WRITTEN STATEMENT OF

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BEFORE THE

U.S. SENATE COMMITTEE ON HOMELAND SECURITY AND GOVERNMENT AFFAIRS

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Mr. Chairman and members of the Committee, thank you for this opportunity to contribute my thoughts on a topic that I believe is of great importance to our nation's economic future.

Introduction

I am the founder of a startup technology company located in Mountain View, California called Think Computer Corporation ("Think"). Think began developing its patented FaceCash® mobile payment system, which uses a digital image of a consumer's face to reduce fraud and lower interchange fees at the point of sale, in 2009.[1] FaceCash was operational at a number of retail merchants in the Bay Area until July 1, 2011, when Think was forced to shut it down due to passage of the California Money Transmission Act ("MTA"), one of approximately forty-seven state money transmission laws ("MTLs") implicitly authorized by Congress pursuant to 18 U.S.C. § 1960 ("Section 1960"), an anti-drug statute introduced in 1992 long before the commercial internet—let alone mobile payments or virtual currencies—even existed. Section 1960 has since been updated by the USA PATRIOT Act to address concerns regarding terrorism, but not technology.

1 Think does not have venture capital backing, which became a material factor as the controversy described herein developed. I was fortunate enough to attend Harvard College from 2001-2004, where I designed and developed the predecessor to Facebook, Inc. Think reached a confidential settlement agreement with Facebook, Inc. in 2009. Since then, I have also spent time as a CodeX Fellow at Stanford Law School's Center for Legal Informatics.

With its new authority under Section 1960 and the MTA, the California Department of Financial Institutions ("DFI", since merged into the California Department of Business Oversight, or "DBO") required me to appear at a mandatory pre-application interview at the DFI's San Francisco offices after I made a timely inquiry about the process of applying for a license. At that meeting, the Deputy Commissioner for Money Transmission, Robert Venchiarutti, threatened both Think and me personally in a variety of ways, including incarceration, thanks to my questions about the new law and an unwritten departmental standard (what the California Office of Administrative Law calls an "underground regulation"). The Deputy Commissioner strongly implied that he would refuse to grant Think a license under the MTA, which would cause Think to violate the law if it continued to operate FaceCash. Even after protracted attempts—including appeals to DFI's parent agency, the Governor of California, both houses of the California legislature, and Congress—to secure the information necessary to apply for a license, such as the *true* (and still unwritten) capital requirement under the new law, Think was unable to determine the DFI's demands, and Think eventually filed a federal lawsuit against the Governor of California and the DFI in November, 2011. The lawsuit is still pending.[2] All of Think's employees were laid off.

To be clear, FaceCash was a legitimate and well-received initiative about which no complaints were ever filed with any agency, state or federal. FaceCash did not and does not make use of bitcoin or any other so-called virtual currencies. At the time that this dispute arose over the MTA's requirements, FaceCash could only be used to process United States Dollars, which was a deliberate decision on my part to minimize financial risk. Nonetheless, as has been clarified by FinCEN Guidance FIN-

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2 See https://www.facecash.com/legal/brown.html for correspondence regarding Think's attempts to obtain a license under the MTA, and http://www.plainsite.org/flashlight/case.html?id=716056 for the latest docket information concerning the lawsuit, Case No. 5:11-cv-05496-HRL in the Northern District of California. Think has been waiting on Magistrate Judge Howard R. Lloyd to rule upon the State of California's motion to dismiss for 643 days—nearly two years—as of the date of this hearing. In the motion hearing on April 17, 2012, Judge Lloyd remarked, "I think that the situation cries out for some more legislative solution."

2013-G001 issued on March 18, 2013, the same state MTLs apply to virtual currency operators as apply to money transmitters running mobile payment systems. Therefore, the discussion about bitcoin and virtual currency really boils down to a discussion of the effectiveness of state MTLs and Section 1960, which authorizes them.

FaceCash could have been of immense benefit to businesses, consumers and government had it been allowed to flourish, and it can still be with appropriate legislative action. A modern replacement for plastic payment cards that makes point of sale transactions more secure, FaceCash is more convenient and less expensive than just about any other payment system. In place of the traditional card signature on the back of the card, a digital image of the consumer's face is used to verify identity, and because Think developed its own network based on modern technologies, there is no need to use the aging plastic card technology infrastructure, saving on costs. Importantly, FaceCash can capture line item-level transaction data, which even the most exclusive and expensive plastic payment cards cannot. This alone has enormous implications for businesses large and small, who could use such data to automate accounting functions, including tax preparation.

I. Problems with State Money Transmission Laws Generally

A. The State Money Transmission Patchwork Protects Large Financial Companies, While Disproportionately Harming Low-Income Consumers and Small Businesses Through the Imposition of Monopoly Pricing

Setting out the nominal purpose of the MTA, which is generally no different from that of other states' money transmission statutes, California Financial Code § 2001(d) states:

> "To protect the interests of consumers of money transmission businesses in this state, to maintain public confidence in financial institutions doing business in this state, and to preserve the health, safety, and general welfare of the people of this state, it is necessary to regulate money transmission businesses in this state."

This text was drafted by a lobbying group comprised of several multi-billion dollar financial institutions calling itself The Money Services Round Table ("TMSRT")[3], acting through its chief lobbyist, Ezra Levine (formerly of the defunct Howrey LLP, now with Morrison & Foerster LLP), with the additional frequent help of the California DFI. According to TMSRT's August 18, 2006 comment letter to FinCEN and the Federal Reserve System, the members of TMSRT are, "the leading national non-bank funds transmitters in the United States including: Western Union Financial Services, Inc., MoneyGram International, Travelex Currency Services, Inc., Integrated Payment Systems, American Express Travel Related Services, RIA Financial Services, Comdata Network, Inc. and Sigue Corporation."[4]

For roughly the past decade, Mr. Levine has literally made it his business to pass laws similar to the MTA in states throughout the nation, slightly modifying them in each instance to suit the particular fears of state legislators and bureaucrats—but most of all, to suit the needs of his clients, the member companies of TMSRT. According to Mr. Levine's biography as prepared for the 2006 Global Consumers Money Transfer Conference, "He has had an active role in the enactment of the money transmitter laws in Oregon, Minnesota, Washington, Iowa, West Virginia, Illinois, Wyoming, North Carolina, Florida, Idaho, North Dakota, New Jersey, Tennessee, Maine, Vermont, Arizona, the District of Columbia and Indiana." Since that biography was written, he and his clients have also succeeded in constructing unconstitutional laws in Hawaii, and now, California.

As concerned as these multi-national conglomerates may be about consumers—and there is no evidence whatsoever that they actually are concerned—they are also clearly concerned about themselves, which is why they pay Mr. Levine to ensure that no new competitors with more advanced technologies are permitted to enter the payment industry and render their overpriced

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3 TMSRT, formerly known as the Non-Bank Funds Transmitters Group, was the sole sponsor of the MTA.

4 According to a February 22, 2001 comment letter, members of the Non-Bank Funds Transmitters Group at that time also included Citicorp Services, Inc. and Thomas Cook, Inc.

services obsolete. In other words, the thinly-veiled core purpose of modern MTLs is economic protectionism, and nothing more.

