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Cryptocurrency at a Regulatory Crossroads in New York

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Cryptocurrency's market cap reached \$2.7 trillion this month—more than doubling in less than a year. In September, El Salvador adopted Bitcoin as legal tender in an effort to increase financial inclusion, innovation, and tourism. And this month, New York City's next mayor, Eric Adams, pledged to convert his first three mayoral paychecks to Bitcoin, and he wants all New Yorkers to have the option to do the same. As part of his effort to position the city as a cryptocurrency leader, Adams has promised to take a "look at what's preventing the growth of Bitcoin and cryptocurrency in our city."

Cryptocurrency's widespread adoption is limited—in part—by an uncertain, still developing regulatory framework surrounding it. A growing number of state and federal regulatory

and law enforcement agencies are taking an active role in regulating cryptocurrency, and perhaps even operating at cross-purposes. In particular, in the face of jurisdictional gaps at the federal level, state banking regulators historically played a significant role in regulating crypto. But, more recently, state attorneys general are taking a more active role in the cryptocurrency regulatory and enforcement landscape.

Nowhere are these dynamics more prominently on display than in New York, where the attorney general (NYAG) has taken increasingly aggressive steps to regulate the cryptocurrency ecosystem in the last several years, notwithstanding the already prominent role the New York State Department of Financial Services (NYDFS), New York's banking regulator, is already playing. Overlapping, duplicative state regulation poses—and will continue to pose—compliance challenges for cryptocurrency companies in the years to come absent strong and clear federal legislation.

Federal Regulatory Gaps

For years, the crypto market has developed with little direct federal supervision. For instance, where



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virtual currencies (VCs) are deemed securities, the Security and Exchange Commission (SEC) regulates their issuance and oversees the broker/dealers that make markets in them. Within the banking context, the Office of the Comptroller of the Currency (OCC) has become somewhat involved, issuing three conditional approvals for bank charters to VC businesses earlier this year and stating that crypto will be one of 11 supervisory priorities in 2022. But, for dealers in assets that are not securities or derivatives, and for crypto companies that are not chartered as national trust banks, there is no single federal regulator with day-to-day supervisory responsibility. As a result, the major exchanges, custodial wallet providers, and token issuers have sought state financial services licenses of one form or another.

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Most recently, the new SEC Chair, Gary Gensler stated his view that many existing VCs are actually securities; he hinted that the SEC will take enforcement action where necessary. This fresh interest makes sense—it is simply hard to ignore an asset class this massive—but what the SEC will do is unclear.

New York DFS's BitLicense

But, while federal regulators (at least initially) have acted slowly, New York anointed itself the leader in the space, and it has sought to attract VC businesses to the state with its novel regulatory structures.

NYDFS started eyeing VCs long before Bitcoin was mainstream. In 2014, when the price of Bitcoin was still below \$500, NYDFS held its first public hearings on regulating VCs and proposed the country's first VC regulations; by the following June, they were finalized as the BitLicense. Any person engaging in "virtual currency business activity" involving the state of New York or its residents after that point had to obtain a BitLicense. VC business activity includes transmitting, buying, or selling VCs as a customer business, storing or controlling VCs on behalf of others, converting or exchanging VCs as a service, and controlling or issuing a VC. Importantly, the definition excludes activities that resemble those of currencies or technology, such as use by merchants and consumers for the sale of goods or services, the use by consumers for investment, or use by software developers not acting as financial intermediaries. 23 CRR-NY 200.2.

In many ways, the BitLicense was a smart solution to the difficult problem

of trying to force VC businesses into an existing category. Instead of trying to analogize VCs to commodities or securities, NYDFS instead created a new category for them and regulated their potential use on their own terms, giving the agency greater room to develop a more flexible regime for the regulated entities.

The application process to obtain a BitLicense is a significant undertaking, and the diligence NYDFS performs is also extensive. Prospective licensees must provide detailed information in the application, including documentation of banking arrangements, policies and procedures, insurance, and more, as well as detailed disclosures about

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the nature of their business and the people behind it. 23 CRR-NY 200.4.

Once licensed, BitLicensees must maintain original books and records for seven years, 23 CRR-NY 200.12, implement robust compliance and anti-money laundering (AML) programs, 23 CRR-NY 200.15, and maintain capital requirements and bonds determined by the NYDFS Superintendent, 23 CRR-NY 200.8. Moreover, BitLicensees are subject to substantial oversight by NYDFS, including regular examinations, 23 CRR-NY 200.13, and routine regulatory oversight and dialogue. NYDFS has granted almost 20 BitLicenses to date, though some VC players have declined to enter the New York market.

