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Custody Takeaways After NY Crypto Guidance, Bankruptcies

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Demand for virtual currency services, including custody services, has soared in the past several years.

Like their counterparts in traditional finance, these custodians are stewards of retail and institutional customer funds and serve an important and valuable function.

However, as evidenced by a number of headline-grabbing failures during the lingering crypto winter, inadequate disclosures and poor custodial practices can seriously harm retail and institutional customers alike.

For many virtual currency customers, this recognition — in an industry built on the pillars of trust and transparency — was realized too late.

Recent disclosures emerging from notable bankruptcies involving crypto companies have led to allegations of fraud and mismanagement in connection with custodial services. These allegations strike at the very core of the custodial relationship and have reverberated throughout the crypto industry.

Seemingly in direct response to these developments, on Jan. 23, the New York Department of Financial Services issued industry guidance to virtual currency entities, or VCEs, who act as custodians.[1]

In its recently issued on guidance on custodial structures for customer protection amid insolvency, the department emphasized the "paramount importance of equitable and beneficial interests always remaining with the customer" and reminded covered institutions of their obligations in connection with "sound custody and disclosure practices in the event of an insolvency" or similar proceeding.

The guidance comes on the heels of developments in two high-profile insolvency proceedings.

The FTX Trading Ltd. proceedings, where, among others, the U.S. Securities and Exchange Commission has alleged co-founder Sam Bankman-Fried concealed the diversion of FTX customer funds to the co-founder's private crypto hedge fund.[2]

In the Celsius Holdings Inc. proceedings, the chief judge for the U.S. Bankruptcy Court for the Southern District of New York issued a decision holding that Celsius' terms of use made clear that customer deposits into earn accounts became Celsius' property at the time of deposit, such that the digital assets now constitute property of the debtors' bankruptcy estate.[3]

In Celsius, customers argued that the deposits in the earn accounts were held by Celsius as a custodian, but the court found that the plain language of the terms of use made clear that ownership interest had passed to the debtors.

The guidance applies to entities licensed under Section 23 of the New York Codes, Rules and Regulations, Part 200, that have a BitLicense, and limited-purpose trust companies that engage in virtual currency business activities.

So what is a virtual currency business activity? As defined under the BitLicense rules,[4] a virtual currency business activity means any of the following activities that involve New York or a New York resident:

- Receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for nonfinancial purposes and does not involve the transfer of more than a nominal amount of virtual currency;
- Storing, holding or maintaining custody or control of virtual currency on behalf of others;
- Buying and selling virtual currency as a customer business;
- Performing exchange services as a customer business; or
- Controlling, administering or issuing a virtual

The list above is taken directly from a December 2022 industry letter issued by the NYDFS. In that December industry letter, the NYDFS also identified a number of specific activities that would constitute virtual currency-related activity, including activities such as:

- Offering digital wallet services;

- Lending activities collateralized by virtual currency assets;
- Facilitation of customer participation in virtual currency exchange or trading, stablecoin services such as providing reserve services for issuers, and traditional banking activities involving virtual currency through the use of a new technology that may expose the entity to different types of risk, e.g., underwriting a debt product effected partially or entirely on a public [5]

In light of this, it would be prudent to take a more expansive approach when considering whether one is engaged in a virtual currency business activity subject to NYDFS oversight.

In the guidance, the NYDFS outlines several fronts on how VCE custodians can provide a "high level of customer protection with respect to asset custody" under the BitLicense requirements. Outlined below is the framework the NYDFS highlighted in the guidance.

Segregation of and Separate Accounting for Customer Virtual Currency

As stated in the guidance, in order to maintain appropriate books and records, VCE custodians must separately account for and segregate customer virtual currency from the corporate assets of the VCE custodian and its affiliated entities, both on-chain and on the VCE custodian's internal ledger accounts, clearly disclosing the manner of segregation and accounting for customer virtual currency.

VCE custodians must also refrain from commingling customer virtual currency with any noncustomer virtual currency. This guidance stands in stark contrast to FTX, which, as alleged in the SEC's complaint against Bankman-Fried and as testified by the current CEO John Ray's testimony before the U.S. House of Representatives' Financial Services Committee in December, commingled customer assets with noncustomer assets.[6]

The NYDFS specifies that customer virtual currency should be maintained in either separate on-chain wallets and internal ledger accounts for each customer under that customer's name, or 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 those customers.

If the latter, according to the NYDFS, VCE custodians should maintain appropriate records and an explicit internal audit trail to protect the customer's beneficial interest, along with documented policies and procedures evidencing such protections.

In addition, the NYDFS highlighted that VCE custodians should be able to reconcile the virtual currency entity's internal records and on-chain activity upon request from the NYDFS.

VCE Custodians' Limited Interest in and Use of Customer Virtual Currency

According to the guidance, VCE custodians should only take possession of assets for the limited purpose of custody and safekeeping services and should not thereby establish a debtor-creditor relationship.

To preserve customers' equitable and beneficial interest in the virtual currency, the guidance advises a VCE custodian to treat customer virtual currency as belonging solely to the customer, and refrain from employing it for its use by securing or guaranteeing an obligation against the virtual currency or acquiring general discretion beyond the terms expressly described in the customer agreement — whether that be for marketing, investing or other spend.

