

## Ohio's Risky Foray Into Bitcoin: Part 1

By **John Reed Stark** (December 12, 2018, 3:03 PM EST)

In the celebrated "John Wick" thriller films, John Wick, played by Keanu Reeves, is an international assassin who frequents the Continental, a hotel that functions as neutral territory for hired cutthroats and murderers.

To serve its criminal clientele, the Continental Hotel uses its own uniquely branded gold coins as currency. All services in the Continental are paid by the coins, including weapons and munitions supply (from the Continental's sommelier) or body armor (from the Continental's seamstress). All the criminals Wick encounters seem to accept the coins — which can pay off expenses ranging from a bar tab to an invoice from the contractor Wick hires to dispose of the typically 20 to 30 bodies he leaves behind after a particularly deadly negotiation or dispute.



John Reed Stark

Only a few years ago, the Continental's coin-based barter exchange may have seemed limited to the imaginary universe of Hollywood blockbusters — but the Continental's in-house currency system and the John Wick economy are no longer fiction, and are now happening right in our midst. But instead of the Continental's exclusively minted gold coinages, there has emerged a broad range of so-called cryptocurrencies, mined on virtual servers, rather than forged in iron and fire. And the biggest virtual currency of them all is bitcoin, which has become a household name despite its having been around for barely a decade.

Recently, bitcoin hit yet another milestone when Ohio began accepting bitcoin payments for taxes, an initiative that is the brainchild of its visionary state treasurer, Josh Mandel, who apparently has ambitions to transform Ohio into a real-life version of John Wick's Hotel Continental.

Ohio's accepting of bitcoin is a first for any U.S. government agency, and while perhaps a boon for the John Wicks of the world, the rest of us, not so much. This two-part series discusses why Ohio's treasury, or any other state or federal government entity, should be the very last institutions to even consider accepting this dubious form of payment.

Part one begins by providing some background concerning bitcoin and then continues with a discussion of the liquidity, fraud, price volatility and manipulation risks associated with Ohio's crypto adventure. Part one also incorporates a discussion of Ohio's bitcoin collection process, including the participation of BitPay, the financial intermediary Ohio has engaged to execute the tax payment transactions, but that is not registered as an Ohio money transmitter business.

Part two will: (1) discuss the array of intricate money laundering issues pertaining to Ohio's crypto efforts, together with other concerns for Ohio, such as cybersecurity risk, tax hazards and the Office of Foreign Assets Control implications; and (2) provide some final thoughts and suggestions going forward.

### The Birth of Bitcoin

Ten years ago, on Oct. 31, 2008, bitcoin was born — and in the past 10 years bitcoin has evolved from an anti-establishment hobby among coders to a common discussion topic on Wall Street.

Supposedly invented by an anonymous cryptographer going by the pseudonym Satoshi Nakamoto, bitcoin's founding white paper, issued on Halloween, kicked off the phenomenon. Bitcoin's original goal, according to its white paper, was straightforward: A "usually peer-to-peer version of

goal, according to its white paper, was straightforward: A purely peer-to-peer version of electronic cash which would allow online payments to be sent directly from one party to another without going through a financial institution."

Bitcoin is a virtual or digital currency that uses encryption techniques for governance and security and operates independent of any central bank. A token is a digital asset that can be used in many ways — for example, as a unit of value or as means of providing access to and transactional value inside a particular blockchain system (e.g., Siacoin allows access to electronic data storage space in Sia's blockchain ecosystem). Tokens are built on top of blockchain technology, a form of distributive ledger technology, which is a digital database that is consensually shared and synchronized across networks spread across multiple sites, institutions or geographies.

Like the world of John Wick, bitcoin also traces its origins as the currency of choice for criminals within the dark web marketplace. In fact, four primary areas of criminal activity lend themselves nicely to cryptocurrency: tax evasion, money laundering, contraband transactions and extortion — not to mention the theft of cryptocurrency itself, which is all too easy with bitcoin.

