

# ANTI-MONEY LAUNDERING LAWS FOR BITCOIN EXCHANGES

Raphael Davidian\*

## INTRODUCTION

The prospect of an individual from the other side of the world successfully funneling tainted cash into a bank account is truly any criminal's dream, especially when there is no trace of the true sender or information on the legal status of the money. Today, the advent of digital currencies allows the transmission of money between computers, phones, and other wirelessly connected devices within a matter of seconds. Encrypted data carrying virtual currency can be unlocked from any remote location where there is a wireless connection. Until recently, the exchange of virtual currency into fiat currency was accomplished through a centralized intermediary<sup>1</sup> that was explicitly covered as a "money transmitter"<sup>2</sup> under the Bank Secrecy Act ("BSA").<sup>3</sup> Money transmitters are legally required to comply with numerous reporting requirements in place to prevent money laundering and other illegal activities.<sup>4</sup> Bitsquare—an application that allows its users to buy and/or sell bitcoins in exchange for foreign currency—operates as if currency is exchanged in person and subsequently deposited into a bank account without ever being held onto by any middleman.<sup>5</sup> Bitsquare's decentralized, peer-to-peer network<sup>6</sup> is thus unlikely to fall under the current definition of a "money transmitter." This piece will introduce the reader to the general framework of the most popular virtual currency, Bitcoin, and discuss its various components. I will discuss the existing regulatory requirements for

---

\* Georgetown University Law Center, J.D. expected 2018. Mr. Davidian is a featured online contributor for the *American Criminal Law Review*.

<sup>1</sup> See FIN. CRIMES ENFORCEMENT NETWORK, FIN-2014-0R011, REQUEST FOR ADMINISTRATIVE RULING ON THE APPLICATION OF FINCEN'S REGULATIONS TO A VIRTUAL CURRENCY TRADING PLATFORM (Oct. 27, 2014), [https://www.fincen.gov/sites/default/files/administrative\\_ruling/FIN-2014-R011.pdf](https://www.fincen.gov/sites/default/files/administrative_ruling/FIN-2014-R011.pdf).

<sup>2</sup> See *id.* at 6.

<sup>3</sup> See *FinCEN's Mandate from Congress*, FIN. CRIMES ENFORCEMENT NETWORK, <https://www.fincen.gov/resources/fincens-mandate-congress> (last visited Mar. 26, 2017, 9:34 PM).

<sup>4</sup> See Records and Reports on Monetary Instruments Transactions, 31 U.S.C. §§5311-5314 (2001).

<sup>5</sup> See *The Decentralized Bitcoin Exchange*, BITSQUARE (January 3, 2016), <https://bitsquare.io/whitepaper.pdf> at 3 (describing itself as "[n]ever hold[ing] user's funds").

<sup>6</sup> See *id.* (describing itself as "an open source peer-to-peer application that allows anyone to buy and sell Bitcoin in exchange [for] national currencies or alternative crypto currencies.").

conventional currency exchanges under the BSA and the Anti-Money Laundering statute (“AML”) and examine how Bitsquare’s exchange platform may potentially facilitate the circumvention of current requirements and curtail their preventive effect.

## I. BASIC OPERATING FRAMEWORK OF BITCOIN

In simple terms, bitcoins can be compared to a form of online cash.<sup>7</sup> Bitcoins are stored and recorded within a decentralized, pseudonymous, peer-to-peer virtual network.<sup>8</sup> Users of the bitcoin network can sign up for an anonymous wallet from a third-party software developer.<sup>9</sup> The wallet operates as one lock with two different keys on each end—a private key gives access to the wallet while the public key is displayed when a transaction is completed.<sup>10</sup> The individual uses the private key to confirm the transaction, which essentially operates as a password to the wallet.<sup>11</sup> The public key is then displayed on bitcoin’s block chain ledger once a transaction is verified. The transaction is verified by “miners”—network users who receive newly created bitcoins in exchange for using their computing power to integrate transactions onto the ledger—and subsequently encoded as a block chain onto the end of all of the previously completed blocks.<sup>12</sup> While users’ identities are unknown, the ledger includes the public keys, the time, and the amount of every transaction ever made.<sup>13</sup> Theoretically, if wallets were required to collect the identity of each user (contrary to wallets’ actual objective), every transaction could be traced back to the individual by way of the public key that was previously recorded on the bitcoin ledger.

## II. CURRENT REGULATIONS

In 1970, Congress delegated to the Financial Crimes and Enforcement Network (“FinCEN”) the authority to implement, administer, and enforce the Bank Secrecy Act (“BSA”).<sup>14</sup> The BSA’s purpose is to detect and prevent money laundering by requiring certain institutions to report

---

<sup>7</sup> See DIANA MERGENOVA ET AL., Investigation of Money Laundering Methods Through Cryptocurrency, 83 J. THEORETICAL & APPLIED INFORMATION TECH. 2, 244, 245 (2016), <http://www.jatit.org/volumes/Vol83No2/11Vol83No2.pdf>.