The effects of money transmission laws are mostly felt by low-income consumers, and especially immigrants, who have almost no choice but to patronize members of TMSRT when they send or receive money from foreign countries. The prices of funds transfers and currency conversion are considerably higher than they would otherwise be due to these laws.[5]

The laws also have a disproportionate effect on small businesses, who lack the bargaining power necessary to force credit and debit card issuers to lower interchange fees. This problem has recently been so pronounced that Congress enacted the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to lower debit (but not credit) card interchange fees, perhaps not fully realizing the role of state laws in contributing to the unusual upward trend in interchange pricing. The most promising new payment models that compete with credit and debit cards necessarily involve money transmission.

Of course, when businesses are forced to charge higher prices to cover their payment processing costs, as many often do, average consumers end up hurt as well. In a time of economic instability, this is most unfortunate.

B. Member Companies of TMSRT, Which Sponsored Several MTLs, Have Repeatedly Engaged in Criminal Activity Involving Money Transmission, Illustrating the Ineffectiveness of MTLs

On November 9, 2012, the United States Department of Justice ("USDOJ") filed criminal felony charges against MoneyGram International, Inc. ("MoneyGram") in Pennsylvania Middle District

5 See "New Rules for Money Transfers, but Few Limits," Jessica Silver-Greenberg, *The New York Times*, June 1, 2012, http://www.nytimes.com/2012/06/02/business/new-rules-for-money-transfers-but-few-limits.html.

Court, Case No. 1:12-cr-00291-CCC.[6] MoneyGram is one of approximately six members of TMSRT, the lobbying group that was the sole sponsor of the MTA. The USDOJ accused MoneyGram of perpetrating a fraud costing the American public approximately $120 million over a period of almost a decade. Three weeks after the USDOJ filed charges, MoneyGram agreed to settle the allegations for $100 million. A division of MoneyGram, MoneyGram Payment Services, Inc., is still in possession of California Money Transmission License No. 1910 despite the USDOJ's serious allegations. In fact, no state regulator of money services businesses has ever taken any action at all against MoneyGram as a result of this nationwide fraud.

Similarly, in 2008, Sigue Corporation, another member of TMSRT, entered into a deferred prosecution agreement with the USDOJ and agreed to forfeit $15 million due to Bank Secrecy Act violations.[7] Despite these serious transgressions, it still possesses California Money Transmission License No. 2062.

These alleged criminal actions and the resulting federal investigations reinforce three points. First, state regulators have effectively failed to enforce the laws they are charged with enforcing. Second, the federal government is in a far better position to investigate and regulate money transmission activity, both because the federal government has more resources, and because money transmission by its very nature crosses state lines. Third, in addition to being unconstitutional on their face and as applied, state MTLs are ineffective at both preventing illegal activity and protecting consumers. This is especially evident now that a number of well-publicized failures of and thefts from bitcoin exchanges have transpired. In effect, the state MTL patchwork forces consumers into the arms of criminals, some of whom are rich enough to possess licenses, but most of whom are not.

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6 See http://www.plainsite.org/flashlight/case.html?id=2334104 for docket information.

7 See http://www.justice.gov/opa/pr/2008/January/08_crm_068.html for more information.

C. Direct Conflicts with the United States Constitution in the Internet Age

Since the pioneers of traditional money orders began moving funds from place to place in the nineteenth century, the country has changed considerably. Today, the internet permits instant electronic funds transfers that until recently were inconceivable. Virtual currencies such as bitcoin are merely the latest iteration in the long history of electronic funds transfer, but are hardly novel from an accounting or regulatory perspective. Bitcoin's main notable attribute is the nature of its supply, which is to say that it is obtained through so-called "mining," or the computation of mathematical problems of increasing difficulty. Regulation comes into play because once mined, even despite the lack of a central authority to govern supply (which is fixed instead), a bitcoin can be exchanged for value electronically over the internet, just like a dollar on FaceCash or PayPal.

MTLs started to come into being on a state-by-state basis in the 1960s in response to localized crises involving fraud. Federal law bolstering those state laws, in the form of 18 U.S.C. § 1960, came into being in 1992 as part of H.R. 5334, the Housing and Community Development Act.[8] It was not until 1995 that the National Science Foundation allowed the commercialization of the internet, meaning that the majority of today's regulatory regime concerning money transmission is obsolete, failing to account for massive changes in market conditions.

Fundamentally, in an environment where money can and often does change hands electronically in the blink of an eye, whether across a distance measured in feet or thousands of miles from coast to coast, there is no role for state regulation. According to Article I, Section 8, Clause 3 of the United

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[8] Before and after the creation of 18 U.S.C. § 1960, several attempts were made in Congress to pass legislation that would have directed states to standardize money transmission laws, with the Treasury reporting to Congress on their progress. Such language is found in § 10 of H.R. 26, the Money Laundering Enforcement Amendments of 1991 ("Uniform State licensing and regulation of check cashing services."); § 7 of H.R. 3235, the Money Laundering Suppression Act of 1994 ("Uniform State licensing and regulation of check cashing, currency exchange, and money transmitting businesses."); and Title IV, § 407 of H.R. 3474, the Community Development Banking Act of 1994 (identical heading). Some of these bills passed in the House or the Senate, but not both simultaneously.

States Constitution (commonly referred to as the Commerce Clause) and court decisions rendered relatively recently such as *American Libraries Assn. v. Pataki*, 969 F. Supp. 160 (S.D.N.Y. 1997), it is within Congress's purview—and only Congress's purview—to regulate internet commerce.[9] The reason why can be illustrated with a simple analogy.

Commercial air traffic is regulated by the Federal Aviation Administration (FAA) because air travel almost by definition requires that aircraft cross state borders, and sometimes, international borders as well. Until the advent of the Global Positioning System, it was not always immediately clear which state a particular aircraft was in at any given time. Had states insisted on regulating the skies, airlines and pilots would have been subject to a system of regulatory chaos, endangering the lives of passengers.

Today, commercial internet traffic involving payments (also known as money transmission) is regulated by precisely such a system of regulatory chaos.[10] Virtual currencies aside, it is frequently unclear where a given sender or recipient of funds is physically located, even with available Internet Protocol (IP) address information; it is furthermore difficult to determine where the funds themselves, which are symbolic representations of value, are physically located. This problem is

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[9] Although Congress is permitted to delegate its authority to regulate commerce to the states, and Congress may have done so implicitly via 18 U.S.C. § 1960, its delegation power is curtailed by the fact that for purposes of regulation, the internet is a "national preserve." *American Libraries Assn. v. Pataki*, *supra*. Even if delegation to the states did occur, it took place three years before the existence of the modern internet, which has come to dominate money transmission—especially those "emerging" forms of money transmission the MTA now restricts. (FaceCash, in fact, completely *depends* upon the internet to transfer the image of each consumer's face to internet-connected cash registers.) Although Congress's delegation may have been legitimate in 1992 when it was hardly considering mobile payments, the heavy involvement of internet traffic today makes any supposed delegation presently unconstitutional.