Indeed, cryptocurrency and criminal activity have remained inexorably linked ever since the 2011 launching of The Silk Road, which began using bitcoin as its main currency in its virtual marketplace for buying and selling drugs, weapons and all things illicit on the dark web — until shut down by law enforcement in 2013 and then again in 2014 and finally going offline in 2017 due to loss of funding.

Silk Road served as a glaring example of the crimes so easily facilitated by cryptocurrency (in 2015, Silk Road's creator, Ross Ulbricht, was sentenced to life in prison). After Silk Road was shut down, bitcoin's price plummeted, and many crypto pundits expected demand to dry up. But in the following years, the opposite seemed to happen.

Tyler Winklevoss and Cameron Winklevoss, the twins who famously battled Mark Zuckerberg over the origins of Facebook, notably opted to invest in bitcoin in 2013 — and bitcoin's value shot up to almost \$1,000 that year. Around that same time, cryptocurrency trading platform Coinbase, recently valued at \$8 billion, was founded and several years later, bitcoin gained status as a retail investor darling during its 1,300 percent price rise and march to nearly \$20,000 in 2017. **Here** is the gist of what the Winklevoss brothers had to say about bitcoin back in 2013.

Though bitcoin traversed from the digital to physical world with the first-ever bitcoin ATM at a Vancouver coffee shop in 2013, bitcoin's use as a real currency has not truly caught on. The U.S. government has never recognized bitcoin as a currency — rather, bitcoin and all other cryptocurrencies are simply property or, as lawyers would say, chattel.

Meanwhile, bitcoin and other cryptocurrencies have continued to serve as the payment mechanism of choice for unlawful transactions — from buying a fake ID or a bottle of opiates, to receiving a cache of credit card numbers or stolen identities, to collecting a ransomware payment demand or even for funding terrorist-related activities. In its October/November 2017 issue, AARP's magazine warned its senior citizen readers about bitcoin in plain English, (perhaps sarcastically) capturing the nuances of bitcoin quite well:

A bunch of computer code that a bunch of criminals, idealists and speculators agree is worth "real" money. Sadly, its real-money value swings widely, making it impractical except for criminals, idealists and speculators.

Nonetheless, Overstock.com, Newegg, Expedia, Microsoft, Dish Network, OKCupid, CheapAir and Etsy are among the companies that have reportedly accepted bitcoin for certain kinds of transactions.

## **Ohio and Bitcoin**

In late November 2018, Ohio became the first U.S. state and one of the first governments in the world to allow businesses to pay taxes, including sales and public utility taxes, with bitcoin. Businesses that operate in Ohio can now use bitcoin to pay for 23 different types of taxes, with a 1 percent fee levied on each transaction. Companies can now go to OhioCrypto.com, enter their tax information, then third-party payment processor BitPay verifies the transaction on blockchain.

BitPay then converts the cryptocurrency into U.S. dollars and transfers those dollars to the state of Ohio. For now, taxpayers will be able to use only bitcoin, but the Ohio treasurer's office said it might allow other cryptocurrencies in the future.

The idea to accept bitcoin for taxes was the brainchild of Mandel, who has held the office since 2011 and started taking an interest in bitcoin several years ago. Mandel views the new program both as a convenience for filers and an opportunity for "planting a flag" for Ohio in the currency's adoption.

"I do see bitcoin as a legitimate form of currency," Mandel told the Wall Street Journal, adding that he hopes other states will follow Ohio's example. Mandel, who is an elected official, also told the Wall Street Journal he can direct his office to accept bitcoin without approval from the Legislature or governor. That seems like a lot of power for one person.

