

# NYAG's Digital Asset Proposal Shouldn't Be Taken Lightly

By **Brian Mahanna, Tiffany Smith and Isabel Dai** (May 24, 2023)

On May 5, New York Attorney General Letitia James announced a landmark legislative proposal — titled the Crypto Regulation, Protection, Transparency and Oversight Act — to tighten regulations on the digital asset industry.

The proposal, which James called "the strongest and most comprehensive set of regulations on cryptocurrency in the nation,"[1] has the stated purpose to "protect customers and investors in digital assets from fraudulent practices, eliminate conflicts of interest and increase transparency." [2]

It would add a new layer of regulation on top of the existing regulatory framework for digital assets in the state, i.e., the BitLicense regime, and could challenge the business models of many digital asset companies that currently operate from or within New York state.

Thus far, New York state's digital asset activities are primarily regulated by the New York State Department of Financial Services, which is the administrator of the BitLicense regime.

The BitLicense — which the DFS finalized in June 2015 — was the first comprehensive regulatory framework specifically designed for firms dealing in "virtual currency," defined by the DFS as "any type of digital unit that is used as a medium of exchange or a form of digitally stored value," regardless of whether it is centrally managed or decentralized.[3]

Since then, 24 BitLicenses have been issued by the DFS, and the DFS supervises an additional nine firms that have obtained a limited purpose trust charter under the New York Banking Law for the purpose of engaging in "virtual currency business activity." [4]

In comparison to the BitLicense regime, which focuses on business activities specifically involving virtual currencies, the proposal would broadly apply to all digital assets, including but not limited to virtual currencies and any other coins, tokens and digital assets that "can be used as a medium of exchange, a form of digitally stored value, or a unit of account," regardless of whether it is centrally managed or decentralized.[5]

The definition of "digital asset," on its face, could apply to a token that does not currently fit the definition of "virtual currency" under the BitLicense regime because it is not used as a medium of exchange or stored value but that nevertheless qualifies as a digital asset under the proposal because it has the potential to be used for that purpose.

The proposal defines five categories of digital asset participants that would be subject to all or parts of the law: digital asset issuer,[6] digital asset broker,[7] digital asset marketplace,[8] digital asset investment adviser[9] and digital asset influencer.[10]



Brian Mahanna



Tiffany Smith



Isabel Dai

The last of these — digital asset influencer — appears to draw inspiration from the anti-touting provision of the federal securities laws, which has subjected a number of celebrities to U.S. Securities and Exchange Commission enforcement.[11]

According to the proposal, any person who "widely promotes, publishes, publicizes, or circulates" any notice, advertisement, or electronic posting or communication, among others, that encourages investment in a digital asset, where such person receives compensation or owns, or expects to own such digital asset, in the amount of \$25,000 or more in value, would be a digital asset influencer.

Given the low-dollar threshold and the lack of clarity around what it means to "widely" promote something, this definition has the potential to subject a number of digital asset enthusiasts and owners[12] to additional registration and disclosure rules, as we discuss in more detail below.

The proposal would prevent common ownership of digital asset issuers, digital asset marketplaces, digital asset brokers and digital asset investment advisers; prevent any person from engaging in more than one of these activities; prevent digital asset brokers and digital asset marketplaces from proprietary trading; require public reporting of financial statements; and require digital asset brokers and digital asset investment advisers to reimburse customers for certain types of self-reported unauthorized transfers.

It would also codify the DFS' authority to supervise and examine digital asset issuers, digital asset brokers, digital asset marketplaces and digital asset investment advisers, and it would allow the DFS to oversee the digital asset licensing regime.

Finally, it would require digital asset influencers to register with the Office of the Attorney General and to submit certain disclosures prior to engaging in any promotion of digital assets.

Digital asset issuers, brokers, marketplaces and investment advisers would be required to publicly post a certification of compliance with all requirements of the proposal before operating from or within New York state.

The proposal is another example of James' increasingly aggressive approach to regulating digital assets using her office's own powers, as opposed to relying on the DFS.

In 2021, the attorney general's office issued an industry alert reminding crypto brokers, dealers, salespersons and investment advisers to register with the office's Investor Protection Bureau,[13] and it directed several platforms to cease activities in New York state for failure to register under the Martin Act.[14]

Since then, the office has filed suits against a number of crypto platforms, including a suit in March against KuCoin, a crypto exchange, for failing to register as a securities and commodities broker-dealer.[15]

While the proposal codifies the BitLicense regime and has received endorsements from five state senators, seven assembly members and former DFS Superintendent Maria T. Vullo,[16] it adds to the attorney general's powers in myriad ways, and as of the date of publication of this article, current DFS Superintendent Adrienne A. Harris notably has not endorsed the proposal.