[10] On June 21, 2012, Mr. Levine *and* one of his clients, Western Union, each appeared before the United States House Committee on Financial Services at a hearing entitled, "Safe and Fair Supervision of Money Services Businesses." The attorney-client relationship was not explicitly disclosed, nor were any technology companies heard from. At the hearing, both Mr. Levine and his client lamented the absurd complexity of the regulatory system that they built, and unsurprisingly encouraged Congress to do nothing but further entrench the role of the states.

exacerbated by the steady march of internet-enabled devices in the direction of mobility. Cellular mobile devices rely on networks with pooled IP addresses that do not reveal the location of a user. (Every iPhone and Android device on the Sprint network appears to be in Kansas, for example. BlackBerry traffic worldwide often seems to originate in Canada.) In addition, TCP/IP packets representing transactions cross multiple state lines routinely within milliseconds, millions (if not billions or trillions) of times per day. Accordingly, the burden on emerging money transmitters, who must comply with the arcane and anachronistic regulations of some forty-seven geographies who are themselves scarcely able to monitor such activity, is immense. The only way to effectively monitor a modern-day money transmitter is in real-time, electronically, which not one government agency actually does.

Therefore, states lack not only the legal jurisdiction and authority to regulate money transmission in the modern world; they also lack the expertise and equipment necessary to track it. That is part of the reason why some states that have MTLs have long admitted to prospective applicants that they do not even bother enforcing them unless an applicant has a physical presence in the state.

D. <u>Wasteful Spending</u>

On average, no state has more than one hundred registered money transmitters. (According to the DBO web site, California has roughly sixty-five, a relatively high number given the number of publicly-traded technology companies in the state. Of those sixty-five, nine are now or at some point have been connected to TMSRT.) Despite the small scale of each state's licensing program, each money transmitter is subject to a complex litany of requirements that the state agency charged with enforcing the law must monitor. Such monitoring, usually conducted quarterly, requires manpower, and that manpower costs money.

Furthermore, due to the sweepingly broad scope of MTLs and the aforementioned constitutional issues, keeping such laws on the books requires funding for state Attorneys General to defend against lawsuits challenging their validity. As previously mentioned, Think is presently engaged in one such federal lawsuit against the California DBO. Even though the MTA was largely written by enormous financial conglomerates, the law is actually defended by the California Attorney General *using taxpayer dollars*, making the extra budgetary strain on the state government particularly egregious. In effect, the large financial institutions (whose own legal budgets are plenty large) have figured out a way not only to protect their own economic interests, but to charge the taxpayer and the state for defending those interests in court as well.

Laws that cost society more than they benefit society fail the test for constitutionality set out by the Supreme Court in *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970). Here, the costs of money transmission laws are felt by countless consumers, businesses, and state governments. The benefits accrue to less than ten companies.

For all of these reasons, the Commerce and Consumer Affairs Committee of the State of New Hampshire House of Representatives recently concluded a study of a bill, H.B. 1700 (2012) that would completely repeal that state's own money transmission law, Chapter 399-G. As of October 2, 2012, the bill to repeal the law has been recommended for legislation in 2013 by a vote of 8 in favor, 3 against.

Before Mr. Levine and local attorney Marvin S.C. Dang began their extensive lobbying efforts in Hawaii on behalf of TMSRT in 2006, the Auditor of the State of Hawaii issued a report to the Governor and the Legislature of that state entitled, "Sunrise Analysis: Money Transmitters," regarding H.B. No. 2428 of the 2004 Regular Session. The report's conclusion was clear: "Money transmitters pose little risk of harm to consumers and the public. Some protections already exist, and regulation would likely benefit certain money transmitters more than consumers. We conclude that the bill should not be enacted."

Once TMSRT's Act 153 was signed anyway in 2006, the *Honolulu Star Bulletin* wrote about the new law, which was passed without Mr. Dang being able to cite even a single complaint about money transmitters:[11]

> "Sen. Gordon Trimble (R, Downtown-Waikiki) cast the sole dissenting vote against Hawaii's first regulation of the money transmitters industry because he said he felt it would raise costs for consumers and put some small operations out of business.
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> 'Many people chose to use unregulated money transmitters because they provide better service for a lower price,' said Trimble, who first got exposed to the cottage side of the industry while serving as a peace corps volunteer in the Philippines. 'This legislation is only going to force people to pay a lot more to send money home.'"

Today, as residents of the Philippines suffer the cataclysmic aftermath of Typhoon Haiyan, it costs more for Americans to send them much-needed funds than it otherwise would have, thanks to TMSRT's MTL.

Bitcoin exchanges especially are more risky than typical money transmitters because the use of bitcoin is presently limited for the most part to extremely high-risk goods and services such as gambling and illegal drugs. By design, bitcoin is also decentralized, which means that like cash stuffed in a mattress or a poorly-protected vault, it can easily disappear. Not a single bitcoin exchange is properly licensed nationwide in each state with MTLs; most exchanges have no state licenses at all. Many are located overseas to avoid MTLs entirely. This does not mean that all money transmitters are inherently high-risk or that bitcoin's risk profile will never change (it may or may not for a host of reasons). Rather, bitcoin's high risk profile should be viewed as the symptom of an ailing and outdated regulatory structure unable to adapt to changes in the market. If anything, bitcoin proves the need for a comprehensive federal money transmission regulatory framework that does

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11 See "New law regulates transmitters of money," Allison Schaefers, *Honolulu Star Bulletin*, June 7, 2006, http://archives.starbulletin.com/2006/06/07/business/story02.html.

not increase the risk to consumers by driving new technologies underground or out of business, and that is capable of keeping up with quickly-changing technological trends, whether they involve bitcoin or something new.

E. Distortions in the Competitive Market for Payments

1. Spotty Enforcement Causes a Tilted Playing Field

Except on extremely rare occasions, state agencies rarely take action against unlicensed money transmitters. If they do take action, not all states bother, because doing so would be require duplicative effort, and they instead allow one state agency to take the lead. This model is nonsensical. Even with coordinating groups such as the Money Transmission Regulators Association (MTRA) in place, it means that the same entity is often monitored by more than forty separate agencies so that only one may ultimately act, almost at random. State regulators proudly declare this to be evidence of coordination; really, it is evidence of a broken system with gaping holes that allows financial fraud and narcotics trafficking to go undetected.

