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**PRESENTATION OF THE
DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS**

TO THE HOUSE COMMITTEE ON
INTRASTATE COMMERCE

AND

TO THE HOUSE COMMITTEE ON
CONSUMER PROTECTION AND COMMERCE

THE TWENTY-NINTH LEGISLATURE
REGULAR SESSION OF 2017

TUESDAY, MARCH 21, 2017
2:00 p.m.

**TESTIMONY ON S.B. NO. 949, S.D. 1, PROPOSED H.D. 1
RELATING TO MONEY TRANSMITTERS**

TO THE HONORABLE TAKASHI OHNO, CHAIR,
TO THE HONORABLE ROY M. TAKUMI, CHAIR,
AND MEMBERS OF THE COMMITTEES:

My name is Iris Ikeda, Commissioner of Financial Institutions ("Commissioner") of the Division of Financial Institutions ("DFI"), testifying on behalf of the Department of Commerce and Consumer Affairs, in strong support of this administration bill, S.B. No. 949, S.D. 1, Proposed H.D. 1, Relating to Money Transmitters ("Proposed HD 1").

In addition to initial comments offered in support of this measure, DFI offers comments specifically concerning the newly introduced portions of the Proposed HD 1 creating an exemption for decentralized virtual currency from Hawaii's Money Transmitters Law. DFI respectfully defers to the Legislature as to whether decentralized virtual currency, as defined in this measure, should be exempt from Hawaii's Money Transmitters Law. Given the rapidly evolving area of virtual currency, DFI provides the information below related to the Proposed HD 1's virtual currency-related provisions as background information on the current regulatory environment for virtual currency in Hawaii in order to assist the Committees in making an informed decision on this measure's proposed exemption.

Comments on non-virtual currency-related provisions

This measure clarifies and strengthens Hawaii's Money Transmitters Act, Chapter 489D, Hawaii Revised Statutes ("HRS"), to provide appropriate supervision of the money transmitter industry. The measure makes the chapter more effective, improving compliance within the industry, regulatory oversight, and the Commissioner's ability to enforce the chapter.

The measure updates the chapter's permissible investments provision, Section 489D-8, HRS, which a licensee must follow in the interests of safety and soundness. Currently, a licensee must possess permissible investments "of not less than the aggregate amount of all outstanding payment instruments issued or sold by the

licensee in the United States. . ." (emphasis added). Today, many money transmitters transmit money electronically. The measure makes it clear that these obligations are also subject to the permissible investments requirement, by changing the term "outstanding payment instruments" to "outstanding payment obligations", and adding language to the latter term to expressly include "[a]ll other outstanding money transmission obligations of the licensee issued in the United States". These updates will enhance consumer protection, and provide the Commissioner with more relevant information on licensee condition for better supervision.

The measure also clarifies the persons associated with a money transmitter applicant, licensee, or applicant for change of control of the licensee, for whom a criminal history record check or other background information must be provided. This is implemented by amending the definitions of "person" and "principal" in Section 489D-4, HRS; repealing the definition of "key shareholders" and chapter references to that term; and tightening language concerning licensure applications, and change of control applications, in Sections 489D-9 and 489D-15, HRS, respectively. These clarifying changes will help applicants and licensees understand and comply with various background information requirements, and streamline DFI's processing and review of the information.

Finally, the measure makes it clear that the term, "payment instrument", in Section 489D-4, HRS, includes an "electronic instrument". This will better protect

consumers who use stored value cards and other electronic instruments. The term "payment instrument" is integral to the definition of "money transmission", which is a key term in the administration of Chapter 489D, HRS.

This measure will improve licensee compliance with the chapter, and DFI's ability to effectively and efficiently administer it. It will enhance consumer protection by strengthening requirements for background information, and by making the chapter more clearly applicable to new technology and creative payment options.

Comments on Proposed HD1 provisions regarding virtual currency

DFI provides the following information in response to Proposed H.D. 1.

In broad terms, a virtual currency is an electronic medium of exchange typically used to purchase goods and services from certain merchants or to exchange for a sovereign currency (money of a government), or other virtual currencies. The DFI is not aware of any virtual currency that has legal tender status in any jurisdiction, nor of any virtual currency issued by a governmental central bank. As such, virtual currencies exist outside of established financial institution systems.

Federal Guidance

At the federal level, digital currency is regulated by the Financial Crimes Enforcement Network ("FinCEN"). In its first guidance on virtual currency, FinCEN defined the parties in virtual currency transactions and identified those considered money services businesses (MSB). A money services business must register with

FinCEN and is subject to reporting and recordkeeping requirements. Parties defined as administrators and exchangers are MSBs under the guidance, while users are not.

FinCEN's initial guidance on virtual currency issued March 18, 2013, defines the parties to various virtual currency transactions.¹ FinCEN released additional guidance on virtual currency on January 30, 2014, describing the application of FinCEN's regulations to mining activities² and software development for investment purposes³. More detailed guidance provided that for certain mining and conversion activities, the miner is considered a user of the virtual currency and therefore is not subject to FinCEN's MSB registration, reporting and recordkeeping requirements. A company developing software to facilitate the purchase of virtual currency for sale to and from other parties all exclusively as investments for its own account, is also considered a user of virtual currency and is not subject to registration, reporting and recordkeeping requirements.

Additionally, on March 25, 2014, the IRS published its guidance document, IR-2014-36. The IRS provided notice that virtual currency is treated as property for federal tax purposes. General tax principles that apply to property transactions apply to transactions using virtual currency. Among other things, this means that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.

¹ <https://www.fincen.gov/sites/default/files/shared/20130318.pdf>

² <https://www.fincen.gov/sites/default/files/shared/FIN-2014-R001.pdf>

³ https://www.fincen.gov/sites/default/files/administrative_ruling/FIN-2014-R002.pdf

- Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue a Form 1099.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.