## Ohio's Crypto-Friendly Posture: Seems Like a Good Idea, Right?

What better way to attract the business of fintech than to create a financially friendly environment where a company's cryptocurrency fanaticism is not only inventively crafted and philosophically championed — but also enthusiastically embraced as consideration for tax liabilities. You can watch a news interview with Mandel, touting his bitcoin foray [here](#). Per the Ohio Department of Treasury's website, paying taxes in bitcoin enjoys a vast array of benefits:

The screenshot shows the Ohio Department of Treasury website header with the logo for Josh Mandel, Treasurer of Ohio, and navigation links for OHIOCRYPTO.COM, FAQ, and CONTACT. The main heading is "THE BENEFITS". Below this, a paragraph states: "The Ohio Treasurer's office continues to be an innovation leader by leveraging technology to offer cutting-edge tools and services to Ohioans. We are proud to offer another tax payment option for Ohio taxpayers." The benefits are listed in a grid:

- QUICK & EASY**: Businesses can pay their taxes in three quick steps using the Cryptocurrency Tax Payment Portal.
- REAL-TIME TRACKING**: Payments on the blockchain can be tracked on a second by second basis.
- SECURE PAYMENTS**: Cryptocurrencies cannot be transferred to third parties without user initiation, thereby practically eliminating fraud.
- LOW FEES**: A minimal fee is charged to confirm transactions on the blockchain network.
- TRANSPARENCY**: Anyone can view all transactions on the blockchain network.
- MOBILE OPTIONS**: Easily make tax payments on your mobile phone or tablet.

In fact, crafting cryptocurrency fee arrangements for taxes might seem like a no-brainer, in line with the lessons of Basic Marketing 101, including:

- **The Medium Can Become the Message.** By accepting cryptocurrency as payment, Ohio is demonstrating its commitment to creativity, modernization and originality — traits that companies might appreciate and find compelling. States tend to compete for software engineers and new businesses, and the idea is that by being open to bitcoin, Ohio might attract blockchain companies that set up their headquarters in the state;
- **Cheaper Payment Solution.** While there is no fee to pay taxes with a check, or ACH deposit, paying by credit card incurs a 2.5 percent fee. Paying in bitcoin is a 1 percent fee, collected by BitPay;
- **Payment Flexibility.** Payment flexibility can attract business in and of itself. Given that accepting debit and credit cards online can make a state more appealing to current and

accepting debit and credit cards online can make a state more appealing to current and potential businesses, so too can accepting other forms of payment, including cryptocurrencies; and

- **Winning the Blockchain Arms Race.** With an “arms race” of sorts occurring among states angling to be the center of blockchain and fintech, there will undoubtedly sprout more state laws in the future encouraging development of such technologies, and Ohio wants to be out in front. By allowing bitcoin tax payment collections, Ohio can demonstrate tangible support for the technological enterprise of its citizenry and the future of digital currency. Moreover, Ohio can set itself apart from other states that remain content to observe the crypto revolution from the safety and shelter of the sidelines.

Unfortunately, while the above marketing claims might have some populist appeal, they are not at all compelling. Simply stated, accepting bitcoin or any other cryptocurrency runs a perilous gamut of legal, regulatory, financial, ethical and reputational dangers. And Ohio’s accepting of cryptocurrency as a tax payment in today’s crypto-maniac environment is, despite all of the bus dev allure, just not worth it.

### **Ohio’s Crypto Gamble**

By accepting cryptocurrency payments for taxes, beginning with bitcoin, Ohio is taking a serious risk not just for its reputation but the safety and security of the financial future of its citizens.

For starters, taking on all of the associated risk with cryptocurrency payment arrangements is not for the faint of heart. Federal and state law enforcement and regulatory efforts pertaining to all things crypto have increased dramatically in the past year, and some cryptocurrency institutions that seem to be thriving at the moment might not even be doing business in the future. The risks are broad and myriad.

### **Liquidity, Fraud and Manipulation Risks**

The logistics of accepting cryptocurrency are unique, complicated and problematic. It is not as if Ohio’s state controller can stroll across the street and convert cryptocurrency to U.S. dollars, record the data in Ohio’s accounting software, and be back in time for lunch. First, Ohio must identify a reliable and trustworthy financial institution to safeguard the cryptocurrency and to convert the cryptocurrency upon demand.