It has been well known for years in the payments community that Dwolla, Inc., a company that purports both to be an "agent" of a credit union in Iowa, which it is not,[12] and a "mobile payments" company, which is true only from a purely technical perspective, mostly facilitated the exchange of bitcoins which were frequently used for illegal activity, such as buying and selling drugs on underground Tor sites such as The Silk Road. Not a single state regulator has ever taken any action against Dwolla, Inc., although the State of New York Department of Financial Services did issue Dwolla, as well as many other bitcoin-related entities, subpoenas in August, 2013 due to their lack of compliance with MTLs, which caused Dwolla to abandon its involvement with bitcoin as recently

12 See "Dwolla, Veridian CU Describe and Defend Their Strange Symbiosis," Bailey Reutzel, *PaymentsSource*, November 6, 2012, http://www.paymentssource.com/news/dwolla-veridian-cu-describe-and-defend-their-strange-symbiosis-3012326-1.html?zkPrintable=1&nopagination=1, also available at http://www.themembersgroup.com/news/tmg-in-the-news/dwolla-veridian-cu-describe-and-defend-their-strange-symbiosis/.

as October 28, 2013. Think is actively engaged in an unfair competition lawsuit[13] against Dwolla and many of these entities, which have, with the help of their venture capital and angel investors, knowingly exploited the regulatory chaos to profit from as much illegal activity as possible.

2. **Investors Who Cheerlead and Profit From Criminal Activity**

Some of these investors have been forthright about their views on financial regulation: they believe that MTLs are simply a game where the potential rewards of "winning" far outweigh the costs. At an invite-only dinner that was videotaped, Marc Andreessen, principal of the leading venture capital firm Andreessen Horowitz that has invested millions upon millions of dollars in illegal money services businesses, gleefully recalled the advice of his lawyer on the topics of bitcoin and its regulators, "The good news is they're going over who gets to regulate it. Um, and so your job is to *sneak through the fight*, while they're battling it out to see who's in charge!" (emphasis added). Laughter ensued.[14]

Yishan Wong, an early PayPal, Inc. employee well-versed in the complexity of MTLs, Chief Executive Officer of Reddit, and an angel investor in at least one money services business, stated publicly on March 2, 2011, "if you are a startup who feels that the violation of a law (or an excursion into a grey and questionable/undefined area of the law) will allow you to create a business that provides enormous value to people, the tactically wise thing to do is to move forward and try to build the business. Moreover, if your business is not doing something morally egregious (e.g. killing people) but simply violating the law in a somewhat more minor way, the officers of the company bear little more risk than the company being sued out of existence..."[15]

Mr. Andreessen's and Mr. Wong's views are shared by an overwhelming majority of wealthy

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13 For docket information see http://www.plainsite.org/flashlight/case.html?id=2434524, Case No. 5:13-cv-02054-EJD, Northern District of California.

14 See http://pandodaily.com/2013/10/03/andreessen-bitcoin-is-like-the-early-internet/.

15 See Yishan Wong's answer to "Airbnb: Why has Airbnb not been sued or regulated out of existence?", https://www.quora.com/Airbnb/Why-has-Airbnb-not-been-sued-or-regulated-out-of-existence.

technology investors who have placed investments in the most popular brands in the payments space. In private conversations, some have confided that although they believe federal regulation of money transmission is the right and only answer to the problem of inconsistent, ineffective and onerous state MTLs, they will not speak up, effectively because the potential profits to be made from simply ignoring the current, broken system are too lucrative to sacrifice. The fact that consumers and their law-abiding competitors are injured by their deliberately unlawful approach does not concern them in the least. The message from these respected investors is clear: success at any cost is fine; laws are for other people.

3. <u>"Consultants" Who Were "Regulators" The Day Before</u>

At least in California, it is not a mere coincidence that enforcement of MTLs had been so spotty and lackluster while high-profile startups with millions of dollars publicly announce their intent to violate the law practically weekly. Consulting firms such as Promontory Financial Group lead the way in helping their elite clients evade MTLs. The most glaring example of this was visible on October 17, 2013 when the Financial Women of San Francisco held an event called "New Payments Networks and Virtual Currencies: Are They the Future of Payments?" at which virtual currency entrepreneurs from Ripple Labs, Coinbase and Dwolla presented their views on a panel. (Dwolla cancelled at the last minute.) All three companies, none of which have even applied for a license under the MTA in California (making their founders and investors federal felons), share more than just an interest in financial technology—they also have a common investor: Andreessen Horowitz. The panel's moderator was none other than William Haraf, until recently Commissioner of the California DFI, on whose watch the MTA was implemented. Mr. Haraf is now Managing Director at Promontory Financial Group. It was suggested by a former Promontory Director in attendance at the event that the panelists were also Promontory clients. That individual was a former Director, and not still a Director, because he had been forced to resign from Promontory when he decided to join the team at one of the panelist's companies, a Promontory client, which focuses on virtual currency.

F. Redundancy

The federal prosecutors who most often handle cases involving complex financial crimes already have an arsenal of statutes at their disposal. State MTLs, and even Section 1960, are rarely invoked and generally redundant in the context of these other statutes. Covering a roughly twenty-year period, nationwide case data from PlainSite (http://www.plainsite.org) show:

- **18 U.S.C. § 1341 (Frauds and swindles):** 3,545 cases
  See http://www.plainsite.org/laws/index.html?id=14176
- **18 U.S.C. § 1343 (Fraud by wire, radio, or television):** 2,591 cases
  See http://www.plainsite.org/laws/index.html?id=14178
- **18 U.S.C. § 1956 (Laundering of monetary instruments):** 3,306 cases
  See http://www.plainsite.org/laws/index.html?id=14422
- **18 U.S.C. § 1957 (Engaging in monetary transactions in property derived from specified unlawful activity):** 756 cases
  See http://www.plainsite.org/laws/index.html?id=14423
- **18 U.S.C. § 2314 (Transportation of stolen goods, securities, moneys, fraudulent State tax stamps, or articles used in counterfeiting):** 915 cases
  See http://www.plainsite.org/laws/index.html?id=13668
- **31 U.S.C. § 5324 (Structuring transactions to evade reporting requirement prohibited):** 354 cases
  See http://www.plainsite.org/laws/index.html?id=30138

Compare these figures to:

- **18 U.S.C. § 1960 (Prohibition of unlicensed money transmitting businesses):** 66 cases
  See http://www.plainsite.org/laws/index.html?id=14426

Of the few cases invoking Section 1960, many already invoke at least one of the other statutes listed above. Clearly, prosecutors can still easily do their jobs when it comes to financial crime without state money transmission laws. Most would likely agree that their jobs would be easier with a single, updated federal statute.

G. Surety Bonds are Ineffective, Inefficient and Costly Insurance Mechanisms That Will Become Increasingly Insufficient with the Rise of Mobile Payments

A money transmitter wishing to do business in the United States of America must presently pay for almost fifty surety bonds of varying amounts with a total worth of approximately $20 million—annually. Even at a premium rate of 5%, this represents a $1 million annual expenditure. Aside from being impossible to afford for most startups, who might be lucky to raise a fraction of that amount in angel or venture capital financing, the insurance mechanism doesn't even make sense.

The California MTA's maximum bond requirement is $9 million according to Financial Code § 2037(f), which explicitly combines the $2 million maximum for "stored value" with the $7 million maximum for "receiving money for transmission." Aside from the fact that these numbers are totally arbitrary, they are also far too small. A large money transmitter such as PayPal holds far more than $9 million in consumer funds. If PayPal's parent company, eBay, Inc. were to suffer a sudden collapse for whatever reason, the funds held by PayPal's customers would be mostly uninsured. PayPal customers would be lucky to receive pennies on the dollar.

