

Summary of New York Department of Financial Services Guidance on Virtual Currency Custodial Structures

On January 23, 2023, the New York Department of Financial Services (“NYDFS”) issued an [industry letter](#) providing guidance to certain NYDFS-regulated institutions that provide custody services¹ for virtual currency on behalf of their customers. Specifically, the guidance applies to entities licensed under the state’s virtual currency (or “BitLicense”) regulations, as well as entities chartered as limited purpose trust companies under the New York Banking Law, to engage in virtual currency business activity (such entities collectively referred to in the guidance as “VCEs” and, in their capacity as custodians, “VCE Custodians”). This guidance follows NYDFS’s December 2022 guidance for banking organizations seeking to engage in “virtual currency-related activity” and June 2022 guidance for institutions that issue U.S. dollar-backed stablecoins (see our summaries [here](#) and [here](#), respectively). In comparison, the federal banking agencies have yet to issue similar guidance regarding stablecoin or virtual currency custody activities.

The guidance seeks to clarify standards and practices that, in NYDFS’s view, will help ensure that VCE Custodians are providing a high level of customer protection with respect to virtual currency custody activities. In this regard, the guidance also seeks to better protect customers in the event of insolvency or a similar proceeding.

SEGREGATION OF AND SEPARATE ACCOUNTING FOR CUSTOMER VIRTUAL CURRENCY

The guidance states that a VCE Custodian must separately account for and segregate customer virtual currency from its own (and its affiliates’) corporate assets “both on-chain and on the VCE Custodian’s internal ledger accounts.”² The VCE Custodian must

also make clear and prominent disclosures in this regard.

The guidance provides that a VCE Custodian may maintain customer virtual currency in either: (1) separate on-chain wallets and internal ledger accounts for each customer under that customer’s name, or (2) 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 an omnibus account is used, the VCE Custodian must maintain appropriate records and a clear internal audit trail to identify customer virtual currency and account for all customer transactions, so that each individual customer’s beneficial interest is always evident and

up to date. To the extent a VCE Custodian funds transaction costs (e.g., gas fees) on behalf of its customers, the VCE custodian should consider these as customer funds. Upon NYDFS's request, a VCE Custodian must also readily demonstrate reconciliation between its books and records and its on-chain activity.

VCE CUSTODIAN'S LIMITED INTEREST IN AND USE OF CUSTOMER VIRTUAL CURRENCY

NYDFS states that a VCE Custodian must only take possession of assets that are transferred by a customer for safekeeping for the limited purpose of carrying out custody and safekeeping services, and that it will not thereby establish a debtor-creditor relationship with the customer. The VCE Custodian should structure its custodial arrangement "in a manner that preserves the customer's equitable and beneficial interest in the customer's virtual currency." The guidance further makes clear that a VCE Custodian should not use customer virtual currency for the VCE Custodian's own use (e.g., use customer virtual currency to secure or guarantee an obligation of, or extend credit to, the VCE Custodian or any other person). A VCE Custodian must also act on customers or their authorized representatives' instructions and not exercise general discretion over customer assets (other than as expressly authorized in the VCE Custodian's customer agreement).

SUB-CUSTODY ARRANGEMENT

The guidance states that a VCE Custodian may enter into a sub-custody arrangement with a third party for

the safekeeping of customer assets, but a VCE Custodian must first conduct appropriate due diligence of the third party and generally obtain prior approval from NYDFS before implementing the arrangement.³ A request for prior approval should include, at a minimum: (1) the applicable risk assessment performed by the VCE Custodian; (2) the proposed service agreement(s) between the parties; and (3) the VCE Custodian's updated policies and procedures addressing the processes and controls to be implemented around the proposed arrangement.

CUSTOMER DISCLOSURE

NYDFS reiterates existing expectations and requirements⁴ that a VCE Custodian, prior to entering into transactions with the customer, clearly disclose to each customer in writing the general terms and conditions associated with its products, services and activities, and obtain the customer's acknowledgment of receipt of such disclosure. The guidance further outlines specific expectations for a VCE Custodian's customer agreement and disclosures. These include that the VCE's customer agreement make clear the nature of the custodial relationship, how assets are custodied and accounted for, and how the VCE Custodian may use customers assets, including the limitations that apply to such use. Further, the guidance states that, if a VCE Custodian engages a third-party sub-custodian, the customer agreement should clearly disclose the terms and the material risks of the sub-custodian arrangement. A VCE Custodian must also make its standard disclosures and customer agreement readily available on its website.

1 The guidance states that custody services include, without limitation, storing, holding, or maintaining custody or control of virtual currency on behalf of others, consistent with 23 CRR-NY 200.2(q)(2).

2 NYDFS expressly states that a VCE Custodian may not commingle customer virtual currency with its own virtual currency or any other non-customer virtual currency.

3 With respect to the approval requirement, the guidance states that NYDFS generally views the establishment of any new sub-custody or third-party arrangement as a "material change" to a VCE's business. See 23 NYCRR 200.10.

4 See, e.g., 23 NYCRR 200.19.

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