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NYDFS' Virtual Currency Oversight Plan Lacks Clarity

By **Jason Cabral, Sara Weed and Alejandra Castañeda** (June 12, 2023, 11:09 AM EDT)


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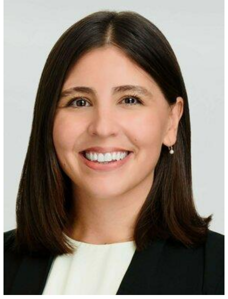
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On April 19, the New York State Department of Financial Services finalized regulations establishing a new assessment structure, i.e., the "BitLicense" assessment framework, for businesses subject to New York's virtual currency regulation, Title 23 of the New York Codes, Rules and Regulations, Part 200.[1]

Under the new BitLicense assessment framework, the NYDFS will rely on a complex set of formulas to directly assess virtual currency businesses for the costs of their supervision and examination.

The new framework will provide a predictable funding model for the NYDFS and may reduce its reliance on licensing fees, but because the assessment structure relies on various undefined components, it presents some uncertainty for businesses subject to Part 200.

With the first such assessments approaching, this article breaks down the material components of the BitLicense assessment framework and discusses the implications and associated issues.

Background

In 2015, the NYDFS adopted Part 200, establishing a licensing and comprehensive regulatory regime for virtual currency businesses operating in the state.[2]

The regulatory regime, i.e., the BitLicense framework, was the first of its kind, making New York, and the NYDFS in particular, the first to contend with the unique challenges posed by regulating the remarkably heterogenous mix of virtual currency businesses, including determining how to fund the costs of such regulatory operations.

Under the BitLicense framework, entities must obtain a NYDFS-issued license — a "BitLicense" — in order to engage in "virtual currency business activity," which is defined broadly to include:

1. Transmitting or receiving virtual currency for transmission for financial purposes;

2. Storing, holding or custodying, or controlling virtual currency for others;

3. Buying and selling virtual currency as a customer business;

4. Performing exchange services, i.e., converting fiat currency into virtual currency or vice versa, as a customer business; or

5. Controlling, administering or issuing a virtual currency.[3]

Those BitLicensees authorized under Part 200 are subject to a rigorous set of requirements, many of which are commonly imposed in the supervision of both depository and nondepository providers of financial services.

Key requirements include: capital, safeguarding and segregation of customer assets, third-party audit and financial reporting, maintenance of anti-money laundering and cybersecurity programs, and marketing and disclosure obligations.[4]

BitLicensees also must seek the prior approval of the superintendent before making any material changes to their businesses or undergoing a change in control.[5]

When the BitLicense framework was adopted in 2015, Section 206 of the Financial Services Law provided that "the costs and expenses of the [NYDFS] would be respectively charged to and paid by the persons regulated by the NYDFS pursuant to the Banking Law or Insurance Law, with no provision made for the assessment of costs for persons regulated pursuant to the FSL."[6]

In other words, costs and expenses would not be not charged to BitLicensees, which the NYDFS regulated pursuant to the FSL — although assessments would be levied, and will continue to be levied, separately under the New York Banking Law for a money transmission license, which BitLicensees also are required to obtain if they have a fiat currency component to their offering.

In practice, entities seeking a BitLicense could expect to incur a $5,000 nonrefundable application fee intended to cover the cost associated with the NYDFS' review of the application.[7] However, noticeably absent from Part 200 was a provision that would allow for examination fees, annual licensing fees or other special assessments of BitLicensees.

In June 2022, Section 206 of the FSL was amended to require the NYDFS to assess BitLicensees engaged in virtual currency business activity "for the operating expenses of the [NYDFS] that are solely attributable to regulating such persons."[8]

The NYDFS published the proposed BitLicense assessment framework in early 2023 and finalized it on April 19, which indicated how the NYDFS would approach allocating the costs and expenses among BitLicensees and setting forth the NYDFS' process for making such assessments.

