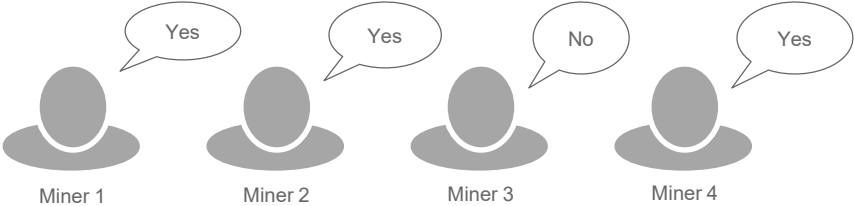
The Mechanics of a Blockchain Transaction

Transaction #3 in a blockchain



The Mechanics of a Blockchain Transaction

Transaction #4 in a blockchain



What are Smart Contracts?

- A 'smart contract' is a computer protocol intended to digitally facilitate, verify, or enforce the negotiation or performance of a contract.
- Features:
 - Partially or fully self-executing, self-enforcing, or both.
 - Allow performance of credible transactions without third parties.
- Platforms:
 - Solidity (Ethereum)
 - Hyperledger
 - Corda (R3)

Public and Private Blockchains

PUBLIC BLOCKCHAINS



public (inter-)
The internet



ENTERPRISE BLOCKCHAINS



private (intra-)
Intranets & IT



Early Movers and Leaders

MAJOR BLOCKCHAIN CONSORTIA AND NETWORKS

R3 CEV (selected members)

Digital Asset Holdings (investors)

Hyperledger Project (selected members)

Ripple (selected members)

Enterprise Ethereum Alliance (selected members)

Examples: Payments

- Challenge from standalone cryptocurrencies? Central banks across the world are exploring the potential for shifting parts of their payments systems on to blockchain technology or even using it to launch digital currencies.
- Ripple is growing to become a significant contender for Swift, which is also experimenting with its own blockchain technology.
- “Utility settlement coin“ by Switzerland's UBS: tokens convertible into cash on deposit at central banks.
 - Other financial institutions part of the consortium: Barclays, CIBC, Credit Suisse, HSBC, MUFG, State Street, BNY Mellon, Deutsche Bank, Santander, NEX and blockchain startup Clearmatics.

Examples: Trade Finance

- Trade finance is still mostly based on paper, such as bills of lading or letters of credit, being sent by fax or post around the world. R3 has come up with a unique blockchain based solution.
- Startups working in this space: Wave (based in Israel), EssDocs (based in Malta) and Bolero (based in UK)

Examples: Identity

Identity is core to running a distributed ledger (you need to know who is on the ledger!).

- Identity on blockchain is core to R3's Corda
- Accenture is working with UN and Microsoft on a blockchain identity system for people with no identity papers
- Dozens of start-ups are working on building blockchain systems for customer identification, including Cambridge Blockchain, Tradle, Credits and Blockstack.

Examples: Syndicated Loans, PE Capital Allocations

- Credit Suisse is leading a consortium of 19 financial institutions to work with Synaps to start putting syndicated loans on blockchain systems.
- In partnership PwC, Northern Trust is building a blockchain-based platform for private equity funds. Auditors will have fast access to data stored on its private blockchain.

Cryptocurrency & ICO

WHAT IS BITCOIN?



Types of Cryptocurrencies



Regulation on the Anvil?



Cryptocurrency latest: 'Unprecedented' Bitcoin legal battles BAFFLE top regulation lawyers

UNPRECEDENTED legal battles are set to take place in the UK after it was reported that divorce lawyers are struggling to come up with settlement agreements over cryptocurrencies.



What can you do keep up with the latest regarding Blockchain?

- Keeping abreast with the latest:
 - FDIC, Fed Reserve, OCC, Dept. of Treasury, Chamber of Digital Commerce, Finnovate, Money 20/20, Blockchain Accounting Alliance, Coindesk (Consensus), Wall Street Blockchain Alliance etc.
- Explore participating in a FinTech regulatory sandbox effort

Responsibilities of an MSB



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Responsibilities of an MSB

- Every MSB must register with FinCEN (unless a person or business is only an MSB because they serve as an agent of another MSB).
- MSBs are required to develop and implement a written anti-money laundering (AML) compliance program. The program should reasonably prevent individuals from using the MSB to facilitate money laundering or to finance terrorist activities.