Where can Ohio find this kind of honorable, respected and U.S.-registered financial institution? Not among Wall Street’s traditional ranks, for sure. The institutions servicing cryptocurrency clients are barely in their infancy. There is no central regulatory authority; no state or federal team of bank auditors, insurance examiners and compliance experts monitoring transactions and policing for manipulation; no existing federal licensure for any of the participants at the cryptocurrency institutions — it’s not just the Wild West, it’s global anarchy.

Ohio selected BitPay for the job, a company founded in 2011, which will convert taxpayer bitcoin into dollars for the state of Ohio and, after taking a 1 percent fee, pay those dollars directly to the Ohio state treasury. The only problem? BitPay is not registered to provide money-related services in Ohio.

### **BitPay Has Not Registered as an Ohio Money Transmitter**

Under Ohio statute, regardless of the location of a person, its facilities, or its agent, if a person receives, directly or indirectly and by any means, money or its equivalent for transmission from a person located in Ohio, a money transmitter license is required. Ironically, Ohio is notorious among anti-money laundering practitioners as having one of the most onerous money transmitter regulatory regimes in the U.S., with a vast and unforgiving jurisdictional reach.

Moreover, registration means that an Ohio money transmitter will be subject to significant state scrutiny of its operations, and a lengthy laundry list of very rigorous regulatory requirements enforced by the Financial Crimes Enforcement Network, including:

- Providing financial statements audited by a certified public accountant for the most recent fiscal year;
- Maintaining robust Bank Secrecy Act, OFAC (see below) and Patriot Act compliance programs;
- Hiring an independent compliance officer;
- Having an independent AML audit; and
- Posting a bond of as much as \$2 million.

But BitPay is not registered as an Ohio money transmitter, in possible violation of one of Ohio's more exacting and cumbersome financial regulations. BitPay told me in an email that while BitPay has "numerous money transmitter licenses," BitPay's money transmitter registration application with Ohio is "pending." Neither Ohio nor BitPay could state for certain when, or if, the BitPay money transmitter application would receive approval.

This means that the money transmitter hired by the state of Ohio to process tax payments is not licensed to conduct money transmitter business in Ohio. This is a bit like the Cleveland Clinic offering health insurance to its employees where the only preferred provider is an unlicensed hospital in the Caribbean. The choice is unsettling and makes little sense.

Failure to register as a money transmitter in a state can, under certain conditions, even generate criminal prosecutorial interest. Pursuant to 18 US Code §1960, captioned Prohibition of Unlicensed Money Transmitting Businesses:

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.

Section 1960 then goes on to list three categories of unlicensed money transmitting businesses, which are, in a summarized fashion:

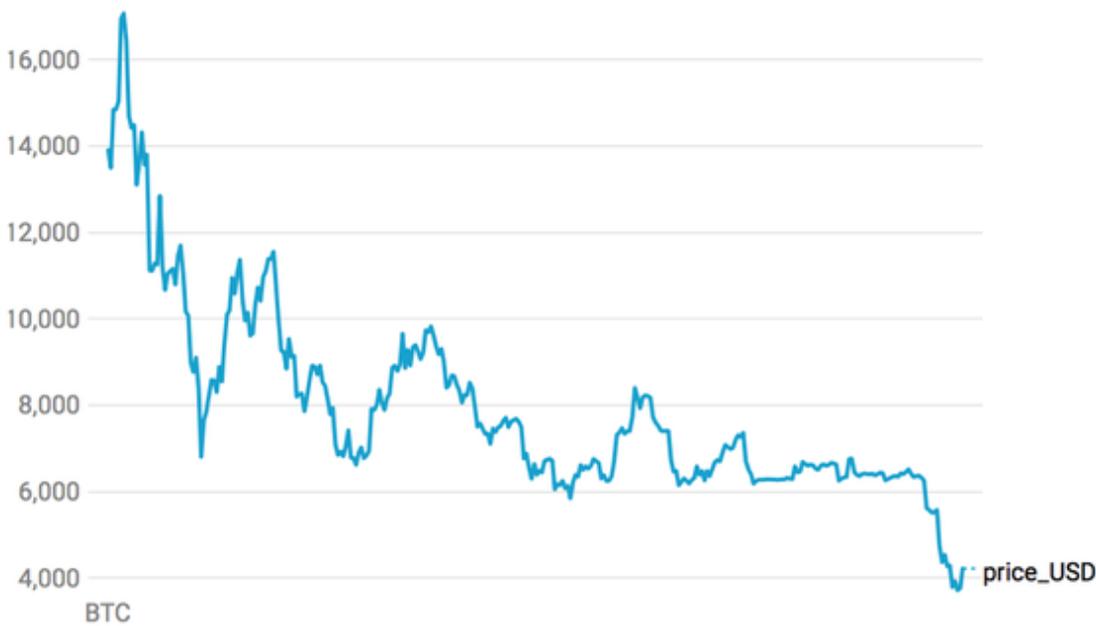
1. Those operating in a state that requires that business to be licensed and makes it a misdemeanor or felony not to do so;
2. Those that fail to comply with U.S. Treasury Department regulations covering such a business (e.g., registering with FinCEN); and
3. Those that transmit money known to the transmitter to come from or intended to finance criminal activity.

