FinCEN Proposes Reporting, Recordkeeping and Verification Requirements for Digital Currency Transactions Involving Unhosted Wallets

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On December 18, 2020, the Financial Crimes Enforcement Network ("FinCEN") issued the latest in a string of proposed rules applying compliance obligations to banks and money service businesses ("MSBs") that process certain transactions involving convertible virtual currency ("CVC") (*e.g.*, bitcoin, ethereum) or digital assets with legal tender status ("LTDA").[1]

Specifically, the proposed rule would require banks and MSBs to report, maintain records, conduct counterparty identification and verify customers for CVC/LTDA transactions above specified value thresholds that involve (1) wallets not hosted by a financial institution (known as "self-hosted," or in FinCEN's terminology, "unhosted" wallets) or (2) wallets hosted by foreign financial institutions located in certain jurisdictions. Public comments on the proposed rule are due by January 4, 2021.

In this [Debevoise Debrief], we briefly describe the proposed rule and discuss its potential implications for banks, MSBs and the digital asset industry as a whole.

Why is FinCEN proposing this rule?

The proposed rule represents FinCEN's latest effort to extend the anti-money laundering ("AML") regulatory framework under the Bank Secrecy Act ("BSA") to transactions related to CVCs. In May 2019, FinCEN issued comprehensive guidance regarding application of the BSA/AML regulatory framework to various types of CVC transactions and business models.[2] In June 2019, the Financial Action Task Force ("FATF"), an international policymaking and standard-setting body of which the United States is a member, issued guidance on global standards for AML regulation of transactions in virtual assets or involving virtual asset service providers, including

[1] FinCEN's proposed rule is available here. An accompanying set of Frequently Asked Questions (FAQs) released by FinCEN is available here.

[2] Our client update on the 2019 FinCEN CVC Guidance is available here.

information transmission and recordkeeping requirements.[3] Most recently, in October 2020, FinCEN and the Federal Reserve issued a proposed rule that would clarify the application of existing recordkeeping and information transmission requirements for fund transfers and other transmittals, including those involving CVC/LTDA.[4]

In this latest release, FinCEN seeks to "address the illicit finance threat" and "national security imperatives" resulting from increased use of CVC transactions involving unhosted wallets "to facilitate international terrorist financing, weapons proliferation, sanctions evasion, and transnational money laundering" among other unlawful activities. Although the agency describes this as a "targeted" expansion of BSA/AML obligations, and notes its engagement with the cryptocurrency industry in developing the proposed rule, some industry participants have expressed concern that the associated compliance obligations will deter regulated financial institutions from processing CVC/LTDA transactions at all.

What types of financial institutions would be subject to the proposed rule?

The proposed rule would impose requirements on banks and MSBs only, including foreign-located MSBs with respect to their U.S. activities. FinCEN considered extending the scope of the proposed rule to other financial institutions (such as broker-dealers, futures commission merchants and mutual funds), and has requested comment as to whether the CVC/LTDA transaction reporting and recordkeeping requirements should be extended more broadly.

What does the proposed rule require?

Transactions involving "unhosted wallets" and "otherwise covered wallets"

Compliance obligations under the proposed rule apply to CVC/LTDA[5] transactions involving an "unhosted wallet," which are generally thumb drives or software that enable the owner of CVC/LTDA to access a blockchain on which transactions can be

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3 Our client update on the 2019 FATF Guidance is available here.

4 Threshold for the Requirement To Collect, Retain, and Transmit Information on Funds Transfers and Transmittals of Funds That Begin or End Outside the United States, and Clarification of the Requirement To Collect, Retain, and Transmit Information on Transactions Involving Convertible Virtual Currencies and Digital Assets With Legal Tender Status, 85 Fed. Reg. 68005 (Oct. 27, 2020), available here.

5 The term legal tender digital assets (or LTDA) has recently been introduced in FinCEN releases and basically encompasses assets that are commonly referred to as central bank digital currencies (i.e., digital assets that are issued and regulated as legal tender by a competent monetary authority of a sovereign country or other recognized jurisdiction).

initiated, recorded, validated and settled. As the name suggests, unhosted wallets allow the owner to store, send and receive CVC/LTDA without the involvement of a third-party financial institution. Little information is available to third parties about the users of unhosted wallets.

