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***The Crypto Exchange*: Will Resiliency Carry the Digital Asset Sector Through 2024: State-Level Developments**
Speakers: Ethan Ostroff, Addison Morgan, Trey Smith

Ethan Ostroff:

Welcome to another episode of *The Crypto Exchange*, a Troutman Pepper podcast. Focusing on the world of digital assets. I'm Ethan Ostroff, the host of the podcast and a partner of Troutman Pepper.

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Today I'm joined by my colleagues, Addison Morgan and Trey Smith for part three of our four-part Year in Review series about 2023 in digital assets and distributed ledger technology. Today we're focusing on some state-level activities. In particular, the NYDFS guidance document on digital asset-related custodial structure. California's new Digital Financial Assets Law, and some other various state bills that were proposed and enacted during 2023.

Addison, Trey, thank you again for joining me today. I wanted to jump in and start by talking about what's been going on with New York this past year. We go back with New York to the creation of the BitLicense regulation in 2015. The first such attempt at passing laws and regulations applicable to digital assets and virtual currency businesses in the US.

And then we fast forward to 2020, we get conditional licenses being permitted by the NYDFS allowing companies to partner with existing licensed entities. New guidance streamlining coin listing processes for license exchanges and some other things.

And then we come forward to January of 2023 where we got this new guidance document for BitLicenses as well as entities chartered as limited purpose trust companies under the New York banking law who provide digital asset custody services. Generally speaking, the purpose was to ensure that virtual currency entity custodians provide a higher level of customer and consumer protection with respect to asset custody.

Trey, maybe we could just start off, man? What are the main principles behind this guidance?

Trey Smith:

Yeah, Ethan. Thanks for having me. In the wake of the 2022 sort of collapse of various large players in the industry, we saw a lot of customer funds being subject to bankruptcy proceedings and just held in advance. To answer your question, the main principles of the guidance are to protect consumers from injury in that regard again. The main principles are implementing requirements that relate to segregation and accounting for customers their virtual currency.

They specifically require that a custodian retains only a limited interest in and use of that customer's virtual currency. And then it's also going to put some measures in place that addressed a custodian's sub-custody agreements with service providers who might assist it with having custody over customer assets. And, lastly, the final principle relates to certain disclosures that custodians are required to give to customers.

Ethan Ostroff:

Gotcha. When we talk about segregation, are there options providing the guidance as to how a custodian can segregate the virtual currency of its customers/

Trey Smith:

There are. The guidance provides two different options for how custodians can potentially separate customers' virtual currency. There's separate segregation, which essentially just means that the customer assets have to be held in on-chain wallets with internal ledger accounts for each customer under their specific names. Or there's also an omnibus segregation, which is an on-chain wallet and internal account ledgers that contain exclusively customer crypto. And that crypto is held in the name of the custodian but as an agent or trustee for the customers' benefits. Essentially, both options requiring custodians to segregate and act in the benefit of customers' interests.

Ethan Ostroff:

Okay. And is there limits on a custodian's legal interest in the virtual currency of its customers based on the guidance?

Trey Smith:

There are. As I mentioned at the top of this discussion, the concern was with the customer funds becoming subject to the bankruptcy proceedings in the event of insolvency. And so, the limitation of a custodian's legal interest is that the custodian cannot establish a debt or creditor relationship with the customers. They can only take possession of the customers' assets for the purpose of carrying out custody and safekeeping services. And that's it.

Ethan Ostroff:

Okay. Could you explain a little bit more to the audience about what a sub-custody agreement is?

Trey Smith:

Yeah. the Department of Financial Services guidance, it discusses sub-custody agreements. And, essentially, they're an agreement between a custodian and a third party for the third party to perform the custodial services on behalf of the custodian. It's essentially just subcontracting for custody services.

Ethan Ostroff:

And if I remember correctly, you've got to get pre-approval from the NYDFS before you enter into any type of sub-custody agreement. Is that right?

Trey Smith:

That's right. Entering into a sub-custody agreement is considered a material change under the guidance. It's considered a material change to the custodian's business. And so, that would have to be disclosed to the DFS. And as a result, the BitLicense framework is going to require the custodian to obtain approval from DFS before they can enter into that sub-custody agreement.