Contrast this to FDIC insurance, which presently covers every bank account in the United States up to $250,000. All banks pay premiums to the FDIC based on risk, and those pooled premiums serve as insurance. This system works because the risk of one bank failing is spread out across all banks.

For money transmitters, each entity is required to shoulder the full burden of its own potential failure. Even though an insurance provider backing surety bonds can collect premiums from multiple money transmitters, offsetting that *provider's* own risk, this does little to offset the risk to *customers* of any one failure, because the bonds only insure one party each.

In short, the surety bond system used in place of FDIC insurance for money transmitters is hardly more than smoke and mirrors. It offers too little protection for large players, and is prohibitively expensive for vastly over-insured small ones. And for customers of the riskiest entities who have no licenses, e.g. bitcoin exchanges, it offers no protection at all.

As mobile payments and virtual currencies (and therefore money transmission) become more prevalent, more money will be entrusted with money transmitters, and less with chartered banks. *Under the current model, surety bonds alone, in any amount, will not be able to adequately protect increasing amounts of funds.* Government officials at all levels ignore this inevitable trend at their own peril.

H. Capital Requirements Have Been Repeatedly Proven Ineffective as Regulatory Safeguards in Non-Banking Contexts

Banks (which have the option of obtaining national charters) require minimum levels of capital because they make loans. If too much money has been loaned out at the same time by a bank and there is a spike in demand for deposits on hand at that bank, a run can result, leaving the bank insolvent.

Money transmitters do not make loans. Money transmitters therefore do not suffer from the same type of problem as banks, and capital requirements must be evaluated in a different light. Every dollar entrusted to a money transmitter is available to its holder at all times. The key regulatory objectives are merely ensuring that customer funds are not co-mingled with the money transmitter's operational funds, and that customers have access to their funds as needed. In essence, maintaining the distinction between consumer accounts and operational accounts is a matter of good record keeping.

Nonetheless, ignoring this logic, many (but not all) money transmission laws regulate commercial activity on the basis of surety bonds, as previously discussed, and capital requirements. The conventional wisdom is that financial institutions with greater levels of capital are more trustworthy.

Simply put, this conventional wisdom is wildly wrong.

One only need recall the events of 2008 to see that capital amounts in absolute terms (as opposed to reserve ratios) only go so far. The creditors of Lehman Brothers, an entity once managing $600 billion of assets, were hardly protected by the firm's immense reserves of capital when it declared bankruptcy on September 15, 2008. Bear Stearns suffered a similar fate. Bernard Madoff's investment firm had many millions of dollars in its accounts before it was discovered to be a Ponzi scheme of unprecedented scale.[16] Although these entities were not money transmitters and in many cases used leverage to attempt to bolster their returns, extremely large companies such as MF Global (with $41 billion in total assets and $39.7 billion of debt according to its bankruptcy filing)[17] and Peregrine Financial Group operated much more like money transmitters (not making loans) and suffered the same fate.[18] Yet financial regulators continue to place trust in capital alone when it is a totally irrelevant factor for money transmitters.

At least in the case of MF Global, wire transfers of *hundreds of millions of dollars* were made without any regulators noticing that customer funds and operational funds were being co-mingled.[19] Were MF Global a money transmitter instead of a futures brokerage, under the MTA, it would have had no problem obtaining a money transmission license given the original written $500,000 tangible

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[16] MTLs are also flawed in that they rely heavily on third-party audits to assess capital levels, *paid for by the applicant, the same entity being audited*. This perverse incentive structure gives the auditor a strong desire to please its customer, not the government, lest it not get paid. It partially explains how Madoff was able to hide his fraud for so long. It also makes compliance that much more expensive: Think paid $18,000 for useless MTA audits.

[17] See "MF Global Holdings Amends Agreement to Use JPMorgan Cash," Tiffany Kary, *Bloomberg*, http://www.bloomberg.com/news/2012-09-07/mf-global-holdings-amends-agreement-to-use-jpmorgan-cash.html.

[18] See "MF Global redux as regulator says PFGBest client funds missing," *Reuters*, July 10, 2012, http://www.reuters.com/article/2012/07/10/us-broker-pfgbest-mfglobal-idUSBRE86905120120710.

[19] See "Investigators Scrutinize MF Global Wire Transfers," Azam Ahmed and Ben Protess, *The New York Times*, February 26, 2012, http://dealbook.nytimes.com/2012/02/26/investigators-scrutinize-mf-global-wire-transfers/.

net worth requirement, or even the unwritten $1 million-plus tangible net worth requirement. Nonetheless, its management would not have been any more trustworthy.

This all goes to show that there is no relationship between capital and trust. Even if such a relationship did exist, the actions of large banks in the 2008 financial crisis suggests that it would be inverse and certainly not strong enough for policy to be based on its existence. Therefore, basing the licensure process on absolute amounts of capital, as most MTLs do, accomplishes nothing except to discriminate against small firms just starting out who inevitably cannot meet the requirements on day one of business.

I. <u>The Domino Effect</u>

Virtually every state money transmission application asks the applicant to present a list of all other states in which licenses have been obtained or applied for. Rejections must also be noted, often in answer to a yes-or-no question asking whether the applicant has ever been rejected for a money transmission application in any other state. If the answer to this question is "yes," then the chances that the instant application will also be rejected increase dramatically. (This question is often next to other questions concerning whether any of the applicants' officers have criminal records.)

As a result of the domino effect, applicants cannot risk applying for licenses in states where it seems possible that their application might be rejected for any reason, including insufficient capital. Applying anyway could easily and irreversibly jeopardize that applicant's chances at doing business nationwide.

J. <u>Nervous Banks</u>

Many bitcoin exchanges are poorly-run, fly-by-night operations that should not be able to obtain banking services in the United States. Yet many money transmitters having nothing to do with virtual currency are legitimate, and these companies also increasingly have trouble obtaining banking services. Banks are required to comply with the Bank Secrecy Act (BSA), and many fear penalties for associating with the wrong money transmitters given the regulatory complexity inherent in the present system.

K. Criminalization of Legitimate Entrepreneurship

Perhaps the most counter-productive aspect of Section 1960 is part (a), which reads:

> Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business, shall be fined in accordance with this title or imprisoned not more than 5 years, or both.

In effect, while the CEOs of failed banks that caused the 2008 financial crisis walk free, entrepreneurs trying to improve upon the enormous mess they have left behind are told that if they do not comply perfectly with forty-seven incredibly confusing and contradictory state laws (as explained in part (b)), they might well go to jail, along with their investors, directors, and even shareholders. Never has there been such a stark disincentive to enter an industry.

The fact that failing to comply with *any* state law is a federal crime, combined with the naturally interstate nature of money transmission, means that compliance with *all* state laws is required at all times, even if it is not clear which states regulate which aspects of commerce (which it is not, as applicants for licenses are frequently told to write to state agencies for determination letters, which can take months or years to receive). Compliance with even a few state laws can be prohibitively expensive for a new entrant, which typically must hire an army of lawyers to explain forms, compile documentation, assemble notarized affidavits, etc.