It is also critical to note that, in most cases, Section 1960 is not a specific intent statute. As part of the USA Patriot Act, Congress amended Section 1960(b)(1)(A) to provide that a defendant can be convicted of operating an unlicensed money transmitting business "whether or not the defendant knew that the operation was required to be licensed or that the operation was so punishable." This is a useful and potentially devastating federal "hook" for U.S. Department of Justice prosecutors seeking a slam-dunk trial victory.

### **Price Volatility Risks**

Because the cryptocurrency's value can vary drastically in a single day, its unprecedented volatility creates serious challenges to using bitcoin as a method of payment. Bitcoin's volatility has even entered the realm of pop culture. Season five of HBO's "Silicon Valley" started its cryptocurrency saga with a creepy alert set up for the price of bitcoin — whenever the volatile virtual currency's price fluctuated, a network engineer's computer would blast out Napalm Death's two-second long song, "You Suffer." Bitcoin's volatility is remarkably extreme; since January, bitcoin has fallen roughly 70 percent and recently fell below \$3,500 for the first time in 14 months, losing 30 percent in over seven days. Bitcoin recovered slightly afterward but continues to experience dramatic, unpredictable and startling price swings.

## Bitcoin's One-Year Performance Prices Since January 2018



Source: CoinDesk • [Get the data](#) • Created with [Datawrapper](#)

To combat price volatility challenges, BitPay asserts that it will assume all of the risks, but the volatility is so extreme. Ohio's website explains:

BitPay sets the exchange rate for a 15 minute allotted time window for each transaction once a business taxpayer begins to make their payment at OhioCrypto.com ... BitPay assumes the risk of any market fluctuations during the allotted time window.

However, what about the Ohio taxpayer's risk? By rolling out the red carpet for bitcoin, Ohio has proclaimed a not-so-subtle endorsement of investing in bitcoin — which is replete with too many risks to mention. This seems irresponsible and reckless — and also dangerous.

### BitPay and the NYDFS

To its credit, in July 2018, BitPay became only the eighth company to receive a BitLicense from the New York State Department of Financial Services. New York's Bitlicense application, which is 30 pages long and includes a \$5,000 application fee, asks numerous questions about the history of the business, as well as information about its owners and operators, financials, and the company's anti-money laundering and compliance procedures. Compliance with the BitLicense also requires the appointment of a dedicated compliance officer, written compliance and anti-fraud procedures, and the maintenance of minimum capital reserves. Additionally, any company that plans to introduce a "material change" to their business model, such as a new product or service, must notify and obtain consent from the superintendent of the NYDFS.

