ELLIPTIC

25 January 2020

To: New York State Department of Financial Services

Re: Proposed Coin Listing Policy Framework

To whom it may concern:

We are writing in response to the request for comment that the Department of Financial Services (DFS) issued regarding its proposed coin listing policy framework for licensed virtual currency businesses. Our full response to the proposed framework is enclosed below.

We welcome and appreciate DFS's efforts to enhance the BitLicense regime, and to enable innovation in New York's virtual currency sector.

As a provider of anti-money laundering (AML) risk management solutions to virtual currency businesses operating in New York, Elliptic remains committed to engaging with DFS as it administers and refines the BitLicense framework. We share your aim of ensuring that virtual currency businesses servicing New York state can deliver safe and trusted financial products to consumers and investors.

Please do not hesitate to contact us if you have any specific questions regarding our response.

Sincerely,

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Comments on the Proposed Framework

DFS's aim of enabling licensed virtual currency businesses ("licensees") to list new coins in a more streamlined fashion is a welcome objective that is critical to ensuring that New York state remains an innovation hub in this emerging area of financial services.

One drawback of the existing BitLicense framework implemented to date has been the inability of licensees to list new tokens under a common and consistent approach. Licensees have not been able to make new coins available to New York state consumers and investors in a manner that keeps pace with the broad evolutions and developments in the crypto-asset sector.

While estimates of their exact numbers vary, it is likely that at least several thousand crypto-assets exist - representing a new asset class that is driving competition in financial services and offering consumers the prospect of greater financial access and inclusion. Any jurisdiction that wishes to be at the forefront of financial innovation should enable regulated businesses to list new tokens and make them available to consumers and investors, so long as that is done in a safe and responsible manner, and consistent with the objectives of regulators to ensure the soundness and integrity of the financial system. Jurisdictions that fail to remove barriers to entry and allow new coins to come to market may find themselves falling behind those that manage to harness these new innovative payment systems.

In proposing a new policy framework for coin listings[1], DFS has recognized that enabling a more streamlined approach to coin listing is essential for New York state's competitiveness vis-a-vis other financial centers.

To that end, DFS has proposed a coin listing policy with two features. First, it has proposed a "whitelist" of preapproved tokens that any licensee could add to its platform

[1] See, "Proposed Guidance Regarding Adoption or Listing of Virtual Currencies," December 11, 2019, https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/pr_guidance_regarding_listing_of_vc

without prior consent from DFS.[2] Second, it has proposed a model coin listing framework that a licensee can use to add any new coins to its platform that do not appear on the whitelist, subject to certain conditions.

This broad approach is prudent, in our view, but it could be enhanced and made more effective with certain adjustments. We offer two recommendations below for enhancing the proposed framework.

Recommendation 1: DFS should clarify its methodology for selecting coins it includes on its whitelist.

A DFS whitelist would offer licensees basic clarity about which coins they can offer without having to seek case-by-case approval from DFS on each and every coin they might provide on their platforms. This is an important first step in the direction of enabling more streamlined coin listing arrangements - a prerequisite if New York state service providers can continue to meet market demands.

However, DFS has not provided a clear rationale for why it selected the eight coins for inclusion on its whitelist and why other coins that bear similar features and characteristics (such as their trading volume and reputation in the market) are not included. DFS should provide clarity around the methodology it relies on to select coins for inclusion on its whitelist.

One criterion we feel DFS should include when whitelisting coins is whether anti-money laundering (AML) risk management solutions exist for them. We discuss the relevance and importance of licensees having bespoke AML solutions for newly listed coins in more detail below.

More generally, DFS should update the whitelist frequently so that it remains reflective of new coin innovations and market trends.

Recommendation 2: DFS should provide greater specificity on requirements for monitoring coin-specific risks, including a requirement that licensees have in place technology solutions to assess the risks associated with transactions and identify the source and destination of funds for any listed coin.

On its own, a whitelist would prove overly restrictive in that it would provide no room for licensees to add other coins in a manner consistent with a risk-based approach, and reflective of their risk appetite. DFS's proposed model coin listing framework, which would complement the whitelist, therefore ensures that licensees can add new coins in an innovation-friendly manner while controlling for and mitigating identified risks.

[2] The initial proposed whitelist would include the following coins: Bitcoin, Bitcoin Cash, Ether, Ether Classic, Litecoin, Ripple, Paxos Standard, and Gemini Dollar.

The model coin listing framework that DFS has proposed is reflective of broad considerations that should factor into any licensees' risk based approach. We would, however, recommend that DFS provide greater specificity in Section III ("Monitoring") of the proposed company policy framework.

In that section, DFS has proposed that, "After a new coin is adopted or listed, the VC licensee should have policies and procedures in place to monitor the newly adopted or listed coin to ensure that the licensee's continued adoption or listing of the coin remains prudent. This includes . . . Adoption, documentation, and implementation of control measures to manage risks associated with the coin."