In the end, the result is that fewer law-abiding entrepreneurs have any interest in entering an industry where punishments are plentiful and rewards are hard to come by. Suffice it to say that PayPal would not have been able to succeed as quickly as it did, if at all, had a law such as the MTA existed in California in 1999. (Those MTLs that did exist ended up being an enomous challenge for PayPal in its early days.)

Most states are hardly in a position financially to crush non-polluting, efficiency-driving businesses who hire workers and pay taxes. Yet that is exactly what they have done with MTLs.

L. The Money Services Round Table Presents MTLs to State Legislatures Under the False Pretense of "Consumer Protection"

That the interests of large financial companies are really the motivating force behind MTLs' myriad restrictions is self-evident from the bulleted prospectus that Mr. Levine and his colleagues supplied to the California DFI in late February, 2010. Under the bold heading of "ADVANTAGES," this unsigned document on no letterhead states that the new proposed law would reduce administrative burden for DFI and "industry;" would bring California's financial laws "into the mainstream;" would give DFI more power (to harass the competitors of TMSRT's members); and apparently reflects "a DFI-Industry consensus." This last statement is blatantly false unless the capitalized "Industry" is a code word for TMSRT. Consumers are mentioned only in passing as the supposed beneficiaries of additional disclosures required by statute "with regard to emerging electronic technologies"—obstacles clearly targeted at technology startups that naturally threaten TMSRT members.

Conspicuously missing from TMSRT's bulleted list was a mention of any specific event or reputable study (or any study at all) that would have suggested that more state MTLs were necessary in the first place. This is because the MTA represented nothing more than a naked power grab on behalf of both TMSRT and the DFI.

This is not to say that consumer protection is not a legitimate state interest, for it clearly is. Unfortunately, the MTA and other MTLs lack any effective means by which consumers would actually be protected, and even if they did contain such effective means, state regulators have shown time and again that they have little to no intention of actually enforcing the law in a manner that would protect consumers.

M. Some MTLs Are So Broad as to Encompass Virtually All Aspects of Routine Commerce

Under the California MTA, every law firm that maintains a trust account or remits funds to government agencies on behalf of clients is a money transmitter. Every payroll company that drafts and holds onto client funds is a money transmitter. (Consequently, the payroll industry lobbied for an exemption from the MTA and got one in October, 2013.) Every private university that operates a pre-paid debit system for students, allowing them to purchase goods and services at on-campus third-party merchants, is a money transmitter. Every construction company, real estate agency, escrow service, and political donation aggregator is a money transmitter. The definition of "money transmission" in Financial Code § 2003(o) is so absurdly broad as to encompass much of the daily activity that keeps California's economy running. Of course, a good number of technology startups are also unwittingly money transmitters under this definition, even if their core business has nothing to do with payments.

Almost none of these types of entities listed above have licenses, let alone licenses nationwide; after all, California only has sixty-five licensed companies[20] with the MTA having been in effect for slightly more than two years. Meanwhile, as the MTA claims to regulate everything, the DBO does almost nothing to enforce it, save for threatening those prospective applicants who dare to ask questions.

N. MTLs Are Completely Inconsistent with Each Other

Despite the nominally common goal of consumer protection, MTLs each have requirements that are considerably different. There does not appear to be any particular logic to the original or amended

[20] This represents $325,000 of application fee revenue for the DFI, enough to cover the salary and benefits of only 1-2 bureaucrats to oversee the program. Yet the sacrificed tax revenues are in the tens of millions.

figures in the MTA ($500,000, amended to $250,000[21]; $2 million; $7 million) except that they are big, round numbers.

In contrast to the California MTA's original $500,000 (but really not) minimum tangible net worth requirement and $750,000 aggregate surety bond requirement, Alabama requires $5,000 in minimum tangible net worth and a surety bond anywhere from $10,000 to $50,000. The MTA's non-refundable application fee is $5,000; in Alabama, the total fee is $500.

Ohio requires a minimum net worth of $25,000 but a $300,000 surety bond. Oregon requires $100,000 in net worth but a $25,000 minimum surety bond—except that it defines "money transmission" in a way that exempts payment processors such as FaceCash.[22] Maryland's application fee changes depending upon whether one applies in an even-numbered or odd-numbered year.[23] Clearly it is impossible to find much consistency between the various laws, but even given the variation built into the regulatory regime, the MTA is an order of magnitude more expensive to comply with, and therefore more restrictive. Unfortunately in these circumstances, Silicon Valley is in California.

State laws that are completely inconsistent with one another are often found to be unconstitutional by federal courts as they tend to impede interstate commerce.

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21 With Assembly Bill 786 (2013), in response to pressure from Think and others, the California legislature decided to lower the MTA's minimum tangible net worth requirement by half. Then it gave the DBO the statutory power to raise it up again to infinity, based on any factor at all, accomplishing nothing.

22 According to FinCEN, money transmitters are distinct from payment processors. Even though this distinction is embodied in the Code of Federal Regulations, the DBO and certain other state agencies choose to actively ignore it. See FinCEN Rulings 2003-8; FIN-2008-R005; FIN-2009-R001; and FIN-2009-R004.

23 See "Held Hostage: How the Banking Sector Has Distorted Financial Regulation and Destroyed Technological Progress," Aaron Greenspan, Think Computer Corporation, August 15, 2011, http://www.thinkcomputer.com/corporate/whitepapers/heldhostage.pdf.

II. Think's Experience in California

A. State Regulators Abused Their Discretion Under the MTA

Both before and after the passage of California Assembly Bill 786, which Governor Brown signed into law in October, 2013, the MTA gave, and now to an even greater extent gives, the DBO *carte blanche* to do whatever it wants with respect to money transmission licensure. Applicants are now to be assessed on the "quality of their management" (whatever that means) and "any other factor," according to the statute. The issuance of licenses can be put on hold for up to a year, giving an applicant's competition more than enough time to gain traction illegally. Or, as happened to Think, applicants can be told that they will simply never be granted a license, no matter what—but that they could try applying anyway, so long as they remember that the application fee is non-refundable.

1. The DFI Invented Its Own Set of Illegal Underground Regulations Not Subject to a Notice and Comment Period in Violation of California Government Code § 11346.8(c) and 1 C.C.R. § 44

Relying on what he called his "personal experience," DFI Deputy Commissioner Venchiarutti explained at Think's mandatory pre-application interview, held at the DFI's San Francisco office on June 14, 2011, that the MTA gave him unbridled discretion to set the tangible net worth requirement as high as he desired so long as it exceeded the $500,000 statutory figure. During the meeting, he cited a minimum net worth requirement of $1 million, $2 million, $20 million, and as high as *$80 million* as potentially necessary to obtain a license. When Ms. Eileen Newhall, Staff Director of the California Senate Banking, Finance and Insurance Committee inquired again on behalf of Think after the meeting, the Deputy Commissioner told her that the number was $1.5 million, but did not put this statement in writing. Without clarity as to the *actual* threshold used to evaluate applications, Think was unable to apply for a license without running a significant risk of rejection that would ultimately trigger irreversible nationwide ramifications, due to the aforementioned domino effect.