The BitLicense assessment framework only applies to BitLicensees — New York state-chartered limited-purpose trust companies that engage in virtual currency business activities will continue to be assessed under the New York Banking Law — and is intended to cover only the costs and expenses associated with the NYDFS' oversight of each BitLicensee's virtual business currency activities.

The BitLicense Assessment Framework

The general rule under the BitLicense assessment framework is that BitLicensees will be charged a total annual assessment that is the sum of its "supervisory component" and its "regulatory component."[9] According to the NYDFS, each BitLicensee will be billed five times per fiscal year: four estimated quarterly assessments and a final true-up.[10]

The NYDFS also included a special assessment provision in the BitLicense assessment framework that provides for assessments of specific examinations, investigations or reviews.[11] Special assessments will be billed within 180 days after the calendar quarter in which such expenses were incurred and are payable within 30 days.[12]

Supervisory Component

A BitLicensee's supervisory component is the sum of its "transaction volume basis assessment" and its "custody basis assessment."[13]

A BitLicensee's transaction volume basis assessment is the product of: (1) the hourly rate, which is the "average hourly salary and fringe benefit cost of the examiners and staff assigned to the supervision of [Bit]Licensees plus a multiplier, as determined by the superintendent, representing a portion of the other operating overhead expenses of the [NYDFS]," and (2) the BitLicensee's share of either 5%, 15% or 30% of the total supervisory hours worked by NYDFS staff attributable to the ongoing supervision of BitLicensees divided by the total number of BitLicensees.[14]

For purposes of this component of the calculation, BitLicensees are classified as small, medium or large based on the individual reported total number of virtual currency transactions by the BitLicensee in New York for the prior calendar year, and are assessed the same amount as other BitLicense holders within the same category: 5%, 15% or 30%.[15]

A BitLicensee's custody basis assessment is the product of: (1) the hourly rate and (2) the BitLicensee's share of either 5%, 15% or 30% of the total supervisory hours worked by NYDFS staff attributable to the ongoing supervision of BitLicensees divided by the total number of BitLicensees.[16]

For purposes of this component of the calculation, BitLicensees are classified as small, medium or large based on the total U.S. dollar value of virtual currency held on behalf of all customers — not just New York customer funds — averaged over the prior four quarter-end balances reported by the BitLicensee, and are assessed the same amount as other BitLicense holders within the same category: 5%, 15% or 30%.[17]

Because the supervisory component sums two separate components, assessments may vary based on a BitLicensee's activities. BitLicensees principally engaged in custodial activities may be classified as "large" for the custody basis assessment, whereas exchanges that do not custody assets may experience the opposite result and be classified as "large" for the transaction volume basis assessment.

BitLicensees that custody large sums of customer funds, even where New York customer funds represent a small portion of their overall custody business, also may be classified as "large" for the custody basis assessment component because this component measures total custodial funds, not just New York customer funds.

Regulatory Component

A BitLicensee's regulatory component is the "total operating cost" less the "supervisory component" divided by the total number of BitLicensees.[18] The total operating cost is the sum of the NYDFS' operating expenses solely attributable to BitLicensee oversight and "the proportion deemed just and reasonable by the [S]uperintendent of the other operating overhead expenses of the [NYDFS] which may be assessed against [Bit]Licensees under FSL section 206(a)."[19]

The regulatory component represents the baseline cost of examining BitLicensees and is spread evenly among BitLicensees — that is, BitLicensees of all sizes and complexity share equally in the regulatory component assessment.

Special Assessments

In addition to the general annual assessment discussed above, the BitLicense assessment framework grants the superintendent the authority to bill specific expenses to individual BitLicensees upon a determination "that the expenses associated with a specific examination, investigation or review are best allocated solely to the individual [Bit]Licensee or [Bit]Licensees subject to such examination or investigation, rather than to all [Bit]Licensees generally or any subgroup thereof."[20]

The BitLicense assessment framework sets forth that in calculating special assessments, "[t]he time of each person associated with such examination or investigation shall be multiplied by the average costs of the examiners and specialists at their respective grade levels assigned to such examination or investigation, plus expenses for travel outside of New York, and the resulting amount shall be assessed separately to each such [Bit]Licensee subject to such examination or investigation in such amounts as the superintendent shall deem appropriate."[21]

In the case that the NYDFS seeks another entity or person to perform examination, investigation or review of an individual BitLicensee, the special assessment will be the sum of the contract amount for such services and a portion of the NYDFS' administrative expenses associated with such a contract as the superintendent deems appropriate.