While this section importantly notes the high-level responsibility of licensees to monitor for risks, it should provide greater clarity in terms of specific control measures that licensees should adopt. In particular, the proposed framework should clarify that before listing a new coin, licensees should have in place AML solutions that can enable them to assess the risks of transactions and identify the source and destination of funds for transactions occurring in any coins listed on their platform.

The public and transparent nature of many crypto-asset blockchains, such as those found in bitcoin, ethereum, and many others, makes it possible to perform forensic analysis on the flow of funds, and for crypto-asset companies to monitor customer activity for signs of risks and misuse using software solutions such as those we provide at Elliptic. Blockchain monitoring tools are now widely available to crypto-asset businesses internationally, and are deployed by firms with BitLicenses, to enable them to comply with AML requirements.

Using blockchain monitoring solutions, crypto-asset businesses are able to scrutinize their customers' transactions and engage in risk-based activity monitoring. This includes scrutinizing, for example:

- whether a customer's specific transactions may have been derived using funds from within a dark web marketplace or other illicit source;
- whether a customer's specific transactions may be destined for a cryptoasset address associated with a known illicit entity;
- the percentages of customers overall deposits or withdrawals that may have derived from or gone to illicit entities and actors.

This insight into the nature of transactions and the source and destination of customer funds enables regulated businesses to fulfill important AML requirements, including those related to ongoing monitoring of customer activity and suspicious activity report (SAR) filings.

We believe that for crypto-asset businesses to operate an effective AML program for transactions in any crypto-asset they require access to blockchain monitoring capabilities for that asset. Blockchain monitoring solutions are now available for many of the most popular coins - including those on DFS's proposed whitelist, and those we've referenced in Recommendation 1. Elliptic's blockchain monitoring solutions currently ensure coverage of approximately 85% of the current market capitalization of all crypto-assets. We have also observed a recent shift in illicit activity from assets such as bitcoin, where blockchain monitoring is widely deployed, to crypto-assets where there no such capability is available - suggesting that monitoring capabilities act as a deterrent to illicit activity.

We therefore recommend that DFS include in its model framework a specific requirement that licensees should have in place AML monitoring solutions that can be applied to any coin they list.

Several other regulatory bodies have recently issued guidance clarifying their expectation that virtual asset businesses should employ blockchain monitoring solutions. For example:

- The Hong Kong Securities and Futures Commission's regulatory sandbox framework for cryptoasset trading platforms requires that they "employ technology solutions which enable the tracking of virtual assets through multiple transactions to more accurately identify the source and destination of these virtual assets."[3] It also requires that platforms apply EDD for "transactions involving virtual assets with a higher risk or greater anonymity (eg, virtual assets which mask users' identities or transaction details)."[4]
- The Abu Dhabi Global Market's (ADGM) Financial Services Regulatory Authority lists traceability as one factor it considers when assessing whether a crypto-asset offering is suitable, noting that before approving a cryptoasset businesses's listing of a token it considers whether "transactions in the Crypto Asset can be adequately monitored."[5] The ADGM's crypto asset guidance also notes that "If a transaction is detected that originates from or is sent to a 'tainted' wallet address belonging to a known user, that user should be reported . . . Currently, there are technology solutions developed in-house and available from third party service providers which enable the tracking of Crypto Assets through multiple transactions to more accurately identify the source and destination of these Crypto Assets. It is expected that [cryptoasset businesses] may need to consider the use of such solutions. . ."[6]
- The US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) in May 2019 guidance on virtual currencies noted that service providers "comply with their [AML/CTF] obligations, in part, by incorporating procedures

[3]See:
https://www.sfc.hk/web/EN/files/ER/PDF/App%202_%20Conceptual%20framework%20for%20VA%20trading%20platform_eng.pdf, p7.
[4] Ibid, p. 6.
[5] See:
http://adgm.complinet.com/net_file_store/new_rulebooks/g/u/Guidance_Regulation_of_Crypto_Asset_Activities_in_ADGM_140519.pdf, p. 12.
[6] Ibid, p. 26.

into their AML Programs that allow them to track and monitor the transaction history of a [cryptoasset] through publicly visible ledgers."[7]

DFS should take similar steps to clarify AML monitoring requirements for licensees where new coins are added.

To that end, we recommend that the proposed language in Section III of the model framework be amended to read (additions in bold): "After a new coin is adopted or listed, the VC licensee should have policies and procedures**, and appropriate systems and controls in** place to monitor the newly adopted or listed coin to ensure that the licensee's continued adoption or listing of the coin remains prudent. This includes . . . Adoption, documentation, and implementation of control measures to manage risks associated with the coin**, including the adoption of technology solutions to enable the tracing of transactions and the identification of the source and destination of funds for any listed coins."**

[7] See: https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf, p21.