Although the Commissioner (or practically speaking, the Deputy Commissioner) can increase the tangible net worth requirements on any given licensee pursuant to Financial Code § 2081(b), there is no direct oversight mechanism that would prevent a DBO Commissioner or subordinates from picking "favorites" and selectively raising the capital requirements of particular companies for little to no reason at all, as the DBO appears to already be doing.

Courts tend to look rather unfavorably on statutes that grant unfettered discretion to bureaucrats, or even elected officials. "We hold those portions of the Lakewood ordinance giving the mayor unfettered discretion to deny a permit application and unbounded authority to condition the permit on any additional terms he deems 'necessary and reasonable,' to be unconstitutional." *City of Lakewood v. Plain Dealer Publishing Co.*, 486 U.S. 750 (1988).

After Think filed suit against the DFI, an undated "Money Transmitters FAQ" page spontaneously appeared on the DFI web site to supposedly clarify the following (emphasis added):

> "**Q.** What is the capital requirement?
>
> **A.** The capital requirement *varies based on the licensee's plan of operation and risk profile*. The amount of tangible net worth stated in the Financial Code, $500,000, is *not* the amount required for licensing, but rather the *minimum* allowed for existing licensees. A new licensee would typically be required to have more tangible net worth, *at least* $1 million, to offset the *expected losses* of a new transmitter and support its operational needs at all times."

The DBO therefore pre-supposes that all applicants will immediately lose more than $1 million. This is simply not so. The web page has since been modified and this language has been removed.

When questioned by Magistrate Judge Howard R. Lloyd about the ever-changing requirements for licensure during oral argument on April 17, 2012, according to the official transcript Deputy Attorney General Ryan Marcroft, representing the DFI, stated, "As far as that issue goes, it's kind of a confusing issue, it was to me at least."

In essence, the DBO's interpretation of the MTA requires that applicants pay a non-refundable fee of $5,000 and risk nationwide rejection *before* learning what the requirements even are to apply for a money transmission license in California. This is a gross perversion of due process, rendering the MTA unconstitutional for yet another reason.

Think is not the only company that has expressed concern over the DBO's handling of the MTA. On July 23, 2013, Thomas P. Brown, an adjunct faculty member at the University of California, Berkeley School of Law and partner in the San Francisco office of Paul Hastings LLP (who has testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs about mobile payments and happens to represent many of the unlicensed entities that Think is suing), quietly filed a petition with the California Office of Administrative Law ("OAL") expressing concern that the DBO was attempting to enforce underground regulations. He cited Think's experience but added his own concerns as well. According to counsel at OAL, Mr. Brown withdrew the petition just before the OAL would have issued an acceptance or denial, after a private telephone conversation in which DBO officials promised to issue regulations concerning the MTA. In this conversation, the DBO claimed that it was "unaware" that it had to issue formal regulations, even though this had been a major topic of concern at the March, 2013 oversight hearing before the California General Assembly Committee on Banking and Finance at which the then-DFI Commissioner testified and at which Deputy Commissioner Venchiarutti was present.

2. <u>The DBO Has Threatened to Bankrupt Applicants via the Audit Power Granted by the MTA</u>

In the past, the DFI has specifically threatened that it can abuse its audit power pursuant to Financial Code § 2120 to drive an applicant into bankruptcy if that applicant attempted to apply for a license and managed to somehow be successful in obtaining one. Undoubtedly, the DFI was referring to the fact that licensees are required to pay for the "reasonable costs" of audits. (Of course, no cost is really reasonable because such audits could be conducted for the most part electronically at no cost if the regulator were properly equipped to regulate modern money transmission.)

3. The DBO Bases Policy on a Magic Number with No Foundation

As the basis for many assertions and rationales, then-DFI personnel stated that as a rule it took three years for money transmitters to become profitable. These staff members offered no justification for this arbitrary figure other than personal experience. The three-year rule was repeated in discussions between Think and DBO Senior Counsel Tony Lehtonen. No authoritative source for the rule was ever provided.

B. The MTA's Geographic Scope is Unconstitutional On Its Face and As Applied

On October 13, 2011, in response to Think's repeated inquiries about the actual tangible net worth requirement and the potential liability that Think would assume as a California company conducting *licensed* money transmission activity outside of California (in Alabama and Idaho specifically, where Think held valid licenses), the DFI issued an Order exempting Think from the MTA so long as it effectively promised not to do business as a money transmitter in California. This necessarily implies that the MTA polices the entire United States of America outside of California, which is not possible or permissible given that the MTA is a state, and not federal, law.

To the extent that any state MTL polices money transmission activity anywhere outside of its respective jurisdiction, that MTL is unconstitutional.

C. The DBO Has Enforced the MTA in an Arbitrary and Capricious Manner

Adding insult to injury, the DFI seems indifferent toward the countless companies violating the MTA on a daily basis.

1. The DBO Has Failed to Respond to Formal Complaints

Think filed no less than thirty-four (34) different formal complaints with the DFI in November, 2011, referenced in the lawsuit. No action that has been made public has resulted from their investigation. Namely, many of the startup companies conducting money transmission in California in violation of the MTA are still conducting money transmission in California in violation of the MTA. Meanwhile, Think's inability to operate FaceCash means that its competitors have an unfair advantage in the marketplace. Think intends to re-start FaceCash once a viable regulatory framework is in place, but when that happens, it will find the market already saturated by companies who deliberately broke state and federal laws for years to achieve their positions of dominance.

The DBO has now had a full two years to act since the complaints were filed in or before November, 2011.

2. The DBO Has Made False Statements to the Press Concerning the Existence of the Complaints

In a July 11, 2012 article by Owen Thomas on the *Business Insider* web site entitled, "This Innovation-Killing California Law Could Get A Host Of Startups In Money Trouble" (http://www.businessinsider.com/california-money-transmitter-act-startups-2012-7), DFI spokesperson Alana Golden was quoted as saying, "Thankfully, none," in response to the reporter's question about how many formal complaints the DFI had received about unlicensed money transmitters. Ms. Golden's statement is demonstrably false.

Approximately two months prior, on April 17, 2012 at oral argument, Deputy Attorney General Marcroft stated, "Well, to answer Your Honor's question, my client mentioned this morning they are looking into those complaints," in response to the Judge Lloyd's question as to what had happened to Think's thirty-four formal complaints.

3. The DBO Granted License Applications in Record Time to Entities in Active Violation of the MTA While Delaying Others

Facebook Payments, Inc., a wholly-owned subsidiary of Facebook, Inc. began conducting money transmission through its Facebook Credits program sometime in early 2011, but did not apply for a money transmission license until after Think filed a formal complaint about its activity in November, 2011. This is significant insofar as Facebook missed the application cutoff date of July 1, 2011 prescribed by Financial Code § 2172(a)[24] that would have allowed it to continue operating legally as a money transmitter. In other words, it broke the law, fully aware of its existence.