Ethan Ostroff:

And are there steps to requirements when you go as a custodian to NYDFS seeking approval for sub-custody agreements?

Trey Smith:

Yep. A custodian's going to have to provide at a bare minimum level a number of different pieces of information to the DFS. That's going to include a risk assessment that is performed by the custodian. It's going to also require the custodian to provide the proposed service agreements between the custodian and the third party. And the final piece of information that's going to be required is the custodian's updated policies and procedures that are going to reflect what processes and controls are going to be implemented around that proposed agreement. They're really just sort of vetting the arrangement before allowing the custodian to enter the agreement.

Ethan Ostroff:

Right. And then the last thing I thought was particularly important about this guidance was the requirements for disclosures by custodians in their customer agreements. Could you talk a little bit and describe what those disclosures are?

Trey Smith:

Yes. The guidance, it does require the custodians, as you mentioned, to make particular disclosures regarding the relationship between the custodian and the customer. Some of the required disclosures are, first, the existence of that custodial relationship between the custodian and the customer itself. And the guidance explicitly requires the custodian to inform and disclose to the customer that the relationship is not a debtor and creditor relationship.

The disclosure must also provide a notice that the customer's virtual currency is segregated from the virtual currency of the custodian through either that separate segregation or omnibus segregation method that we discussed earlier. Other disclosures that are required under the guidance include a notice that the customer's property interest in any virtual currency under the care of the custodian remains with a customer at all times. That the custodian will not use the customer's virtual currency to secure or guarantee any of its obligations or to lend to another

party. And the final required disclosure is that the custodian disclosed the terms and material risks of the sub-custody arrangement if there is one entered into.

Ethan Ostroff:

All right. And interestingly enough, if I remember correctly, these disclosure requirements, they're not actually listed in the BitLicense statute, right? You've got to go to this guidance document to find all these, right?

Trey Smith:

That's right. They're not. Custodians should make sure that they're reviewing the guidance and many other applicable guidance documents as the Department of Financial Services releases them.

Ethan Ostroff:

Sure. In other words, more than just checking the statute and the official regs is required, right? You got to stay on top of and aware of the new guidance coming out particularly important in the space as things tend to change somewhat quickly sometimes.

Trey Smith:

That's right.

Ethan Ostroff:

Yeah. I thought maybe we could talk a little bit, Addison, now about California's Digital Financial Assets Law. That one was passed in October of 2023. Doesn't become effective as of now until July 1st 2025. But what we're seeing is California following in the footsteps of New York and Louisiana to become the third state to adopt a comprehensive digital asset regulatory regime.

Essentially, this law is equipping the California DFPI with supervisory and enforcement powers to ensure any entity that engages in digital financial asset business activity obtains a license from the DFPI before engaging that activity with residents of California.

I think, interestingly, it does – the bill itself allows the DFPI commissioner to issue conditional licenses to applicants who have either obtained the BitLicense or the Limited purpose trust Charter from the New York DFS that we were just talking about.

And I will mention to our readers, if they're interested, we did do a full podcast just about the California DFAL earlier in 2023. But I thought, Addison, for year-in-review purposes, we could just hit on some key points here that we want to make sure folks know about. How, at a high level, would you describe the distinctions between the BitLicense framework in New York and California's DFAL?

Addison Morgan:

Sure, Ethan. I think from a high-level standpoint, the BitLicense framework, it refers to virtual currencies more generally. And so, for purposes of this conversation, that could include a virtual currency like a stablecoin, right? But on the other hand, this California's DFAL kind of carves out a specific definition for that asset, which is the stablecoin. Additionally, with that definition, DFAL also sets forth this reasonable consumer standard for determining whether or not an issuer of a stablecoin intended for the public to believe that the stablecoin itself will remain its peg to whichever national currency the stablecoin is tied to.

Ethan Ostroff:

Yeah. Just a little bit more maybe about that reasonable consumer standard. I mean, what do we think about the practical impacts that that may have on stablecoin issuers? If any?

