Ketsal

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August 10, 2020

Superintendent of Financial Services Linda A. Lacewell
New York State Department of Financial Services
1 State Street
New York, NY 10004

VIA EMAIL: innovation@dfs.ny.gov

Re: Proposed Conditional Licensing Framework

Dear Superintendent Lacewell,

Ketsal[1] and Hailey Lennon, Principal of Lennon Legal Consulting,[2] respectfully submit this letter in response to a request by the New York State Department of Financial Services ("**DFS**") for comments regarding the proposed conditional BitLicense framework (the "**Request**").[3] We appreciate the opportunity to comment and wish to express our support for DFS's decision to begin implementation of a conditional licensing regime for the BitLicense. Overall, we are supportive of the proposal, and hope our comments prove helpful as DFS refines its conditional licensing framework.

1. Introduction

Ketsal is a boutique regulatory, litigation, and corporate law firm with attorneys practicing in New York, Washington, D.C., and Washington state. Our clients include emerging companies engaging in key innovations in financial services, with a particular focus in the domain of blockchain-based financial products and services. Hailey Lennon previously served as regulatory counsel for Silvergate, bitFlyer and Coinbase. While our collective experiences advising these companies inform our comments, our comments represent our own views and are not intended to represent those of our clients.

We write in general support of DFS's mission to reduce the hurdles of obtaining a BitLicense. We share DFS's view that the proposed conditional license ("**Conditional License**") has the potential to expand innovative financial services to residents across New York State. With respect to the Request, we encourage DFS to consider the following:

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[1] Blakemore Fallon PLLC d/b/a Ketsal.

[2] Hailey Lennon currently provides legal consulting to cryptocurrency and fintech companies and is a contributing writer for Forbes. Prior to consulting, Ms. Lennon spent years as Regulatory Counsel for various companies in the cryptocurrency space including Silvergate Bank, bitFlyer and Coinbase. Ms. Lennon obtained the BitLicense for bitFlyer and helped manage Coinbase's relationship and product approvals with DFS. She also previously served as Secretary of the Virtual Commodity Association.

[3] DFS, Request for Comments on a Proposed Framework for a Conditional BitLicense (June 24, 2020), https://www.dfs.ny.gov/apps_and_licensing/virtual_currency_businesses/gn/req_comments_prop_framework.

- Clarification of key steps in the conditional licensing process; i.e., which documents an applicant for a conditional licensee ("**Applicant**" or "**Conditional Licensee**") must supply to DFS, the effect of approving an Applicant's Conditional License on the Supervisory Agreement of an existing BitLicense holder ("**Entity**"), and whether and how the Supervisory Agreement between DFS and the Applicant affects the Entity's Supervisory Agreement with DFS.
- Applicants that stand to benefit the most from a Conditional License are those wishing to test an innovative financial product or service and have limited access to capital, while Entities that stand in the best position to act as sponsors of Applicants are those with strong compliance expertise and healthy access to capital reserves;
- Initial due diligence requirements should be minimal, while ongoing due diligence requirements should afford Entities a means to transition supervisory functions to DFS at certain milestones, and potential conflicts of interest should be elevated to outside counsel for review;
- The service level agreement between the Applicant and the Entity ("**SLA**") will likely recognize the temporary nature of the business relationship, and will likely have terms that approach but do not exceed the market standard for SLAs between banks and third-party service providers;
- Clarification that Applicants can provide service offerings beyond that which the Entity engages in, whether such expanded service should come with enhanced supervision, and what limits should be placed on Entity sponsorships, especially with respect to reliance on an Entity's capital reserves;
- Allowing an Entity to demonstrate mitigation of safety and soundness risk in an addendum to its Supervisory Agreement; and
- Consideration of folding oversight of licensed entities into existing money transmitter laws and cybersecurity regulations.