The proposed rule contrasts "unhosted wallets" with "hosted wallets"—digital accounts held in custody and controlled by a financial institution (typically licensed money transmitters, exchanges or banks) that provides CVC/LTDA storage services or facilitates trades by customers. Because such financial institutions that are based in the United States or provide services to U.S. customers are BSA-regulated intermediaries, there is greater transparency into hosted wallet customers and transactions.

The proposed rule would also impose compliance obligations on transactions involving "otherwise covered wallets"—wallets hosted by foreign-located financial institutions in jurisdictions FinCEN has identified to be of "primary money laundering concern." Designated jurisdictions will be included on a "Foreign Jurisdictions List" (currently consisting of Myanmar (Burma), Iran, and North Korea).[6]

Requirements for CVC/LTDA Transactions over $3,000

The proposed rule imposes a range of recordkeeping, identification and verification requirements for CVC/LTDA transactions involving unhosted wallets or otherwise covered wallets that exceed $3,000 in value. In determining the U.S. dollar value of a transaction, a non-U.S. dollar-denominated transaction is to be converted to a U.S. dollar value at the time of the transaction based on the prevailing exchange rate.[7]

Specifically, in the case of any such "withdrawal, exchange or other payment or transfer by, through, or to" the bank or MSB, the institution would be required to:

- Collect, at minimum, the name and physical address of each counterparty, and additional information as necessitated by risk-based identification procedures or as required by FinCEN;

- Verify the identity of the institution's customer that engaged in the transaction, pursuant to its existing risk-based customer identification program ("CIP"); and

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[6] FinCEN notes that other jurisdictions determined to have significant deficiencies in CVC/LTDA regulation may be added by FinCEN to the Foreign Jurisdictions List in the future.

[7] The proposed rule provides little guidance on how the prevailing exchange rate is to be determined, indicating in the release only that it means a rate reasonably reflective of a fair market rate of exchange available to the public for the CVC/LTDA at the time of the transaction, and noting that financial institutions will be required to document their method for determining the prevailing exchange rate.

- Retain the required information in an electronic format, retrievable by reference to the customer's name or account number or counterparty's name.

Because these obligations apply only to transactions involving unhosted or otherwise covered wallets, FinCEN expressly exempts transactions where the counterparty maintains a wallet at (i) a BSA-regulated financial institution or (ii) a foreign financial institution in a jurisdiction not listed on FinCEN's Foreign Jurisdictions List.

Requirements for CVC/LTDA Transactions over $10,000

In addition to the identification and verification obligations described above,[8] the proposed rule would require banks and MSBs to file reports with FinCEN regarding any CVC/LTDA "deposit, withdrawal, exchange or other payment or transfer by, through, or to" the institution that involves an unhosted or otherwise covered wallet and exceeds $10,000 in value. Reports would be required within 15 days of each such transaction and financial institutions must retain transaction records for at least five years. These obligations are similar to existing currency transaction report ("CTR") requirements.[9]

To determine whether the $10,000 reporting threshold is met, the proposed rule would require aggregation of all CVC/LTDA transactions—sent and received—in any 24-hour period by or on behalf of any person. However, aggregation with a customer's fiat currency transactions in the same period is not required. The rule would also prohibit structuring transactions to avoid reporting requirements. As with the recordkeeping requirements applicable to a transaction over $3,000, a non-U.S. dollar-denominated transaction is to be converted to a U.S. dollar value at the time of the transaction based on the prevailing exchange rate.

As above, FinCEN expressly exempts transactions where the counterparty maintains a wallet at a BSA-regulated financial institution or a foreign financial institution in a jurisdiction not included on the Foreign Jurisdictions List. Additionally, certain CTR exceptions available to banks under existing regulations would also be applied to CVC/LTDA transactions above $10,000 in value. For example, reports would not be required where the transaction occurs between banks or between a bank and a U.S. governmental department or agency or entity exercising U.S. governmental authority.