Instead, when asked to comment, the DFS defended its record on virtual currency regulation, stating that it is the "only prudential regulator with virtual asset-specific authority in the United States" and that it is "DFS's priority to ensure that consumers and markets are protected and New York continues to be the global financial center." [17]

The Office of the Attorney General will work with the state Senate and Assembly to introduce the proposal for consideration during the 2023 legislative session, which is scheduled to adjourn on June 8.

Despite James' enviable record of getting legislation she supports passed, time is short for doing so in 2023. The bill, once introduced, will be available for consideration until the end of the current legislative session in 2024.

If passed and signed into law, the proposal could challenge the business models of many existing digital asset companies that currently operate from or within New York state — for example, many exchanges currently offer services that could qualify them simultaneously as a digital asset broker, digital asset marketplace and digital asset investment adviser under the proposal.

Digital asset industry participants to whom this proposal would apply should therefore review it and their existing practices, and evaluate the extent of the impact this proposal might have on the way they operate their business.

They should also consider actively engaging in the legislative process, including attending any public hearings to identify and address potential concerns or issues with the proposal.

### **Key Points**

The proposal aims to protect New York state investors by bringing to the digital asset industry regulations and oversight that are applied to certain other financial services, while also addressing other practices that are unique to digital assets. [18]

The proposal focuses on consumer protection related to three areas: (1) preventing conflicts of interest, (2) promoting financial transparency and (3) bolstering investor protection.

### ***Preventing Conflicts of Interest***

The proposal seeks to prevent conflicts of interest in the digital asset industry by:

- Prohibiting any participant or its affiliate(s) from acting as more than one of the following: a digital asset issuer, digital asset broker, digital asset marketplace or digital asset investment adviser; [19]
- Preventing digital asset issuers, digital asset marketplaces, digital asset brokers and digital asset investment advisers or any of their affiliates from engaging in proprietary trading;

- Prohibiting digital asset marketplaces and digital asset investment advisers from keeping custody of customer funds;
- Requiring digital asset brokers to maintain "physical possession or control"[20] of customer assets, and prohibiting them from borrowing or lending customer assets; and
- Prohibiting digital asset brokers from making referrals to digital asset investment advisers or digital asset issuers for compensation.

### ***Promoting Financial Transparency***

The proposal seeks to increase transparency in the digital asset industry by:

- Requiring digital asset issuers, brokers, marketplaces and investment advisers to undergo independent financial audits and disclose annual and quarterly audited financial statements;
- Requiring digital asset issuers to publish a prospectus prior to the issuance of any digital asset that includes material information about the digital asset issuer and the digital asset;[21]
- Requiring digital asset brokers to disclose to their customers "any fees to be received from any source whatsoever" immediately prior to effecting a transaction on behalf of the customers;
- Requiring digital asset marketplaces to establish and publish listing standards;[22]
- Requiring digital asset brokers and digital asset marketplaces to publish the price and volume of any "off-chain transaction"[23] within 10 seconds of such a transaction; and
- Requiring digital asset influencers to register and report their interest in any digital asset issuer whose digital assets they promote.

## ***Bolstering Investor Protection***

The proposal attempts to bolster investor protection in the digital asset industry by:

- Requiring digital asset brokers and digital asset investment advisers to implement anti-money laundering and "know your customer" procedures in compliance with state and federal rules;
- Banning the use of the term "stablecoin" to describe or market digital assets unless they are backed 1:1 with U.S. dollars or certain high-quality liquid assets;
- Prohibiting digital asset brokers from effecting "cross transactions";[24]
- Prohibiting digital asset marketplaces from maintaining physical possession or control of a customer's digital assets except for the purpose of effecting a specific transaction; and
- Requiring digital asset brokers and digital asset investment advisers to reimburse customers for self-reported "unauthorized digital asset transfers,"[25] including transfers effected without the customer's actual authorization and transfers resulting from fraud.

The proposal imposes registration requirements for digital asset issuers, digital asset brokers, digital asset marketplaces, digital asset investment advisers and digital asset influencers.

Specifically, the proposal would require every digital asset issuer, digital asset broker, digital asset marketplace and digital asset investment adviser to file a registration statement with the attorney general's office prior to engaging in business from or within New York state.