NYAG's Martin Act Regulatory Authority

The BitLicense regime did establish substantial yet predictable regulatory standards by which VC businesses could abide and ensure consumers were adequately protected. For a while, the NYAG deferred to its sister agency's regulatory regime. In its 2018 Virtual Markets Report, NYAG noted the BitLicense requires licensees to "maintain policies and practices designed to... protect deposited funds, prevent money laundering and illegal activity, and respond to other risks." NYAG went on to recommend that consumers inquire whether a virtual exchange is a BitLicensee because the "ongoing supervision and monitoring by the DFS" will provide better customer protections. When NYAG believed that three trading platforms were operating without a license, it referred them to NYDFS rather than taking direct action.

While it was deferential to NYDFS in the regulatory context, NYAG continued to enforce New York's anti-fraud laws in the crypto space. For example, in 2018 it sued Bitfinex and Tether, accusing them of using more than \$700 million of their \$900 million in reserves as a "corporate slush fund," "hid[ing] Bitfinex's massive, undisclosed losses and inability to handle customer withdrawals," and making false statements about Tether's backing.

Ultimately, a New York appellate court upheld a denial of Bitfinex's motion to dismiss, finding that Tether is a commodity and, therefore, can be subject to regulation under the Martin Act, the state's Blue Sky law. That lawsuit settled in February of this year,

with an \$18.5 million penalty and a number of injunctive provisions, including one that bans Bitfinex and Tether from continuing any trading activity with New Yorkers. Since then, NYAG has shut down one platform (Coinseed) and secured a \$479 million penalty from another who sold stocks and two digital instruments promoted as cryptocurrencies (GTV Media Group, Inc. and its parent company).

Now, armed with the *Tether* decision, NYAG is pivoting toward enforcing regulatory compliance and registration requirements, which it had historically left to DFS. In March, NYAG issued an “Industry Alert” announcing that those dealing in cryptocurrency (“broker-dealers, dealers, salespersons, and investment advisors”) must register with NYAG’s Investor Protection Bureau. It has also directed two platforms to cease activities in New York and opened investigations into three more platforms for failure to register under the Martin Act. For its part, NYDFS has not publicly commented on the NYAG’s actions, or the entities’ apparent lack of a BitLicense.

Under the Martin Act, registering businesses must provide extensive business history information and complete examination requirements; annually thereafter, they must file financial reports. N.Y. Gen. Bus. Law §359-eee. Failure to comply with registration requirements under the Martin Act can result in civil or criminal penalties. NYAG’s use of the Martin Act to investigate and enforce against unregistered VC businesses is still evolving, but because of a quirk in the statute, the NYAG’s approach could result in a regulatory compliance burden not only

on companies without any New York licenses at all, but also, conceivably, on companies with a BitLicense.

While the Martin Act exempts banks and trust companies, both of which are regulated by NYDFS, as well as registrants with the SEC or CFTC, it makes no exception for BitLicensees (though there seems to be an exception to the Martin Act by registering as a money transmitter, at least for BitLicensees that are not dealing with securities). And while the NYAG had historically deferred to NYDFS on issues of state licensure, its recent Industry Alert and C&Ds signal that it may no longer do so.

Two State Regulators

The resulting regulatory regime is potentially confusing and inefficient, with two state regulators both claiming proactive, overlapping roles, imposing competing and duplicative requirements. Many companies now understand the need to be both BitLicensees and Martin Act registrants—either as broker-dealers, salespersons, or investment advisors, depending on the specific nature of their businesses.

But dual state regulation is expensive and does not appear to provide obvious additional benefits for consumers. NYDFS and federal law already require BitLicensees to adopt AML programs and ensure VCs are not used to circumvent laws or regulations. To comply, BitLicensees must thus monitor their platforms and ensure that their market activity does not facilitate fraud, money laundering, or other activity that could harm consumers. Under the Martin Act, the NYAG similarly requires similar information from registrants, including disclosures about management,

changes in business activity, and salespersons that directly handle VCs.

If the NYAG determines the VC products are securities, the issuer must also register as a broker-dealer and register each offering. N.Y. Gen. Bus. Law Art. 23-A §§13.2, 359-e, 359-f. By stark contrast, in the data security context, the NY SHIELD Act, which the NYAG enforces and imposes substantive regulatory requirements upon businesses operating in the state, exempts from those requirements businesses subject to NYDFS’s Cybersecurity regulations, which impose their own data security requirements.

New York has an impressive track record in the VC context and much to offer the industry. It has attracted some of the top VC businesses, evidence that these businesses want to be in New York and are willing to subject themselves to substantial regulation in order to operate in the state. But if New York wishes to become the cryptocurrency hub of the future, as Mayor-Elect Adams desires, NYDFS and NYAG will need to harmonize their respective regulatory regimes.