<sup>8</sup> See JERRY BRITO & ANDREA CASTILLO, Bitcoin: A Primer for Policymakers 3 (2013).

<sup>9</sup> See, e.g., *Anonymize Bitcoin*, BITLAUNDER, (2013), <https://bitlaunder.com/> (promising to “anonymize[] Bitcoins, mask[] their origins and obscur[e] their history”).

<sup>10</sup> See JERRY BRITO & ANDREA CASTILLO, Bitcoin: A Primer for Policymakers 5 (2013).

<sup>11</sup> See *id.*

<sup>12</sup> See *id.*

<sup>13</sup> See *id.* at 8.

<sup>14</sup> See FINCEN, *supra* note 3 (establishing “[t]he Currency and Foreign Transactions Reporting Act of 1970,” which is also known as the Bank Secrecy Act or BSA).

suspicious transactions.<sup>15</sup> Specifically, the BSA requires financial institutions and other money-service businesses (“MSB”) to report cash transactions exceeding the daily aggregate amount of \$10,000.<sup>16</sup> Money service businesses include: (1) dealers in foreign exchange, (2) check cashers, (3) issuers or sellers of traveler’s checks or money orders, (4) providers of prepaid access, (5) money transmitters, (6) the U.S. Postal Service, and (7) sellers of prepaid access.<sup>17</sup> Of particular importance is the 2001 amendment that broadened the definition of a “money transmitter” to include any person who, as a business, facilitates an exchange of currency.<sup>18</sup> However, the amendment did not mention informal money transfers, nor did it define what would qualify as operating “as a business.” It is unclear whether some infrequent and informal exchanges of currency would be covered under the existing definition of money transmitter.

During the height of the online black market Silk Road—which facilitated the anonymous sale of illicit substances and materials in exchange for bitcoins<sup>19</sup>—FinCEN issued interpretive guidance on the application of the BSA on virtual currencies.<sup>20</sup> Importantly, the guidance categorizes individuals within the bitcoin community as either “users” or “exchangers,”<sup>21</sup> and it explicitly exempts users from MSB reporting requirements because their activity does not fit within the definition of a “money transmission service.”<sup>22</sup> The working definition of a “money transmission service” requires that the service accept virtual currency or another form of value from one person and transmit value to another location or person.<sup>23</sup> A “user” is someone who obtains virtual currency to

---

<sup>15</sup> See *id.* (requiring “U.S. financial institutions to assist U.S. government agencies to detect and prevent money laundering,” especially “cash transactions exceeding \$10,000”).

<sup>16</sup> See *id.*

<sup>17</sup> 31 C.F.R. § 1010.100(ff) (2012) (defining “money services business”).

<sup>18</sup> See *Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001*, Pub. L. No. 107-56, 115 Stat. 272, 328 §359(a) (including as money transmitters “any person who engages as a business in an informal money transfer system or any network of people who engage as a business in facilitating the transfer of money domestically or internationally outside of the conventional financial institutions system”).

<sup>19</sup> See *MERGENOVA ET AL.*, *supra* note 7, at 247–48 (describing the website as anonymous due to its operating on the hidden TOR network and selling drugs and weapons.).

<sup>20</sup> See *FINCEN, FIN-2013-G001, APPLICATION OF FINCEN’S REGULATIONS TO PERSONS ADMINISTERING, EXCHANGING, OR USING VIRTUAL CURRENCIES* (March 18, 2013), <https://www.fincen.gov/sites/default/files/shared/FIN-2013-G001.pdf>.

<sup>21</sup> See *id.* at 2 (“This guidance refers to the participants in generic virtual currency arrangements, using the terms ‘user,’ ‘exchanger,’ and ‘administrator.’”).

<sup>22</sup> See *id.* (“[A user], in and of itself, does not fit within the definition of ‘money transmission services’ and therefore is not subject to FinCEN’s registration, reporting, and recordkeeping regulations for MSBs.”).