Permission from the NY superintendent is also required for any merger or acquisition of any company holding a BitLicense. The BitLicense requires that records be kept for up to seven years of every cryptocurrency transaction carried out by a company. Sensitive information, such as the physical addresses, bank statements and names of customers who are parties to that transaction, must also be recorded and be made available to the NYDFS upon request.

BitPay may well be an honest and trustworthy institution, but who can say that for sure? A large part of the ethos surrounding cryptocurrencies is a desire for privacy and freedom from intrusive government regulation, and bitcoin devotees loathe subjecting themselves to any sort of regulations. Compliance systems, reporting mechanisms and the like represent a betrayal of the fundamental values of cryptocurrency enthusiasts — and has actually led to a cryptocurrency

exodus from the state of New York.

It is not surprising that the image on the front side of the gold coins in the John Wick films has the phrase *Ens Causa Sui*, or "Something Generated Within Itself, and on the reverse side is the phrase *Ex Unitate Vires*, or "Out of Unity Comes Strength." These notions represent some of the sentiments behind bitcoin fanaticism.

Overall, despite BitPay's New York Bitlicense (which is to be commended but only applies to activities in New York), the list of federal and global regulatory safeguards concerning BitPay remains physically and virtually vacant:

- Unlike banks, financial firms, insurance companies and the like, BitPay has no federal liquidity, net capital, or other depository or financial requirements of any kind;
- BitPay is not examined or audited by any federal agency, such as the Federal Reserve or the U.S. Securities and Exchange Commission;
- BitPay's operations and employees are not registered and licensed with any federal government agency or quasi-government agency, such as the Financial Industry Regulatory Authority.
- BitPay's property such as bitcoin (bitcoin is not recognized as an official currency) is not insured by any federal agency, such as the Federal Deposit Insurance Corp.;
- BitPay does not have any federal accounting requirements with respect to its assets;
- Unlike banks, brokerages and other financial firms, BitPay does not report its financial condition to the federal government in any form of official government filing, such as an annual report or SEC Form 10-K;
- BitPay does not have any SEC record-keeping requirements with respect to its operations, communications or any other aspect of its business;
- BitPay has no federal requirements regarding the pricing of any cryptocurrency trading transaction, the use of employees of its payment systems or any federal anti-manipulation requirements (though BitPay could be sued for fraud and other crimes by any federal agency with appropriate jurisdiction); and
- BitPay does not have any sort of SEC compliance requirements or other code of conduct requirements like investment companies, brokerages and other financial firms, most of whom spend millions (or tens of millions) of dollars every year on compliance and customer protection-related infrastructure.

This lack of a formal bank, insurance or securities firm structure creates enormous challenges for law enforcement to monitor and apprehend any individuals who use cryptocurrencies for illegal activities. Indeed, the range of safeguards relating to U.S. financial institutions have taken shape after decades of scrutiny, analysis and testing and are historically rooted in the U.S. marketplace — the safest and most admired in the world.

But all is not as free reining as many crypto promoters believe. Despite the lack of a formal federal regulatory scheme for all things crypto, there remain several critical federal financial rules and regulations that likely apply to crypto-related activities, beginning with anti-money laundering responsibilities, which will be covered, together with some other critical issues for Ohio, in part two of this series.

\*\*\*

This concludes part one of this two-part series. Please be sure to read part two, which will: (1) discuss the array of intricate money laundering issues pertaining to Ohio's crypto efforts together with other concerns for Ohio such as cybersecurity risk, tax hazards and OFAC implications; and

with other concerns for CMOs, such as cybersecurity risk, tax hazards and ERISA implications, and (2) provide some final thoughts and suggestions going forward.

---

*John Reed Stark is the president of John Reed Stark Consulting LLC, a data breach response and digital compliance firm. Formerly, Stark served for almost 20 years in the Enforcement Division of the U.S. Securities and Exchange Commission, including 11 years as the chief of its Office of Internet Enforcement. He is the author of "The Cybersecurity Due Diligence Handbook."*

*The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.*

---

All Content © 2003-2018, Portfolio Media, Inc.