There are many different virtual currency schemes, and it is not easy to classify all of them. For purposes of this testimony, they can generally be divided into two basic types, centralized and decentralized.

Centralized virtual currency

Centralized virtual currencies are created and issued by a specified source such as OneCoin or AnnurcaCoin. They rely on an entity with some form of authority or control over the currency. Typically, the authority behind a centralized virtual currency is also the creator.

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

Decentralized virtual currency

Decentralized virtual currencies are not created or issued by a particular person or entity, have no administrator, and have no central repository. Thus far, decentralized currencies are all cryptocurrencies such as Bitcoin, Potcoin, Peercoin, Ethereum, and 740 others. A cryptocurrency is based on a cryptographic protocol that manages the creation of new units of the currency through a peer-to-peer network. The creation of cryptocurrency happens through a process called mining that basically involves running an application on a computer that performs proof-of-work calculations. When the computer performs a sufficient amount of these calculations, the cryptocurrency's underlying protocol essentially generates a new unit of the currency that can be delivered to the miner's wallet. Because user wallets act as the connection points of the cryptocurrency's peer-to-peer network, transfers of cryptocurrency are made directly from wallet to wallet without any intermediary, whereas transmissions of sovereign currencies must be made through one or more intermediaries such as a financial institution or money transmitter.

One important characteristic of cryptocurrency is its lack of intrinsic value. A unit of cryptocurrency does not represent a claim on a commodity, and is not convertible by law. And unlike sovereign currencies, there is no governmental authority or central bank establishing its value through law or regulation. Its value is only what a buyer is willing to pay for it. Most cryptocurrencies are traded on third party exchange sites, where the exchange rates with sovereign currencies are determined by averaging the

transactions that occur. Some experts consider cryptocurrency to be a new asset class that is neither currency nor commodity, but possessing characteristics of both, as well as characteristics of neither.

Money Transmission

Because factors distinguishing the various centralized virtual currencies are usually complicated and nuanced, to make money transmission licensing determinations the DFI must individually analyze centralized virtual currency schemes. Accordingly, the DFI does not issue guidance on the treatment of centralized virtual currencies in general under the Hawaii Money Transmitters Act.

For DFI, money transmitter licensing determinations for businesses working with cryptocurrency raise the question whether cryptocurrencies are "money or monetary value" under the Money Transmitters Act. Section 489D-4, HRS, states that:

"Money transmission" means to engage in the business of:

- (1) Selling or issuing payment instruments; or
- (2) Receiving money or monetary value for transmission to a location within or outside the United States by any and all means, including wire, facsimile or electronic transfer.

There is considerable discussion whether cryptocurrencies should be considered money. However, for purposes of money transmission regulation in Hawaii, "monetary value means a medium of exchange, whether or not redeemable in money." Section 489D-4, HRS.

A unit of cryptocurrency does not entitle its owner to anything, and creates no duties or obligations in a person who gives, sells, or transfers it. However, as a medium of exchange, it is monetary value under the Money Transmitters Act.

When a cryptocurrency transaction involves sovereign currency, the transaction may constitute money transmission. DFI's analysis for licensing purposes looks at how the sovereign currency is handled. Examples of common types of transactions involving cryptocurrency include:

Transactions considered money transmission

1. Exchanging sovereign currency for virtual currency, or vice versa. In a typical transaction, the buyer of virtual currency provides sovereign currency to a business that either holds value in the form of a desired virtual currency or who upon receipt of sovereign currency executes a purchase of the virtual currency from another source. In either case the business ultimately transmits virtual currency value to the buyer. The value is transmitted to a wallet location either designated by the buyer or generated by the business. In the reverse transaction, the consumer provides virtual currency value to the business and the business provides sovereign currency to the consumer. These transactions may be completed using a kiosk or "Bitcoin ATM."⁴
2. Exchanging virtual currency for virtual currency. In a typical transaction, the virtual currency purchaser provides virtual currency to a business that holds value in various types of virtual currency. Upon receipt of one type of virtual currency the business transmits another type of virtual currency to the buyer. The value is transmitted from one location to a wallet location either designated by the buyer or generated by the business.

⁴ The Department notes that some Bitcoin ATMs can be configured to conduct transactions only between the customer and the machine's operator, with no third parties involved. If the machine never involves a third party, and only facilitates a sale or purchase of Bitcoins by the machine's operator directly with the customer, there is no money transmission because at no time is money received in exchange for a promise to make it available at a later time or different location.

3. Offering virtual currency wallets for storing value. These companies usually also provide an exchange of value service with sovereign or virtual currencies. If the wallet service includes the transfer of value from one location to another, that activity requires a license.

Transactions not considered money transmission

1. Exchanging sovereign or virtual currencies between privately held wallets. The DFI does not consider the transmitting of value between two individuals not engaged in business to fall within the definition of money transmission. No license is required for an individual to send virtual currency value from his or her wallet directly to another individual.

A cryptocurrency business that engages in money transmission must comply with all applicable licensing provisions of the Money Transmitters Act.

As noted above, DFI defers to the Legislature with respect to whether decentralized virtual currency should be exempted from Hawaii's Money Transmitters Law.

DFI strongly supports this administration bill, and respectfully requests that it be passed. Should the Committees feel the need to review any aspects of the new virtual currency provisions included as part of the Proposed HD 1 following today's discussion, DFI is glad to continue working with your Committees and those subsequent in order to ensure all questions can be satisfactorily addressed within the coming weeks.

Thank you for this opportunity to testify and provide comments. I would be pleased to respond to any questions that you may have.