Issues

The BitLicense as a supervisory construct is wide-reaching, the consequence being a remarkably heterogenous mix of business models subject to a common framework. This variability necessarily stresses supervisory resources with each business model presenting a different mix of risks and requiring the NYDFS allocate resources accordingly.

This dynamic calls into question the utility of what appears to be principally a volume-based approach, which assumes that size is a proxy for complexity. The BitLicense assessment framework can be criticized on the basis that the various components and formulas it relies on make it difficult for BitLicensees or prospective applicants to determine, or even reasonably predict, the costs associated with conducting virtual currency business activity in New York.

This is because various components of a BitLicensee's total annual assessment reference undefined factors that are ultimately left to the discretion of the superintendent, such as the hourly rate multiplier, the portion of the NYDFS' total overhead expenses chargeable to BitLicensees and whether any expenses associated with a specific examination, investigation or review are best allocated solely to an individual BitLicensee.

The BitLicense assessment framework also relies on a key assumption about how costs should be allocated among BitLicensees that may result in BitLicensees with more total virtual currency transactions and more U.S. dollar value of virtual currency held — on behalf of all customers, not just New York customers — shouldering more of the NYDFS' supervisory costs, regardless of organizational or operational complexity.

We appreciate that the BitLicense assessment framework enables a predictable funding model for the NYDFS, particularly in comparison to a funding model based solely on licensing fees. Assessment frameworks, much like the BitLicense assessment framework, may also reduce over time a state banking department's reliance on civil money penalties as a means to fund operations.

However, without greater clarity relating to the various components that inform each BitLicensee's assessments, it remains to be seen how and to what extent the BitLicense assessment framework provides certainty to the industry and enables BitLicensees or new entrants into the market to predict their real costs of conducting virtual currency business activity in New York and build those costs into budgets and revenue or other models going forward.

Although assessments for some entities may become more predictable over time, at least within a range, the BitLicense assessment framework as currently contemplated may pose particular challenges for new market entrants trying to assess the ongoing costs of examination and supervision by the NYDFS under the BitLicense regime.

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[1] 23 NYCRR Part 102; available at https://www.dfs.ny.gov/industry_guidance/regulatory_activity/financial_services#final-adoptions. The BitLicense Assessment Framework was certified by the Superintendent on March 31, 2023 for effectiveness upon publication of the Notice of Adoption in the New York State Register, which occurred on April 19, 2023.

[2] 23 NYCRR Part 200; see also "Virtual Currency Businesses: Main Page," available at: https://www.dfs.ny.gov/virtual_currency_businesses.

[3] See 23 NYCRR § 200.2(q).

[4] Id. at §§ 200.8, 200.9, 200.14, 200.15, 200.16, 200.18, 200.19.

[5] Id. at §§ 200.10, 200.11.

[6] Id. at § 102.1.

[7] See id. at § 200.5.

[8] Id. at § 102.1 (quoting Financial Services Law § 206(a)).

[9] See id. at § 102.4

[10] See "NYDFS Annual Assessment Charges – BitLicense," available at: https://www.dfs.ny.gov/apps_and_licensing/virtual_currency/annual_assessment_charges_bitlicense.

[11] See 23 NYCRR § 102.6.

[12] See id.

[13] See id. at § 102.2(h).

[14] See id. at § 102.2(a), (k), (l), (m).

[15] See id. at § 102.2(l).

[16] See id. at § 102.2(a), (b), (c), (d).

[17] See id. at § 102.2(b).

[18] See id. at § 102.2(g).

[19] Id. at § 102.2(j).

[20] Id. at § 102.6.

[21] Id.