Addison Morgan:

I mean, in practice, I'm not sure how many stablecoin issuers are affirmatively stating that their stablecoins will maintain their pegs at all times. But if there are issues out there that are doing that, I think that, under DFAL, they will refrain from engaging in those types of marketing practices. Because I think history has shown us at this point that all stablecoins, no matter what methodology you use, whether it'd be a reserve-back stablecoin or an algorithmic stablecoin, in times of heightened market volatility and kind of notable external news events, these stablecoins are susceptible to de-pegging.

And just for an example, during 2023, when we had the various bank collaps, Circle, the issuer of USDC, at one time may maintain, I want to say, 3.3 billion of its 40 billion in cash reserves. These are cash reserves that are backing USDC. 3.3 billion of those cash reserves were maintained at Silicon Valley Bank.

And so, when Silicon Valley Bank crashed and Circle confirmed on Twitter that it was unable at this point in time to withdraw that 3.3 billion from SVB, there was a huge selloff, there was a huge run on USDC. And I want to say, very shortly after Circle confirmed that USDC lost 10% of its value – it started trading around from $1 to 88 cents. And this just due to the immense redemption request that kind of followed Circle's announcement.

Ethan Ostroff:

Right. De-pegging really is a collateralization issue. Is that how you see it?

Addison Morgan:

Yeah. Agreed. Right now, most stablecoins are collateralized off-chain. USDC – we're just going to stick with Circle, for example. USDC is a stablecoin that is transferred on the blockchain or whatever DLT-based system you're utilizing. But the US dollars and various other eligible securities that they're using to back that stablecoin for redemption purposes, those things exist off-chain.

In the episode, part two of this series, we discussed the fed's concerns with tokenization. I mean, this is the primary concern right here, de-pegging. No matter if it's a stablecoin. No matter if it's a real-estate-backed asset or a gold-backed asset that's living on the blockchain, even if you have sufficient reserves to back an on-chain asset, if the redemption process is occurring entirely off-chain, the asset itself will be susceptible to runs anytime there's a high demand for that off-chain collateral. And so, the fed, like they stated, is concerned with that process. Is it still possible for these kind of accentuated runs on any asset to occur in DLT-based systems?

Ethan Ostroff:

Yeah. That's sort of a nice transition point to talking about a little bit more about how DFAL authorizes licenses to facilitate transactions involving stablecoins. I mean, you mentioned the distinction between reserve-backed and algorithmic stablecoins earlier. Can entities transact in both under DFAL? Are they treated differently under California's law?

Addison Morgan:

Yeah. And I think this is a very notable point in a DFAL. Because both stablecoins, whether it's a reserve-backed stablecoin or an algorithmic stablecoin, they're both subject to certain requirements. But at a high level, the DFAL permits lenses to facilitate transactions involving reserve-backed stablecoins without any prior approval.

You have a reserve-backed pathway. But on the other hand, if you're a licensee and you want to facilitate transactions involving non-reserve-backed stablecoins, the licensee has to seek approval from the DFPI to engage in those transactions.

Ethan Ostroff:

What are the requirements for facilitating transactions involving reserve-backed stablecoins?

Addison Morgan:

Sure. I want to just make a point here. These authoritative prerequisites, they apply to the issuer of the stablecoin. They don't apply to the licensee, the entity trying to facilitate transactions themselves. They apply to the issuer.

And so, the requirements for facilitating transactions involving reserve-backed stablecoins, the issuer has to be either an applicant, an entity that submitted an application to the DFPI for a license, a licensee under the DFAL, or an exempted entity like a bank trust company or national association.

And so, like I said earlier, this is the reserve-backed pathway. And so, the second requirement is that the issuer of this stablecoin must also always maintain eligible securities in an amount that is not less than the amount of outstanding stablecoins issued or sold by the issuer. And so, that's colloquially referred to as just a one-to-one ratio.

Ethan Ostroff:

Sure. In this context, I mean, did the DFPI give us any information about a standard or how they're going to go about evaluating a licensee's request to facilitate transactions involving non-reserved-backed or algorithmic stablecoins?

Addison Morgan:

Yes. And so, here, the DFPI is primarily concerned that whether the stablecoin compromises the interest of residents who may use the stablecoin as a payment for goods and services or as a store of value. The DFPI still has the same concern the FED has with that respect to de-pegging.