Nonetheless, the DFI looked the other way, ignoring Facebook's illegal activity, and approved its application for a license in just three months, leaving plenty of time before the company's initial public offering in May, 2012 when it would undergo extreme scrutiny by the United States Securities and Exchange Commission. A cursory review of public records concerning license applications reveals that most are not approved within less than six months, while many take a full year (or two years) to review. Since there are no published standards outlining the DFI's application review process, it is not clear why such discrepancies exist. At an oversight hearing before the California Assembly Committee on Banking and Finance in March, 2013, former DFI Commissioner Teveia Barnes claimed that the agency's internal target for application processing is 90 days, but there is absolutely no evidence of such a policy in the actual data. Former Commissioner Barnes also stated, "we don't treat every applicant—it's really an art form in the sense that we don't treat every applicant exactly the same."[25]

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24 According to the official text provided by the State, Financial Code § 2172 was not properly re-numbered, and still references pre-2012 section numbers in the text of the statute itself.

25 See http://www.plainsite.org/flashlight/download.html?id=31313747&z=395adb4e, Case No. 5:11-cv-05496-HRL, Docket No. 47, Page 46.

D. The DBO's Own Lawyers Are "Appalled At" the MTA

In speaking with Think, DBO Senior Counsel Tony Lehtonen remarked that he was surprised by the reasonableness of Think's requests. On September 13, 2011, he admitted that his own personal view, shared by other legal staff, was that, "We have been appalled at the new law. Even though some of us may have been complicit in it, the view from Legal is: what are we doing here?"

On October 17, 2011, Mr. Lehtonen refused to communicate with Think any further, despite his earlier promise that he would be glad to talk any time. Given the DFI's open hostility, this left Think with no channels of communication to its financial regulator.

E. The MTA and DBO Have Engendered a Culture of Fear, Making Money Transmission More Dangerous

Institutional investors are not the only ones who have taken note of the DBO's arbitrary and capricious actions with respect to the MTA, not to mention the Byzantine and draconian nature of the MTA itself. Entrepreneurs are very much aware of the DBO's antipathy towards their work on improving payments. Consequently, those entrepreneurs most affected by the MTA are afraid to come forward, for those who identify themselves are most likely to be targets of reprisals (as Think has been).

Further aware of the DBO's lackluster record in enforcing the MTA, many entrepreneurs also correctly calculate their risk of being prosecuted for running an unlicensed money transmission business as being low if they simply stay quiet, and proceed with money transmission activities regardless. This has the ironic effect of endangering consumers, who may be able to turn to the DBO for help with a handful of giant, licensed conglomerates, but not for help with most other smaller businesses of which the DBO is unaware. For example, in the past few months alone, several unlicensed bitcoin startups have cost consumers hundreds of thousands, if not millions, of dollars.

Were there reasonable federal money transmission regulations in effect, these consumers might have some recourse, but alas, they do not.

Ironically, the 2006 version of Mr. Levine would agree here. As he wrote in that same comment to FinCEN and the Federal Reserve in which he disclosed TMSRT's members, "The bottom line is that from the standpoint of law enforcement and for national security, it is far better for all financial transactions to be conducted through legitimate financial institutions rather than illicit operators who maintain no transaction records accessible to law enforcement, file no reports and have no BSA compliance costs. Therefore, neither law enforcement nor the overall security of the United States is served by promulgating regulatory requirements which have the effect, at least insofar as MSB customers are concerned, of driving funds underground by providing an unintentional incentive for customers to use these illicit channels."

This is exactly what Mr. Levine's state MTLs do. They raise prices on the services provided by "legitimate financial institutions" and render all other channels "illicit."

III. <u>Proposed Solutions</u>

A. <u>Federal Harmonization of MTLs</u>

As described herein, state MTLs are fundamentally flawed and cannot be salvaged, nor would there be any point in trying to do so. No level of surety bonds or capital requirements can actually keep consumers safe; insurance only truly works in pooled networks. What *will* ensure that consumers funds are in safe hands are comprehensive background checks, character assessments, and real-time electronic auditing of money transmitters by a federal agency that collects insurance premiums *based upon the quantity of deposits held in trust*. There is no role for any state in such a regulatory regime, just as there is no role for any state in policing interstate commercial airline travel.

Notably, the steps for starting a money services business in Canada are much more straightforward, and Canada is hardly known as a hotbed of financial crime. It requires registration with one federal agency, the Financial Transactions Reports Analysis Centre (FINTRAC). There are no up-front fees, no surety bonds, and no capital requirements for money transmitters to register.

Here in the United States, the Consumer Financial Protection Bureau (CFPB) has expressed an interest in regulating non-banking entities such as money transmitters on a federal level. FinCEN already coordinates the registration of money services businesses for Bank Secrecy Act purposes. The FDIC has considerable expertise in the area of financial account insurance. Congress should choose an agency to house the comprehensive regulatory framework needed to manage money transmitters, including virtual currency operators, in a responsible manner reflecting the concerns raised in these comments, as soon as possible.

B. Virtual Currencies Should Not Be Regulated Separately

Recently the State of New York Department of Financial Services proposed a new kind of separate "BitLicense" for virtual currency operators. The notion that specific branches of mathematics should require licensure under any regime is ludicrous. Furthermore, the regulatory landscape is already unfathomably complex. New York's proposal, however well-intentioned, would only worsen an already serious problem and achieve very little to help protect consumers. Separate regulation might give entrepreneurs perverse incentives to classify their financial products as "virtual currency" products just to fall within or outside of a more or less favorable regulatory regime. It may very well also prove useless, as technology could quickly move on from bitcoin as we know it today. The abrupt rise in the price of one bitcoin, even factoring in the system's deflationary design, suggests that a combination of market manipulation, media hype and general confusion may be fueling a spike in interest that is not necessarily warranted given the technology's extremely sparse uptake and severe security limitations. Bitcoin is one of the few financial technologies developed wherein it is possible to actually delete one's wallet by mistake.

C. Money Transmitter Deposit Insurance Should Be Modeled Upon the FDIC

For these reasons and others, it is true that virtual currency operators have a higher risk profile than most other money transmitters. The sensible approach to this problem would be to multiply the premium paid into an FDIC-like insurance pool by such high-risk entities (whether bitcoin exchanges, on-line casinos, or otherwise) for money transmitter deposit insurance. In other words, using arbitrary figures for illustrative purposes only, low-risk money transmitters might pay in \$0.005 per dollar held for deposit insurance, while high-risk money transmitters might pay in \$0.05 per dollar held. Risk would be best defined by federal agency regulations in order keep up with changing technology.

Deposit insurance up to a limit of \$10,000 (as opposed to the \$250,000 FDIC/NCUA limit) should be more than sufficient for most money transmitters' client accounts.

D. Stop The Revolving Door

The actions of "consulting" companies such as Promontory Financial Group are inexcusable. Former senior-level financial regulators should not be permitted to earn salaries for helping their clients evade the laws they enforced only weeks or months before. Congress should specifically outlaw such activity for at least a period of ten years and impose severe criminal penalties for former financial regulators who hope to profit from helping others evade or outright violate the law.