In addition, the proposal would require digital asset influencers to register with the attorney general and to submit disclosures prior to engaging in any promotion of a digital asset. Existing BitLicenses would not be exempt from the proposal's registration requirements.

The proposal also would codify the DFS' authority to supervise and examine entities licensed under the BitLicense regime as well as digital asset issuers, brokers, marketplaces and investment advisers that file a registration statement with the attorney general's office.

The DFS would be authorized to examine each such entity as if they were a licensee under the BitLicense regime.

This means that each entity would be examined no less than once every two calendar years to determine, among other things, the financial condition of the entity, the safety and soundness of its business, the policies of its management, and whether the entity has complied with the requirements of applicable laws, rules and regulations.[26]

Finally, the proposal would grant the attorney general, in addition to its powers under existing law, jurisdiction to enforce any violation of the law; issue subpoenas; impose civil penalties of \$10,000 per violation per individual or \$100,000 per violation per firm; collect restitution, damages and penalties; and shut down businesses for fraud and other illegalities.

## **Looking Forward**

State legislatures have become increasingly active in regulating the digital asset industry.

So far in 2023, 39 states have passed or have some form of pending legislation affecting the digital asset industry, mostly centered on customer protection.[27]

Recently enacted legislation has ranged from minor changes to include digital assets under the unclaimed property laws and the enactment of new digital asset education programs to significant changes to state regulation of digital assets, state money transmission laws and state commercial codes.[28]

The proposal is another example of state leaders remaining focused on the digital asset industry and concerned with certain aspects of its practices.

Given New York state's prominence both in the digital asset industry and as a proving ground for state regulatory innovation, all digital asset industry participants should take this proposal seriously.

Digital asset industry participants to whom this proposal would apply should assess the proposal's requirements against their existing practices and evaluate the impact this proposal might have on the way they operate their business.

They should also consider actively engaging in the legislative process to ensure that New York state lawmakers are fully informed about any issues or concerns about the proposal.

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*Brian K. Mahanna is a partner and co-chair of the state attorneys general practice at WilmerHale.*

*Tiffany J. Smith is a partner at the firm.*

*Isabel Dai is counsel at the firm.*

*WilmerHale partner Zachary Goldman, senior counsel Eric P. Lesser and senior associate Zachary M. Kessler contributed to this article.*

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[1] Press Release, N.Y. Att'y Gen., "Attorney General James Proposes Nation-Leading Regulations on Cryptocurrency Industry" (May 5, 2023), <https://ag.ny.gov/press-release/2023/attorney-general-james-proposes-nation-leading-regulations-cryptocurrency>.

[2] Crypto Regulation, Protection, Transparency, and Oversight (CRPTO) Act (2023), [https://ag.ny.gov/sites/default/files/2023-05/OAG-Crypto-Bill\\_0.pdf](https://ag.ny.gov/sites/default/files/2023-05/OAG-Crypto-Bill_0.pdf) (CRPTO Act).

[3] N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2(p).

[4] See Virtual Currency Businesses: Main Page, DFS, [https://www.dfs.ny.gov/virtual\\_currency\\_businesses](https://www.dfs.ny.gov/virtual_currency_businesses) (last accessed May 11, 2023). Note that the DFS defines "virtual currency business activity" to be any one of the following types of activities involving New York or a New York resident: (a) receiving virtual currency for transmission or transmitting virtual currency, except where the transaction is undertaken for non-financial purposes and does not involve the transfer of more than a nominal amount of virtual currency; (b) storing, holding, or maintaining custody or control of virtual currency on behalf of others; (c) buying and selling virtual currency as a customer business; (d) performing exchange services as a customer business; or (e) controlling, administering, or issuing a virtual currency. N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2(q).

[5] "Digital asset" is defined to mean "any type of digital unit, whether labeled as a cryptocurrency, coin, token, virtual currency, or otherwise, that can be used as a medium of exchange, a form of digitally stored value, or a unit of account ... [and it] shall be broadly construed to include digital units that have a centralized repository or administrator, are decentralized and have no centralized repository or administrator, or may be created or obtained by computing or manufacturing effort. [It] shall not be construed to include any of the following: (a) digital units that: (i) are used solely within online gaming platforms; (ii) have no market or application outside of those gaming platforms; (iii) cannot be converted into, or redeemed for, fiat currency or digital assets; and (iv) to the extent they may be redeemable for real-world goods, services, discounts, or purchases, are only used for consumption by the gamer; (b) digital units that can be redeemed for goods, services, discounts, or purchases as part of a customer affinity or rewards program with the issuer or other designated merchants or can be redeemed for digital units in another customer affinity or rewards program, but cannot be converted into, or redeemed for, fiat currency or digital assets; (c) digital units used solely as part of prepaid cards; (d) digital units used solely in sports wagering and mobile sports wagering subject to sections thirteen hundred sixty-seven and thirteen hundred sixty-seven-a of the racing, pari-mutuel wagering and breeding law and regulations thereunder; or (e) digital units that provide an equity interest in a business." CRPTO Act at 3-4.

