May 5, 2022

DFS Issues Guidance on Use of Blockchain Analytics

Guidance Highlights Importance of Blockchain Analytics Tools in Preventing and Managing Financial Risks and Suspicious Activities

SUMMARY

The New York State Department of Financial Services ("DFS") issued guidance to New York-licensed or -chartered virtual currency businesses regarding the importance of leveraging blockchain-based analytics tools in connection with processes and policies designed for compliance with various federal and state laws, including KYC-related controls, transaction monitoring and sanctions screening, given the unique characteristics of virtual currencies (the "Guidance").

THE GUIDANCE

On April 28, 2022, DFS issued guidance to virtual currency business entities that are licensed under 23 NYCRR Part 200 (also referred to as the New York BitLicense) or chartered as limited purpose trust companies under the New York Banking Law (together, "VC Entities"), noting "the importance of blockchain analytics to effective policies, processes, and procedures, including, for example, those relating to customer due diligence, transaction monitoring, and sanctions screening."[1] The Guidance notes that VC Entities' compliance programs and risk-mitigation strategies must "fully take into account the unique characteristics of virtual currencies," and related activities, including where they diverge from traditional, fiat currency activities.[2]

Noting VC Entities' anti-money laundering and sanctions obligations under applicable state and federal law and regulation,[3] the Guidance emphasizes that VC Entities' compliance and control measures should consider leveraging blockchain analytics in a number of ways, including in support of the following:

- Augmenting Know Your Customer ("KYC")-related controls: DFS notes that VC Entities must obtain and maintain information regarding, and understand and effectively address the risks presented by, their customers and potential customers and suggests that products and services that allow their users to obtain identifying information (such as the location of a wallet address on a specific exchange for custodial transactions) that ties directly to the pseudonymous on-chain data, particularly in combination with customer-provided information, could be useful.[4]
- Conducting transaction monitoring of on-chain activity: VC Entities are also required to have in place appropriate control measures, including policies, processes and procedures, to monitor and identify unusual activity tailored to the VC Entity's risk profile.[5] The Guidance states that it is important that VC Entities "evidence appropriately tailored transaction monitoring coverage against applicable typologies and red flags, identify deviations from the profile of a customer's intended purposes, and address other risk considerations as applicable." Relevant typologies include assessing whether a virtual currency: (1) has substantial exposure to a high-risk or sanctioned jurisdiction; (2) is processed through a mixer or tumbler; (3) is sent to or from dark net markets; (4) is associated with scams/ransomware; and (5) is associated with other illicit activity relevant to the VC Entity's business model.[6]
- Conducting sanctions screening of on-chain activity: The Guidance also emphasizes "the importance of risk-based policies, processes, and procedures to identify transaction activity involving virtual currency addresses or other identifying information associated with sanctioned individuals and entities listed on the SDN List, or located in sanctioned jurisdictions."[7]

The Guidance allows VC Entities to use third-party service providers or internally developed blockchain analytics products and services, but cautions that if a VC Entity outsources such control functions, it "must have clearly documented policies, processes, and procedures with regard to how the blockchain analytics activity integrates into the VC Entity's overall control framework consistent with the VC Entity's risk profile."[8]

*   *   *

ENDNOTES

1 New York State Department of Financial Services, *Guidance on Use of Blockchain Analytics*, Adrienne Harris, Superintendent of Financial Services (April 28, 2022) (hereinafter, "Guidance"), *available at* https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics.

2 *Id.*

3 *See, e.g.*, 23 NYCRR § 200.15; FinCEN Advisory on Illicit Activity Involving Convertible Virtual Currency (May 9, 2019), *available at* https://www.fincen.gov/sites/default/files/advisory/2019-05-10/FinCEN%20Advisory%20CVC%20FINAL%20508.pdf (hereinafter, "FinCEN Advisory").

4 Guidance, *supra* note 1.

5 *Id. See, e.g.*, 23 NYCRR § 200.15(e)(3) ("Each licensee shall monitor for transactions that might signify money laundering, tax evasion, or other illegal or criminal activity.") and 3 NYCRR § 504.3 (which requires, among other things, each regulated institution to maintain a transaction monitoring program reasonably designed for the purpose of monitoring transactions after their execution for potential BSA/AML violations and suspicious activity reporting, as well as a manual or automated filtering program, reasonably designed for the purpose of interdicting transactions that are prohibited by OFAC).

6 Guidance, *supra* note 1. *See also* FinCEN Advisory, *supra* note 4, and DFS, *Guidance on Prevention of Market Manipulation and Other Wrongful Activity* (Feb. 7, 2018), *available at* https://www.dfs.ny.gov/system/files/documents/2020/03/il180207.pdf.

7 Guidance, *supra* note 1; 23 NYCRR 200.15(i) ("Each Licensee shall demonstrate that it has risk-based policies, procedures, and practices to ensure, to the maximum extent practicable, compliance with applicable regulations issued by OFAC.").

8 Guidance, *supra* note 1.

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 875 lawyers on four continents, with four offices in the United States, including its headquarters in New York, four offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers or to any Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future publications by sending an e-mail to SCPublications@sullcrom.com.