And so, when the DFPI is evaluating this standard, it will assess specified factors including any legally enforceable rights provided by the issuer of the stablecoin to holders of the stablecoin. Including but not limited to rights to redeem the stablecoin for legal tender, or bank, or credit union credit the amount nature and quality of assets. This particular bullet point refers to the assets backing the algorithmic stablecoin. And so, the amount nature and quality of assets owned or held by the issuer of the stablecoin that may be used to fund any redemption request from residents. And then, lastly, just any representations made by the issuer of the stablecoin related to the potential use of the stablecoin. Interestingly enough, it seems like the DFPI is very concerned with outward marketing with respect to whether or not a stablecoin is going to maintain its peg.

Ethan Ostroff:

Right. It's very interesting developments in California and certainly a lot to be followed there between now and when that law goes into effect. Just bringing this episode of our year in review to a close, I thought we might just touch on a couple of state level legislative events. Some of the notable activity from the past year.

Trey, we mentioned earlier about Louisiana being the second state to enact a comprehensive regulatory framework for digital assets. I believe they finalized that framework in June of 2023. At a high level, what stood out to you about that legislation and its impacts on people in the ecosystem?

Trey Smith:

There were two main points that stood out to me. The first is the scope of the definition of a virtual currency business activity and particularly what it exempted. It specifically exempted digital asset mining and NFT minting. As well as blockchain-related activities not involving exchanging, holding, selling, storing, or transferring digital assets.

And then the second point was that the statutory regime did not provide any guidelines for obtaining a conditional license. A lot of the states have approved possession of New York's BitLicense as a sufficient basis for approving a conditional license. But interestingly, Louisiana chose not to have that sort of conditional approval. It seems like Louisiana intends to force everyone to apply for a license.

Ethan Ostroff:

Interesting. A significant barrier, right? If you want to engage in transactions with residents of Louisiana.

Trey Smith:

Yeah. That's right. And then, finally, I thought, Addison, maybe just touch on briefly the Nevada legislature introduced a bill, the Digital Financial Asset Business Activity Law about a year ago in March of 2023. What, if anything, stood out to you about that one? And in particular, that seemed rather similar to California's DFAL. Do you agree with that?

Addison Morgan:

I agree with that, Ethan. And I think that DFAL was originally introduced in December of 2022. And I have to assume that the Nevada legislature used the defile as a template to draft their proposed legislation. Because like you stated, there are some striking similarities between the two.

For example, the operative term of both the DFAL and Nevada's proposed legislation is this term, the Digital Financial Asset Business Activity. And so, Nevada defines that term exactly how California does.

And then also, Nevada will also – well, whenever if and when this legislation is enacted, Nevada will also grant conditional licenses to applicants who have obtained a BitLicense. Kind of a differentiating factor between Nevada's proposed legislation and Louisiana's current regulatory regime.

And I would say the last notable development was that, unlike the DFAL, Nevada's law or proposed law, it implements the Electronic Funds Transfer Act and Regulation E. And so, the legislation specifically states to the extent the provision of the bill conflicts with the EFTA, the EFTAs provisions will apply.

This is interesting because neither the Supreme Court nor Congress have stated that the EFTA applies to digital asset transactions. We've definitely seen an increased trend, increased filing of EFTA digital asset-related litigation. But the courts that are evaluating those claims right now are split on whether the EFTA applies. If Nevada does pass this law, I'm interested to see whether or not the preemption provision will ever come into play.

Ethan Ostroff:

Yeah. Something definitely to watch and to track as Nevada goes through its legislative process in 2024.

Guys, thank you again for joining us today. Appreciate the audience for listening to today's episode as well. Again, don't forget to visit our blogs, ConsumerFinancialServicesLawMonitor.com and TroutmanPepperFinancialServices.com, and subscribe so you can get the latest updates.

We look forward to our next episode, which will be the part four and the final episode of our 2023 Year in Review series where we will be discussing some important federal legislative developments and some OFAC-related enforcement matters that occurred in 2023.

Until next time, thanks very much. And we'll talk to you soon.

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