[6] "Digital asset issuer" is defined to mean "a person that creates or issues or offers to issue a digital asset that is or will be available to the public and is directly or indirectly for speculation investment purposes or for use as a currency, medium of exchange, a form of digitally stored value, a unit of account or any combination thereof and not for consumption by the offeree or purchaser. Digital asset issuer does not include a person whose activity consists solely of issuing, offering, buying, or selling digital assets for a bona fide artistic purpose, such as the issuance of individual art or music." CRPTO Act at 6.

[7] "Digital asset broker" is defined to mean "any person engaged in the business of effecting transactions in digital assets for the account of others, whether the digital asset

broker receives a benefit directly or indirectly." CRPTO Act at 4-5.

[8] "Digital asset marketplace" is defined to mean "any person that provides, or substantively participates in, or any system that provides, a marketplace or facilities for bringing together purchasers and sellers of digital assets or for otherwise performing, with respect to digital assets, the functions commonly performed by a stock exchange as that term is generally understood with regard to stocks." CRPTO Act at 6.

[9] "Digital asset investment adviser" is defined to mean "any person who, for compensation, engages in the business of advising members of the public, either directly or through publications or writings, as to the value of digital assets or as to the advisability of investing in digital assets, including by recommending or curating a portfolio of digital assets accessible by another or by taking discretion over the use of another's digital asset for any investment purpose. Digital asset investment advisers shall owe a fiduciary duty to any person for whom they provide digital asset investment adviser services." CRPTO Act at 5.

[10] "Digital asset influencer" is defined to mean "any person who in connection with the offer or sale of any digital asset, widely promotes, publishes, publicizes or circulates any notice, circular, advertisement, newspaper, article, letter, investment service, electronic posting or communication which, though not purporting to offer a digital asset for sale, encourages investment in such digital asset, where such person receives compensation of any sort or owns or expects to own such digital asset, unless such ownership or expected ownership amounts to less than twenty-five thousand dollars in value [but it] shall not include a publisher of any bona fide newspaper or news magazine of general distribution." CRPTO Act at 5.

[11] See Press Release, U.S. Securities and Exchange Commission, "SEC Charges Kim Kardashian for Unlawfully Touting Crypto Security" (October 3, 2022), <https://www.sec.gov/news/press-release/2022-183>.

[12] For example, the definition of "digital asset influencer," on its face, could be interpreted to apply to any person who owns a digital asset valued at \$25,000 or more who subsequently publishes a post on social media discussing, in favorable terms, their investment in such digital asset.

[13] See Industry Alert: Registration of Commodity Brokers-Dealers, Salespersons, and Investment Advisors Doing Business Relating to Virtual or "Crypto" Currency, N.Y. Att'y Gen. (March 1, 2021), <https://ag.ny.gov/sites/default/files/crypto-industry-notice.pdf>; see also Investor Alert: Virtual Currency Risks, N.Y. Att'y Gen. (March 1, 2021), <https://ag.ny.gov/sites/default/files/crypto-investor-notice.pdf>.

[14] Press Release, N.Y. Att'y Gen., "Attorney General James Directs Unregistered Crypto Lending Platforms to Cease Operations in New York, Announces Additional Investigations" (October 18, 2021), <https://ag.ny.gov/press-release/2021/attorney-general-james-directs-unregistered-crypto-lending-platforms-cease>.

[15] See Press Release, N.Y. Att'y Gen., "Attorney General James Continues Crackdown on Unregistered Cryptocurrency Platforms" (March 9, 2023), <https://ag.ny.gov/press-release/2023/attorney-general-james-continues-crackdown-unregistered-cryptocurrency-platforms>; see also Press Release, N.Y. Att'y Gen., "Attorney General James Sues Cryptocurrency Platform for Failing to Register in New York" (February 22, 2023), <https://ag.ny.gov/press-release/2023/attorney-general-james-sues-cryptocurrency>.



platform-failing-register-new-york.

