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Lawbitrage

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In itBit We Trust

Since their inception, Bitcoin exchanges have operated under a fog of legal uncertainty. Last week, just one day after the New York-based exchange itBit announced obtaining a banking law charter giving it the ability to operate in all 50 states, a California official called that into question.

Almost every state has its own licensing requirements for traditional money transmitters that include payment processors and money transfer firms like Western Union. The safe but costly route for Bitcoin exchanges would be to obtain a license in each state that requires it for digital currency firms. But it's unclear which do.

Texas, for example, stated that transmitting digital currencies like bitcoin doesn't require a license in its state. Other states, like New York and California, are still in the midst of passing digital currency-specific licensing requirements, making it a question of what Bitcoin exchanges should do until those licensing laws are finalized. The prominent and reputable Bitcoin exchange Coinbase, for example, was operating in New York and California without a license in either state—and probably didn't need one.

itBit was able to bypass much of the uncertainty about being required to obtain state money transmitter licenses. It accomplished this by obtaining a trust charter under New York banking law, which is generally required of exchanges in the state.

Under New York law, a trust company is a type of banking organization that is technically distinct from a bank. A trust company has all of the powers of a bank to take deposits and make loans, and also certain fiduciary powers such as acting as an agent for governmental bodies. Firms organized as trust companies in New York include the derivatives clearinghouse Ice Trust, the wealth and asset manager Northern Trust, and the FDIC-insured bank Stuben Trust.

itBit, in particular, is authorized as a limited purpose trust company. This means it is not allowed to make loans or take deposits. To obtain the charter, itBit had to meet the very strict requirements of ordinary New York chartered commercial banks and subject itself to ongoing oversight. However, itBit is not required to obtain insurance from the Federal Deposit Insurance Corporation (FDIC), and it is subject to a much lower level of minimum capital--\$2 million versus at least \$50 million for a commercial bank.

Despite being organized under New York's banking law, itBit is not a bank in the ordinary sense and is not regulated by any federal banking authority such as the Federal Reserve or the FDIC. Being regulated as a bank would be too expensive and require a level of regulation and oversight ill-suited for a digital currency exchange.

itBit does, however, indirectly provide FDIC insurance to its clients' dollars by holding them at a separate FDIC-insured bank. itBit might be subject to some degree of FDIC oversight or compliance obligations indirectly, but that depends on how closely itBit and its banking partner work together. Bitcoin firms Coinbase and Circle similarly provide FDIC insurance to their customers' dollar accounts.

With a trust charter under New York banking law, itBit is basically in the clear when it comes to needing a state license to operate as a money transmitter.

Under New York's traditional money transmitter statute and its pending Bitlicense, a company chartered under its banking law does not need a license. Nationally, states generally don't require a firm chartered under another state's banking laws to get a money transmitter license.

For example, moving across the Hudson River, New Jersey excludes any federal or state chartered bank from being required to get a money transmitter license in its state, and defines a bank to include a trust company like itBit. Moving westward, things get easier: Illinois is explicit about excluding trust companies chartered in any state from needing a money transmitter license.

But it's when we get out to California that things get a little gnarly.

California does not require a money transmitter license for trust companies authorized under California law. But unlike New Jersey or Illinois, that statutory exemption does not explicitly apply to out-of-state trusts. It's therefore not a surprise that

a California official would question whether itBit's New York trust charter is enough for it to do business with California clients.

Nonetheless, itBit seems to be on solid ground to operate in the Golden State. California recognizes that out-of-state trusts may conduct business within its borders. It also recognizes that out-of-state banks, which include trusts, don't need an office to operate in the state. As an electronic exchange, it's unlikely that itBit will be opening an office in California, or any other state, in the near future. Likewise, the laws that permit commercial banks to open branches in other states through interstate reciprocity don't fit the operational model of itBit.

An out-of-state trust authorized to do business in California thus likely qualifies for the money transmitter exemption that applies to trust companies generally. Indeed, there seems to be no precedent or policy reasons for requiring a regulated banking trust like itBit to obtain a money transmitter license. But it would be good to have greater certainty about the issue. Washington State seems to have a similar snag. And Louisiana, at least by statute, requires an out-of-state bank to be a "federally insured depository" institution to qualify for a licensing exemption. It's not clear whether itBit fits that description.

itBit's road to obtaining a trust charter under New York banking law was long and costly. It also proved to be savvy. In one fell swoop, it gave the firm a basis to operate nationally while building confidence in the Bitcoin ecosystem. So it's no surprise that upon announcing its trust charter that itBit also disclosed a \$25 million round of financing. By doing so, itBit demonstrated the fundraising benefits of being a regulated firm and that financial institutions are not always on the hunt for minimal regulation.

There seems to be some uncertainty about whether itBit—a banking law trust—automatically qualifies to do business without a money transmitter license in certain states. But that uncertainty should, more than anything else, lead law makers to rethink the patchwork quilt of U.S. state money transmitter laws. As of now, it potentially undermines the operations of global digital currency exchanges.

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