

January 25, 2023

# NYDFS Issues Guidance on Virtual Currency Custodial Structures

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## Guidance Provides Expectations With Respect to Digital Asset Custody Practices by New York-Regulated Entities

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### SUMMARY

In the wake of bankruptcy filings by several prominent digital asset firms, the New York Department of Financial Services released guidance regarding digital asset custody practices. The guidance provides that a “virtual currency entity custodian” must: (1) separately account for and segregate customer assets from proprietary assets, (2) take possession of customer assets only for the limited purpose of carrying out custody and safekeeping services, (3) request approval before implementing any sub-custody arrangements, and (4) provide adequate disclosure to customers.

### GUIDANCE

On January 23, 2023, the New York Department of Financial Services (the “DFS”) released Guidance on Custodial Structures for Customer Protection in the Event of Insolvency (the “Guidance”) emphasizing the need for virtual currency entities (“VCEs”)<sup>1</sup> acting as custodians (“VCE Custodians”)<sup>2</sup> to engage in “sound custody and disclosure practices to better protect customers in the event of an insolvency or similar proceeding.”<sup>3</sup> The Guidance states explicitly DFS’s expectations in the following four areas:

- **Segregation of and separate accounting for customer virtual currency:** A VCE Custodian must “separately account for and segregate customer virtual currency from the corporate assets of the VCE Custodian and its affiliated entities, both on-chain and on the VCE Custodian’s internal ledger accounts.”<sup>4</sup> A VCE Custodian may maintain customer assets in either (i) separate on-chain wallets and internal ledger accounts for each customer under that customer’s name or (ii) 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 a VCE Custodian chooses to use an omnibus account, it should maintain appropriate records and maintain 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

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and up to date. A VCE Custodian should also have appropriate policies and procedures in place, and be prepared to demonstrate reconciliation between the virtual currency entity's books and records and on-chain activity upon DFS request.

- **VCE Custodian's limited interest in and use of customer virtual currency:** DFS expects a VCE Custodian to take possession of customer assets solely "for the limited purpose of carrying out custody and safekeeping services, and [...] not [to] thereby establish a debtor-creditor relationship with the customer."<sup>5</sup> Although the Guidance does not specify the specific legal or contractual framework that a VCE Custodian must use in structuring its custodial arrangements, it must do so "in a manner that preserves the customer's equitable and beneficial interest in the customer's virtual currency."<sup>6</sup> Furthermore, the VCE Custodian should treat customer assets in its possession or control as belonging solely to customers, not employ customer assets for its own use (e.g., by using customer assets to meet the obligations of the VCE Custodian) and act upon customer instructions.
- **Sub-custody arrangements:** After "appropriate due diligence," a VCE Custodian may arrange for a third party to safekeep customer assets through a sub-custody arrangement.<sup>7</sup> Any sub-custody arrangement would require prior DFS approval, and the Guidance specifies that any such request should, at a minimum, include: (i) the applicable risk assessment performed by the VCE Custodian; (ii) the proposed service agreement(s) between the parties and (iii) the VCE Custodian's updated policies and procedures reflecting the processes and controls to be implemented around the proposed arrangement.<sup>8</sup>
- **Customer disclosure:** A VCE Custodian must clearly disclose to each customer in writing the general terms and conditions associated with its products, services and activities and obtain acknowledgment of receipt of such disclosure prior to entering into an initial transaction with the customer.<sup>9</sup> In this regard, a customer agreement should (i) make clear the parties' intention to enter into a custodial (rather than a debtor-creditor) relationship and the associated limits on the VCE Custodian's use of customer assets and (ii) disclose segregation, accounting and sub-custody arrangements. A VCE Custodian must also make its standard disclosures and customer agreement "readily accessible to customers on its website, in a manner consistent with New York laws and regulations."<sup>10</sup>

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ENDNOTES

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- 1 “Virtual currency entities” includes entities licensed under 23 NYCRR Part 200 (“BitLicensees”) and limited purpose trust companies chartered under New York Banking Law to engage in virtual currency business activities, inclusive of custody services. 23 NYCRR §§ 200.2(q), 200.3(c)(1).
- 2 NYDFS, Guidance on Custodial Structures for Customer Protection in the Event of Insolvency (Jan. 23, 2023), available at [https://www.dfs.ny.gov/industry\\_guidance/industry\\_letters/il20230123\\_guidance\\_custodial\\_structures](https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures) (the “Guidance”). “Custody services” means, without limitation, the “storing, holding, or maintaining custody or control of virtual currency on behalf of others.” 12 NYCRR § 200.2(q)(2). Note that the Guidance pertains to “custodial safekeeping activity generally and is not intended to address in detail ancillary activities associated with custodial services such as staking or on-chain governance.” Guidance at n.6.
- 3 Guidance.
- 4 *Id.*
- 5 *Id.*
- 6 *Id.*
- 7 *Id.*
- 8 *Id.* The Guidance notes that BitLicense or limited purpose trust charter applicants may seek the required approval with their application while existing VCE Custodians may submit their approval requests as material change in business approvals. *Id.*; 23 NYCRR § 200.10.
- 9 Guidance. The Guidance also cites VCE Custodians’ disclosure obligations under 23 NYCRR § 200.19.
- 10 *Id.*

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