[16] Press Release, N.Y. Att'y Gen., "Attorney General James Proposes Nation-Leading Regulations on Cryptocurrency Industry" (May 5, 2023), <https://ag.ny.gov/press-release/2023/attorney-general-james-proposes-nation-leading-regulations-cryptocurrency>.

[17] See Jack Schickler et al., "New York Attorney General Seeks New Crypto Powers for State Regulators, CoinDesk" (May 5, 2023), <https://www.coindesk.com/policy/2023/05/05/new-york-attorney-general-seeks-new-crypto-powers-for-state-regulators-report>; see also Mengqi Sun, "New York Attorney General Seeks Broader Authority to Police Crypto," Wall St. J. (May 5, 2023), <https://www.wsj.com/articles/new-york-attorney-general-seeks-broader-authority-to-police-crypto-cdcf08ed>.

[18] Press Release, N.Y. Att'y Gen., "Attorney General James Proposes Nation-Leading Regulations on Cryptocurrency Industry" (May 5, 2023), <https://ag.ny.gov/press-release/2023/attorney-general-james-proposes-nation-leading-regulations-cryptocurrency>.

[19] Note that banks and trust companies would benefit from a limited exemption from the conflicts of interest provisions if the entity is not "engaged primarily" as a digital asset broker, digital asset issuer or digital asset investment adviser. However, a bank that operates a digital asset marketplace would not be permitted to engage in digital asset broker, digital asset issuer or digital asset investment adviser activities. See CRPTO Act at 8.

[20] "Physical possession or control" is defined to have the same meaning as in 17 C.F.R. 240.15c3-3(b)(1) and (c) and "includes but is not limited to holding private keys necessary to transfer a customer's digital assets or maintaining custody with a third-party custodian in accordance with 17 C.F.R. 240.15c3-3(c)." CRPTO Act at 7.

[21] The prospectus would have to include, at a minimum, (a) a description of the digital asset issuer's business; (b) a description of its financial condition; (c) a description of its results of operations; (d) a description of risk factors; (e) a description of conflicts of interest; (f) the identities of all directors, executive officers (including their positions) and key employees who make or are expected to make significant contributions to the development of the digital asset; and (g) financial statement schedules. See CRPTO Act at 14-15.

[22] The listing standards would have to include capital requirements for digital asset issuers and public disclosure of each listed asset's source code, which would need to be verified by the digital asset marketplace to ensure that it is consistent with the digital asset issuer's disclosure and contains security properties in compliance with applicable laws and regulations. See CRPTO Act at 13-14.

[23] "Off-chain transaction" is defined in the Proposal as "a transaction that is confirmed or stored outside of a public blockchain network." CRPTO Act at 6.

[24] "Cross transaction" is defined to mean "a transaction in which a digital asset broker effects transactions for both the buyer and for the seller on the other side of the transaction." CRPTO Act at 3.

[25] "Unauthorized digital asset transfer" is defined to mean "(a) any transaction involving a digital asset that is effected without the customer's actual authorization, including when the

password or private key has been used to effect the transfer, so long as the customer receives no benefit; or (b) any transaction involving a digital asset that is effected with the customer's authorization due to fraudulent inducement by a third party, including fraudulent inducement by any digital asset broker, digital asset issuer, digital asset investment adviser, or digital asset marketplace. When a customer reports that a digital asset transfer is unauthorized, such transfer shall be presumed to be an unauthorized digital asset transfer." CRPTO Act at 7.

[26] N.Y. Comp. Codes R. & Regs. tit. 23, § 200.13(a).

[27] The 39 states are Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Dakota, Pennsylvania, Rhode Island, Texas, Utah, Virginia, Washington and Wyoming, as well as the District of Columbia and Puerto Rico. See Cryptocurrency 2023 Legislation, NCSL, <https://www.ncsl.org/financial-services/cryptocurrency-2023-legislation> (last visited May 9, 2023).

[28] For example, Utah adopted legislation recognizing decentralized autonomous organizations (DAOs), providing requirements for DAO formation and allowing DAOs to be treated as limited liability companies under state law, H.B. 357, 2023 Gen. Sess. (Utah 2023); Wyoming adopted new authorizations for a state commission to issue and regulate stablecoins, S.F. 0127, 67th Leg., 2023 Gen. Sess. (Wy. 2023); and South Dakota required money transmission licensees transmitting virtual currencies to hold like-kind virtual currencies of the same volume as that held by the licensee but that are obligated to consumers in lieu of otherwise permissible investments under the money transmission laws, S.B. 47, S.D. Gen. Sess. (S.D. 2022).