<sup>23</sup> See *id.* at 3 (“The term ‘money transmission services’ means ‘the acceptance of currency, funds, or other value that substitutes for currency from one person *and* the

purchase real or virtual goods or services, and without more cannot be a “money transmitter.”<sup>24</sup> An “exchanger” is someone who as a business engages in the exchange of virtual currency for any other form of currency.<sup>25</sup> The guidance also broadly proclaims that a person who buys or sells convertible virtual currency for another currency is transmitting money to another location and is therefore a “money transmitter.”<sup>26</sup>

To reiterate, a mere user, without more, is never subject to money transmitter requirements. If the user, however, engages in a scheme of facilitating the purchase of virtual currency and selling that virtual currency in exchange for another currency, the user becomes an exchanger and a transmitter.<sup>27</sup> In FinCEN’s ruling, a virtual currency-trading platform proposed to use two accounts, one for U.S. dollars and another for Bitcoin, and planned to match users who wanted to exchange currency.<sup>28</sup> This traditional exchange platform would purchase from the person acting as a seller and subsequently sell to the person acting as the buyer.<sup>29</sup> Coinbase, a traditional exchange platform, operates this way and is registered as a Money Services Business with FinCEN.<sup>30</sup>

### III. BITSQUARE CIRCUMVENTION

But what if there is software that never retains the funds of the buyer or seller, instead using a peer-to-peer network to facilitate a direct exchange of currency between the parties without the need for an intermediary? Bitsquare resembles an in-person currency exchange, which is followed by a subsequent deposit into a designated account.

Recall that a person is a “user” as long as that person only *obtains* bitcoins.<sup>31</sup> Without engaging in an additional activity, a user can never be an “exchanger” or a “money transmitter.”<sup>32</sup> The bitcoin miner, who creates bitcoins by verifying transactions, becomes a “money transmitter” as soon as he sells the bitcoins in exchange for real currency.<sup>33</sup> The guidance also

---

transmission of currency, funds, or other value that substitutes for currency to another location or person by any means.”).

<sup>24</sup> *See id.* at 2.

<sup>25</sup> *See id.* (“An *exchanger* is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.”).

<sup>26</sup> *See id.* at 3.

<sup>27</sup> FINCEN, *supra* note 1, at 3 (FinCEN’s ruling established that an intermediary is both an exchanger and a money transmitter.).

<sup>28</sup> *See id.* at 1.

<sup>29</sup> *See id.*

<sup>30</sup> *See Is Coinbase Regulated?*, COINBASE: SUPPORT, (Dec. 21, 2016), <https://support.coinbase.com/customer/en/portal/articles/2689172-is-coinbase-regulated->.

<sup>31</sup> *See* FIN-2013-G001, *supra* note 20, at 2.

<sup>32</sup> *See id.*

<sup>33</sup> *See id.* at 3.

extends to intermediaries, or people who accept virtual currency from one person and transmit it to another *as part of* the acceptance and transfer of value that substitutes for currency.<sup>34</sup> It follows, as the FinCEN ruling announced,<sup>35</sup> that so long as the intermediary is engaged in the scheme of acting as a broker of receiving currency from one person and exchanging it for the currency of another person, the intermediary is acting as both an exchange and a money transmitter.

Bitsquare, however, does not act as a true intermediary.<sup>36</sup> Instead, it is an open-source peer-to-peer application that allows parties to send bitcoins in exchange for real currency directly between parties.<sup>37</sup> Since Bitsquare does not act as a broker, never takes possession of the currencies being exchanged, and merely connects a buyer and seller via a direct network,<sup>38</sup> it is unlikely that it can be defined as an exchange or as a money transmitter. Bitsquare is replacing the need for users to meet in person to exchange cash by instead allowing a transfer of bitcoins into their virtual wallets by way of a direct deposit of the currency into a designated account.

#### CONCLUSION

Whether an individual who is only part of a single transaction on Bitsquare falls within the definition of operating an “exchange” as a business is questionable. Framing all informal exchanges of currency between individuals as a money transmission is difficult to monitor and enforce. Individuals could always create new digital wallets that mask their trail and obscure the source of the funds. Technological advances coupled with criminals’ obfuscating intentions create a gap in the oversight of suspicious financial transactions. This has the potential of creating an opportunity to transact large amounts of illegally-derived currency while significantly curtailing the preventive measures already in place. The increase of users and additional updates of the software may create an exclusive outlet for facilitating money laundering, thereby perhaps making the current “money transmission” and “exchange” definitions obsolete. Although there will always be difficulties in detecting money laundering, it is imperative that the law cover new schemes swiftly

---

<sup>34</sup> See FINCEN, *supra* note 1, at 3.

<sup>35</sup> *Id.*

<sup>36</sup> See BITSQUARE, *supra* note 5, at 6 (prescribing that “[n]ational (or alternative crypto) currency are transferred directly from one user’s payment account to the others [sic] payment account without any intermediate party”).

<sup>37</sup> *Id.* at 3.

<sup>38</sup> See *Peer-to-peer*, MERRIAM-WEBSTER (2017), <https://www.merriam-webster.com/dictionary/peer%E2%80%93to%E2%80%93peer> (defining a peer-to-peer network as establishing a direct connection between parties, unlike a centralized network that is first connected to an intermediate server).

in order to improve the detection of suspicious transactions before the funds benefit the financing of illegal activities.