Responsibilities of an MSB

- MSBs must electronically file a Currency Transaction Report when they have a cash-in or cash-out currency transaction, or multiple transactions, totaling more than \$10,000 during one business day for any one person, or on behalf of any one person.
- MSBs that know, suspect or have reason to suspect that the transaction or pattern of transactions is suspicious and involves \$2,000 or more must electronically file a Suspicious Activity Report on the activity.

Players in the Virtual Currency World

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Players in the Virtual Currency World

- Participants in generic virtual currency arrangements are generally referred to using the terms “user,” “exchanger,” and “administrator.”
 - A user is a person that obtains virtual currency to purchase goods or services.
 - An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.

Players in the Virtual Currency World

- An administrator is a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.

Players in the Virtual Currency World

- A user of virtual currency is not an MSB under FinCEN's regulations and therefore is not subject to MSB registration, reporting, and recordkeeping regulations. However, an administrator or exchanger is an MSB under FinCEN's regulations, specifically, a money transmitter, unless a limitation to or exemption from the definition applies to the person. An administrator or exchanger is not a provider or seller of prepaid access or a dealer in foreign exchange under FinCEN's regulations.

Most Well-Known VCs and VCEs

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VCs and VCEs

- The most well-known digital currency technologies to date have included:
 - E-gold (1996)
 - WebMoney (1998)
 - Liberty Reserve (2006)
 - Perfect Money (2007)
 - Bitcoin (2009)

VCs and VCEs

- Although Bitcoin has evolved into currently the one most in the news and in the public's attention, there are hundreds of VCs vying to be the next “big-thing.”
- The list of exchangers are also changing fast; mergers and failures are keeping the industry volatile.

VCs and VCEs

- Virtual currencies are growing in popularity.
- While the collective value of virtual currencies is still a fraction of the total U.S. dollars in circulation, the use of virtual currencies as a payment mechanism or transfer of value is gaining momentum.

VCs and VCEs

- The number of entities (issuers, exchangers, and intermediaries, to name just a few) that engage in virtual currency transactions is increasing.
- These entities often need access to traditional banking services. Providing banking services to these entities presents some unique risks and challenges.

VCs and VCEs

A small list of current VCEs:

- Coinbase
- Kraken
- Bitstamp
- RobinHood
- Coinsquare
- Gemini
- Binance
- Bittrex
- Coinmama
- CEX.IO

Banking a Virtual Currency Exchange

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Banking a VCE

- Financial institutions have historically shied away from banking MSBs due to the perceived (and real) additional initial and ongoing due diligence required.
- Add virtual currency activity to the mix (an area often not fully understood by bankers), and the fear of being criticized by regulators is often too much to take on...thus enter the de-risking.

Banking a VCE

- Involve senior management, board/supervisory committee, and regulator in discussions.
- Create a business plan for why this service line or customer/member base fits into the institution's overall mission statement.
- Ensure the financial benefit involving fee income is not the top reason.

Banking a VCE

- Research institutions in your area to see which are already banking VCEs.
- Research your market area to determine whether the potential volume of clients makes this endeavor worth it.
- Document all the research performed.

Banking a VCE

- Present to and get approval by board/supervisory committee to bank VCEs.
- Update Risk Assessment and BSA/AML policies.
- Heighten initial due diligence on the businesses.
- Detail understanding of their business models.
- Retain documentation of due diligence performed.

Banking a VCE

- Experience of BSA/AML officer
 - Needs understanding of the VC ecosystem.
 - Needs to understand the products and services the VC-MSB offers, anticipated volume of activity, locations and markets served.
 - May need a designated VC BSA/AML officer.

Know Your VCE Customer/Member

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Know Your VCE Customer/Member

- Baseline for Banking VCE-MSBs

The current BSA minimum due diligence expectations for banking organizations that open and maintain accounts for money services businesses should be tailored for VCEs, dependent upon the various services the VCE offers, and are as follows:

Know Your VCE Customer/Member

- Apply the banking organization's Customer Identification Program (including beneficial ownership);
- Confirm FinCEN registration, if required;
- Confirm compliance with state or local licensing requirements, if applicable;
- Confirm agent status, if applicable; and

Know Your VCE Customer/Member

- Conduct a basic BSA/AML risk assessment to determine the level of risk associated with the account and whether further due diligence is necessary.
- Exchanges located in high-risk jurisdictions or that do not have a strong AML program represent a higher risk to an institution.

Know Your VCE Customer/Member

- Obtain expected virtual currency activity and usage at account opening. This allows institutions to evaluate their clients' intentions and their inherent risk to the institution.
- Don't be afraid to contact the exchange and question the activity in accounts.
- Develop a rapport with the exchange's BSA officer.