The extent to which a debtor-creditor relationship exists between various bankrupt cryptocurrency exchanges and their respective customers will likely be the focal point of a number of high-profile crypto bankruptcies, including FTX and Celsius.

Sub-Custody Arrangements

Sub-custody arrangements with third parties must be consistent with NYDFS guidance.

The NYDFS noted that establishing such an arrangement is considered a material change to a VCE business and requires NYDFS approval before implementation, with the agency looking at such things as whether a risk assessment was performed by the VCE custodian, the proposed service agreements between the parties, and any updated VCE custodian policies and controls relating to the proposed arrangement.

Customer Disclosure

Consistent with the guidance, VCE custodians should provide clear disclosure to each customer, in writing, of the general terms and conditions associated with its products, services and activities, as well as obtain acknowledgment of such disclosure prior to transacting with the customer.

Such customer agreement should make clear the custodial arrangement, as opposed to the debtor-creditor relationship.

For instance, the guidance states such disclosure should clearly outline how the entity segregates and accounts for customer virtual currency, the details of the customers' property interest in the custodied assets, and the VCE custodian's permitted uses of customer virtual currency, including any limitations or exceptions.

It remains to be seen how this point will play out in some of the current bankruptcy cases of crypto exchanges.

As noted above, in Celsius, the court found that the terms of use made clear that customer deposits into earn accounts became Celsius' property at the time of deposit.

Many customers argued that the terms of use were inconsistent with their understanding of how deposits were being held based on representations made by Celsius in its marketing materials and otherwise.

The Celsius court has left open the possibility that customers could raise the issue of inadequate disclosure in the claims reconciliation process.

Conclusion

The recent NYDFS guidance appears to be a part of a broader initiative to provide related guidance in the emerging virtual currency space.

For example, as noted above, on Dec. 15, the NYDFS released[7] its final guidance to banking organizations seeking to engage in "new or significantly different" virtual currency- related activities.[8]

The guidance for crypto-asset custody can be read as a companion to the earlier NYDFS directives on virtual currency-related activity.

VCE custodians, their customers and anyone who may transact with those parties should be cognizant of several takeaways from the January guidance.

First, in light of the FTX and Celsius proceedings, the NYDFS is motivated to ensure VCE custodians can be held accountable to their customers.

To remain compliant with the guidance, VCE custodians must create and maintain robust internal processes to guarantee custodial duties and transparency, ensuring customers' equitable and beneficial interests are at heart.

Second, VCE custodians should strive to improve and refine their internal accounting and storage policies so the VCE custodian can quickly respond to an NYDFS records request and reconcile on-chain wallets or internal ledgers to provide the NYDFS with sufficient evidence that customers' assets are suitably maintained and protected.

Third, the NYDFS is seemingly decreasing the amount of control VCE custodians may exert over customer virtual currency in an effort to further safeguard the beneficial interests of customers.

If a VCE custodian seeks to enter into a sub-custody arrangement whereby the VCE custodian enters into a service agreement that transfers custody of assets to a sub-custodian, then the NYDFS places the onus on VCE custodians to diligence the sub-custodian and submit a risk assessment, the proposed service agreement and the VCE custodian's updated policies and procedures to the NYDFS in its request for approval.

Finally, a VCE custodian should clearly disclose and seek customer acknowledgment of the terms and conditions of service before engaging in any transactions with the customer.

Moreover, the VCE custodian should be mindful that inconsistent representations regarding the custodial relationship may subject the VCE custodian to potential claims.

While the NYDFS issued this reminder in view of recent bankruptcies and high-profile collapses in the crypto industry, particularly where crypto-assets deposited by customers were allegedly mishandled and commingled, the guidance and related BitLicense rules are continually applicable to covered institutions.

As stated in the guidance, the intent is to offer greater clarity regarding standards and practices that, in the Department's view, will help to ensure that VCE Custodians are providing a high level of customer protection with respect to asset custody under the BitLicense and limited purpose trust company frameworks.

However, it remains to be seen whether this guidance will have the intended effect of providing enhanced consumer protection, or whether it will need to be coupled with additional measures to ensure custodial accounts are not mishandled.

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[1] See, Industry Letter: Guidance on Custodial Structures for Customer Protection in the Event of Insolvency, January 23,

[2] Press Release, Securities and Exchange Commission, SEC Charges Samuel Bankman-Fried with Defrauding Investors in Crypto Asset Trading Platform FTX, (Dec. 13, 2022).

[3] See, In re: Celsius Network LLC, et , Debtors, Memorandum Opinion and Order Regarding Ownership Of Earn Account Assets, (Jan. 4, 2023).

[4] 23 NYCRR § 200.2(q).

[5] See, Industry Letter: Prior Approval for Covered Institutions' Virtual Currency-Related Activity, December 15, 2022. Notably, this December NYSFS guidance can be seen as an expansion of the scope of NYDFS oversight, in light of which "virtual currency-related activities" must receive approval, whereas previously, only "virtual currency business activity" required prior approval from the NYDFS.

[6] See, Testimony of John J. Ray III CEO, FTX Debtors: Hearing before the House Financial Services Committee, (Dec. 13, 2022).

[7] Press Release, New York Department of Financial Services, Superintendent Adrienne Harris Releases Virtual Currency Guidance for Banking Organizations, (Dec. 15, 2022).

[8] See, Industry Letter: Prior Approval for Covered Institutions' Virtual Currency-Related Activity, (Dec. 15, 2022).

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