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[8] FinCEN indicates that it has generally conformed the identification and verification requirements for CVC/LTDA transactions at both the $3,000 and $10,000 thresholds; accordingly, a single set of information collection and verification procedures should suffice for any transaction subject to both requirements.

[9] The proposed rule would effect these changes by categorizing CVC/LTDAs as "monetary instruments" solely for purposes of the statutory authorization for CTR rules, codified at 31 U.S.C. § 5313, but would not modify the definition of monetary instrument elsewhere in FinCEN's regulations.

Will there be an opportunity to comment on the proposed rule?

FinCEN determined that the proposed rule is not subject to notice-and-comment rulemaking because it involves a "foreign affairs function" of the United States and there is "good cause" to suspend otherwise applicable procedures. Nevertheless, the agency listed 24 requests for comment and noted that it will accept public comments filed by January 4, 2021, and "endeavor to consider any material comments" received after this date.

What are some implications of the proposed rule, and its expedited timeline?

In light of the limited comment period and FinCEN's statements that national security imperatives "necessitate an efficient response for proposal and implementation of this rule," industry participants should be prepared for the possibility that the rule is adopted and implemented on an expedited basis. The very short comment period and FinCEN's analyses in its release regarding the proposed rule may give rise to potential challenges under the Administrative Procedure Act ("APA"). For example, FinCEN's positions on the justifications for the truncated comment period, its analysis of costs and burdens of the proposed rule and other positions taken in the release could raise issues under the APA. However, in the absence of a temporary restraining order or other similar relief, it will likely be difficult for affected financial institutions to avoid its application pending the outcome of any such challenges.

If adopted as proposed, the rule will have significant implications for banks and MSBs involved in CVC/LTDA transactions, including cryptocurrency exchanges. In addition to transactions involving transfers to third-party unhosted wallets, the rule will broadly apply to withdrawals and deposits by a customer made to or from an off-exchange, unhosted wallet maintained by that customer. The technical and compliance costs may be very high. Further, it is unclear at this time how affected financial institutions can comply with certain requirements under the proposed rule. For example, when CVC is received from a third party that is not a customer of the financial institution, there may be no current reliable method for obtaining the identity and location of such third party. Even if the banks and other MSBs were to comply with the rule, the rule may not achieve its intended objective. For example, the rule may drive many illicit transactions off-chain and into the peer-to-peer ("P2P") space, in which case the net effect may be that banks and MSBs are subjected to high compliance costs without achieving the intended law enforcement benefits.

The rule could also impact certain institutions and/or platforms that have no preexisting compliance program in place (*e.g.*, decentralized exchange applications that facilitate

transactions between unhosted wallets, as well as so-called decentralized finance ("DeFi") projects). For example, many DeFi projects rely on "smart contracts" to store or escrow funds. Such smart contract-powered platforms do not have physical addresses and often are not operated by or under the auspices of a particular company. It is currently unclear how such a DeFi platform would be treated under the proposed rule.

Determining whether an off-exchange wallet of a customer or a customer counterparty is hosted or unhosted (or an otherwise covered wallet) also creates challenges for affected institutions. In the rule proposal, FinCEN indicates that in determining whether available exemptions apply, the institution will need a "reasonable basis" to conclude that the external wallet or account is hosted by a BSA-regulated institution or covered foreign financial institution. This may entail, for example, checking the MSB registration status of a counterparty that purports to be so regulated. For foreign financial institutions, the affected institution would need to apply reasonable, risk-based and documented procedures to confirm that the foreign financial institution is complying with registration or similar requirements that apply to financial institutions in the relevant foreign jurisdiction. The proposed rule provides no guidance on how often such determinations must be reconfirmed or updated. Making such determinations and updating and confirming those determinations periodically will introduce complexity and added costs to an affected institution's BSA/AML compliance program.

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We will continue monitoring developments and provide updates as appropriate. Please do not hesitate to contact us with any questions.

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