Managing the Risks



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Managing the Risks

- Understand the rules from the side of an MSB. FinCEN has issued reference guides for MSBs. Get to know them!
- FinCEN and the Federal Reserve System have also issued guidance to institutions when banking MSBs. Read these!
- Updated guidance is still needed to assist institutions in understanding regulatory expectations.

Managing the Risks

Some examples of potentially lower-risk indicators: The money services business –

- Primarily markets to customers that conduct routine transactions with moderate frequency in low amounts;
- Offers only a single money services business product (for example, only check cashing or only currency exchanges);

Managing the Risks

- Is an established business with an operating history;
- Only provides money transmitting virtual currency services to local residents; or
- Is a money transmitter that only remits funds to domestic entities.

Managing the Risks

*Some examples of potentially **higher-risk** indicators: The money services business –*

- Allows customers to conduct higher-amount transactions with moderate to high frequency;
- Offers multiple types of money services products;
- Is a new business without an established operating history;

Managing the Risks

- Is a currency dealer or exchanger for currencies of jurisdictions posing heightened risk for money laundering or the financing of terrorism or countries identified as having weak anti-money laundering controls; or
- Is located in an area designated as a High Risk Money Laundering and Related Financial Crimes Area or a High-Intensity Drug Trafficking Area.

Managing the Risks

Once they are your customer/member...now what?

- Flag the account as higher-risk.
- Regularly monitor the ongoing activity in the account.
- Perform periodic negative news and social media searches.
- Consider site visits of the business or any VC-ATMs owned by the entity.

Managing the Risks

Be inquisitive

- Test to see if the VCEs know your customer (KYC) procedures are effective for ATM or other electronic avenues utilized. Do they allow for exceptions?
- Does the VCE flag for suspicious activities, and what is their escalation process?

Managing the Risks

- Ensure the board or audit/supervisory committee are kept informed on the efforts of the BSA staff to ensure the adequacy of the entire BSA program is remaining intact and strong.
- File SARs as needed, and don't be afraid to break ties should the VCE not comply with the regulations and the financial institution's expectations.

FinCEN Means Business

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FinCEN Means Business

- P2P virtual currency transmitter fined for BSA violations. In May 2019, FinCEN issued a civil money penalty of \$35,350 to an exchanger of convertible virtual currency for failing to:
 - Register as an MSB with FinCEN;
 - Establish and implement an effective written anti-money laundering (AML) program;
 - Detect and adequately report suspicious transactions; and
 - Report currency transactions.

FinCEN Means Business

- According to the FinCEN Order, between December 6, 2012, and September 24, 2014, the individual conducted over 1,700 transactions as a money transmitter.
- He did so as a peer-to-peer exchanger of the convertible virtual currency bitcoin, purchasing and selling bitcoin to and from others.

FinCEN Means Business

- He participated in online discussions pertaining to AML compliance, including specific conversations about registering as an MSB, which demonstrated his awareness of the relevant BSA requirements.
- Nevertheless, he failed to register—even after FinCEN issued guidance in March 2013 stating that exchangers of convertible virtual currency are money transmitters and must register as MSBs.

Resources – Guidance and Publications

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Guidance and Publications

- FinCEN-2013-G001 Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies

<https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>

- FinCEN-2014-R001 Application of FinCEN's Regulations to Virtual Currency Mining Operations

<https://www.fincen.gov/sites/default/files/shared/FIN-2014-R001.pdf>

- NY DFS March 2014 Public Order on Virtual Currency Exchanges

https://www.dfs.ny.gov/reports_and_publications/press_releases/pr1403111

Guidance and Publications

- Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States (April 26, 2005)

<https://www.fincen.gov/resources/statutes-regulations/guidance/interagency-interpretive-guidance-providing-banking>

- FRS – Community Banking Connections: What Community Bankers Should Know about Virtual Currencies

<https://www.communitybankingconnections.org/articles/2015/q2/virtual-currencies>

Guidance and Publications

- Bank Secrecy Act Requirements: A Quick Reference Guide for MSBs
https://www.fincen.gov/sites/default/files/shared/bsa_quickrefguide.pdf
- Examination Manual for Money Services Businesses
https://www.fincen.gov/sites/default/files/shared/MSB_Exam_Manual.pdf
- Reporting Suspicious Activity: A Quick Reference Guide for MSBs
https://www.fincen.gov/sites/default/files/shared/msbsar_quickrefguide.pdf
- Money Laundering Prevention: An MSB Guide
https://www.fincen.gov/sites/default/files/shared/prevention_guide.pdf

Questions?

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