ALERTS

NYDFS Releases Guidance for BitLicensees and Limited Purpose Trust Companies on Asset Custody in the Wake of Cryptocurrency Insolvencies

January 31, 2023

On Jan. 23, 2023, the New York State Department of Financial Services ("NYDFS") issued guidance to entities licensed under 23 NYCRR Part 200 ("BitLicensees") and entities chartered as New York limited purpose trust companies (together with BitLicensees, "Virtual Currency Entities" or "VCEs"), on custody and disclosure practices to protect customers in the event of an insolvency or similar proceeding ("Guidance").[1] The Guidance applies to VCEs that act as custodians ("VCE Custodians") and discusses the standards the NYDFS expects VCE Custodians to adhere to with respect to asset custody.[2] The Guidance focuses on four areas of customer protection, each of which is further discussed below: (i) segregation of and separate accounting for customer virtual currency; (ii) VCE Custodian's limited interest in and use of customer virtual currency; (iii) sub-custody arrangements; and (iv) customer disclosure.

Segregation of and Separate Accounting for Customer Virtual Currency

NYDFS expects VCE Custodians to separately account for and segregate customer virtual currency from their own assets, including from assets of their affiliates, both on-chain and on the VCE Custodian's internal ledger accounts. Customer virtual currency must not be commingled with the VCE Custodian's own virtual currency. Such segregation and accounting should also be fully disclosed to the customer as further discussed below.

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Specifically, customer virtual currency[3] should be maintained in either (i) separate on-chain wallets and internal ledger accounts for each customer under that customer's name; or (ii) in one or more omnibus on-chain wallets and internal ledger accounts that contain only virtual currency of customers held under the VCE Custodian's name as agent or trustee for the benefit of its customers. If customer virtual currency is held in one or more omnibus accounts, the VCE Custodian must maintain appropriate records and a clear internal audit trail to identify customer virtual currency. VCE Custodians should have clearly documented policies and procedures to evidence that these safeguards are in place. VCE Custodians should also be prepared to reconcile their books and records and on-chain activity upon the NYDFS' request.

VCE Custodian's Limited Interest in and Use of Customer Virtual Currency

When customers transfer virtual currency to a VCE Custodian for custody services, the NYDFS expects that the VCE Custodian will only take possession for the limited purpose of carrying out custody and safekeeping services. Particularly, the VCE Custodian should not establish a debtor-creditor relationship with the customer and use customer virtual currency for its own use, including using customer virtual currency to secure or guarantee an obligation of, or extend credit to, the VCE Custodian or any other person. VCE Custodians are also expected to act upon the instructions of their customers (or authorized representatives) and not acquire general discretion over custodied assets beyond those terms clearly expressed in the VCE Custodian's agreement with its customer.

Sub-Custody Arrangements

To the extent the VCE Custodian engages a sub-custodian for the custody of its customers' virtual currency, it may do so only after appropriate due diligence and obtaining prior approval from the NYDFS.[4] As part of the request for approval, the NYDFS expects the VCE Custodian to provide (i) the risk assessment performed by the VCE Custodian with respect to the new relationship; (ii) the proposed agreement(s) between the parties; and (iii) the VCE Custodian's updated policies and procedures reflecting processes and controls to be implemented for the proposed arrangement.

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VCE Custodians should clearly disclose to their customers in writing the general terms and conditions associated with their products, services and activities, as well as obtain acknowledgment of receipt of such disclosures prior to entering into an initial transaction with the customer. The customer agreement should also clearly disclose (i) how the VCE Custodian segregates and accounts for customer virtual currency; (ii) the property interest the customer retains in custodied assets; (iii) how the VCE Custodian may use virtual currency while in its possession; and (iv) what limitations on the use of custodied virtual currency by the VCE Custodian apply. If the VCE Custodian uses a sub-custody arrangement, the customer agreement should clearly disclose the terms of that arrangement and the material risks presented by such arrangement. Further, the customer agreement and disclosures must be readily accessible to customers on the VCE Custodian's website.

Conclusion

Given the current virtual currency market, including the recent bankruptcies of cryptocurrency exchanges and platforms, the Guidance indicates that the NYDFS is taking a strong stance to ensure the protection of customer assets, particularly in the event of an insolvency of a VCE Custodian. Currently regulated VCEs, or those seeking to apply to become a VCE, should carefully review the Guidance to ensure compliance.

Schulte Roth & Zabel's lawyers are available to assist you in addressing any questions you may have regarding these developments. Please contact the Schulte Roth & Zabel lawyer with whom you usually work, or any of the following attorneys:

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[1] *Guidance on Custodial Structures for Customer Protection in the Event of Insolvency*, N.Y. Dep't Fin. Servs. (Jan. 2023), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structur

[2] Under 23 NYCRR Part 200, BitLicensees are required to, among other things, hold virtual currency in a manner that protects customer assets; maintain comprehensive books and records; properly disclose the material terms and conditions associated with their products and services, including custody services; and refrain from making any false, misleading or deceptive representations or omissions in their marketing materials. Analogous requirements on New York State limited purpose trust companies that engage in virtual currency business activity have been imposed by the NYDFS pursuant to supervisory agreements or through its authority to order the trust company to discontinue unsafe and unsound practices. *See, e.g.*, NY Banking Law §§ 10, 39.

[3] The Guidance notes that to the extent a VCE funds transaction costs (e.g., gas fees) on behalf of its customers, the VCE should consider these funds as customer funds subject to the Guidance.

[4] The NYDFS notes in the Guidance that it views the establishment of a new sub-custody arrangement as a material change to the VCE Custodian's business, which requires prior approval. Applicants can seek the required approval during the *de novo* license / charter application process, while currently regulated VCE Custodians can submit requests as a material change in business.

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