2. Application Process[4]

We suggest DFS clarify certain elements of the proposed conditional licensing process. First, we set forth our understanding of the process, broken down into four steps:

1. The Applicant contacts DFS, names the Entity sponsoring the Applicant, and provides a draft of the SLA. We refer to this as the **Initial Notice** stage.
2. DFS then requests that the Applicant submit a range of documents. We refer to this as the **Document Review** stage.
3. DFS and the Applicant enter into a Supervisory Agreement, perhaps preceded by heightened review of the Applicant by DFS, that details the activities the Applicant will engage in, and the division of responsibilities and liabilities as between the Applicant and the Entity. We refer to this as the **Supervisory Agreement** stage.

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[4] This section responds to preamble in the Request asking for "comments . . . regarding the . . . proposed framework."

4. DFS approves the application and issues a Conditional License to the Applicant. This is the **Approval** stage.

Prior to the Initial Notice Stage

Prior to any communications with DFS, the Applicant and Entity will have already negotiated the key terms of the SLA, and the Entity will have performed initial due diligence on the Applicant. It is not clear how much DFS will defer to the SLA when deciding the terms of the Supervisory Agreement with the Applicant. Thus, so long as DFS maintains absolute discretion with respect to its Conditional License and BitLicense approvals, we expect Entities to be less likely to engage in serious due diligence efforts prior to the Initial Notice stage. We do not recommend DFS give up any discretion in its approval process, but because Entities will not want to waste their efforts, we recognize they will be less likely to engage in burdensome initial due diligence. We elaborate further below.[5]

Further, with respect to the SLA and the Supervisory Agreement:

- We suggest DFS provide clear guidance as to whether the Supervisory Agreement or the SLA will be the governing document between the parties. For instance, DFS should clarify which document would govern where a dispute arises and the language of the SLA and Supervisory Agreement either contradict each other or cannot resolve the dispute. This issue arises as DFS has stated the Supervisory Agreement "will detail . . . division, apportionment and sharing of responsibilities and liabilities with the . . . Entity," language which suggests DFS can either accept the terms of the SLA wholesale, rewrite the terms, or even provide contradictory terms.[6]
- We suggest DFS confirm the parties can engage in the following strategy: (1) provide a draft SLA at the Initial Notice stage that states the division, apportionment, and sharing of responsibilities and liabilities will be determined as per DFS's requirements in the supervisory agreement, and (2) represent to DFS that the final SLA will incorporate the terms of the Supervisory Agreement regarding such division, apportionment, and sharing of responsibilities and liabilities.

Document Review Stage

We suggest DFS provide a detailed list of documents required at this stage. We also request DFS makes clear an Entity can use DFS's list as a substitute for its own in the *initial* due diligence stage.

Supervisory Agreement Stage

First, we suggest DFS clarify, as between the Applicant-DFS Supervisory Agreement and the Entity-DFS Supervisory Agreement, which document should govern in the event of a conflict.

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[5] See Section 4.

[6] Further, where the Supervisory Agreement becomes the governing document, parties are less likely to draft a robust SLA before approaching DFS.

Second, we suggest DFS clarify whether the Entity will be a party to the Applicant-DFS Supervisory Agreement, and if so, whether compliance with such agreements will be reviewed during the Entity's examinations.

Conditional License Stage

We understand it is possible an Applicant can receive a Conditional License, operate with an Entity under their SLA, and ultimately get rejected by DFS during the BitLicense application process. We suggest DFS clarify whether and how long the Applicant, in this scenario, may continue to operate as a Conditional Licensee, and, if not, what the expected wind-down period would be.

3. Applicants and Entities[7]

Emerging companies with small teams who have limited access to capital stand to benefit from the Conditional License. Capital requirements imposed on companies who obtain the BitLicense can be too burdensome for small teams simply looking to test the market for a product within New York State. As a result, the current regime discourages small-scale innovators from testing financial services involving blockchain technology. Even larger-scale companies have left or choose not to launch services in New York due to DFS's level of oversight for BitLicensed entities.[8]

We suggest Entities that stand in the best position to act as sponsors will have one or more the following features:

- **Compliance Expertise.** All Applicants will need to understand the rigorous compliance requirements required to transition into the full BitLicense. Since one goal of the Conditional License is to groom Applicants into BitLicensed entities, any sponsoring Entity should have staff with capacity to supervise, a history of compliance in the fields of money transmission or payments generally, and a nuanced understanding of the operational, compliance, and other risks that flow to an entity dealing with blockchain technology.
- **Healthy Capital Reserves.** It is likely Applicants seeking sponsors will not be able to meet the capital requirements imposed on BitLicensed entities. Thus, we suggest DFS clarify whether capital reserves of the sponsoring Entity can be sufficient to satisfy the capital

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[7] This section responds to Questions 1 and 2 in the Request: "What types or categories of Applicants would be most suitable and benefit most from the proposed framework, including the characteristics and requirements, such as those relating to size, business model, potential impact on innovation and the New York financial markets, revenue, customer base, experience, management, and operational history of Applicants, and the reasoning?" and "What types or categories of VC Entities would be most suitable, and what characteristics and requirements, such as those relating to size, expertise, corporate governance, controls, compliance, operational capacity, and supervisory experience, should they possess in order to effectively and safely work in collaboration with a Conditional Licensee?"

[8] See, e.g., Marc Hochstein, *'BitLicense Refugees': ShapeShift, Kraken Talk Escape from New York* (May 16, 2018), https://www.coindesk.com/bitlicense-refugees-kraken-shapeshift-ceos-talk-escape-new-york; and Joseph Afinolfi, *Some digital-currency startups are fleeing New York* (Aug. 18, 2015), https://www.marketwatch.com/story/some-digital-currency-startups-are-fleeing-new-york-2015-08-18.

requirements imposed on the Applicant. This may be laid out in the supervisory agreement between the Applicant and DFS.

- **Seniority.** Ideally, an Entity sponsoring an Applicant will have had the BitLicense for at least twelve to eighteen months. Looking to seniority ensures the sponsoring Entity has undergone a full compliance cycle and can adequately advise the Applicant regarding compliance expectations. To the extent an Entity has other experience counseling blockchain companies on money transmitter or payments compliance, seniority of the company may not be as important as the experience of the advisors.

- **Positive Examination Results.** Seniority alone does not indicate an Entity will make for a good sponsor. If the Entity has had examination results showing many deficiencies and a lack of capacity to remediate them, it should not be permitted to sponsor an Applicant. An Entity with positive examination results that actively and effectively remedies inadequacies is more likely to make for a good sponsor. Further, we suggest DFS allow new Entities to request an early examination for the purposes of demonstrating the Entity's capacity to serve as a sponsor.

Note the above points refer primarily to Entities who have the BitLicense, not to trust companies. We take no position on the adequacy of a trust company to act as a sponsor for Applicants.

4. Due Diligence and Supervision[9]

The contractual relationship between and Entity and the Conditional Licensee is likely to be that of a principal (the Entity) and an agent (the Conditional Licensee). Banks often engage in a similar capacity with third-party service providers, outsourcing innovative financial services through those service providers as agents of the bank. Thus, well-established industry practices govern the relationship between principals and agents where the agent seeks to offer a range of services the principal does not plan on offering.[10]

In our recommendations below, we draw from our experience assisting third-party service providers in onboarding with banks. However, note that some of our suggestions are modified to account for several unique aspects of DFS's proposed framework: (1) the agent, in the proposed

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[9] This section responds to Questions 6, 7, 9, and 10 in the Request: "What initial due diligence should a VC Entity conduct on an Applicant for a Conditional License, and what initial due diligence should such an Applicant conduct on the VC Entity before they start collaborating under this framework?"; "What ongoing due diligence should a VC Entity conduct on a Conditional Licensee, and what ongoing due diligence should the Conditional Licensee conduct on the VC Entity (including, in each case, the frequency of such due diligence) in order to assess their continued collaboration under this framework?"; "How should a VC Entity and an Applicant for a Conditional License ensure that any conflicts of interest that may exist between them are identified and effectively addressed, and what would be the mechanics for achieving that?"; and "How should a VC Entity and a Conditional Licensee's collaboration be structured to mitigate the risk of an adverse impact on markets as a result of such joint effort and collaboration?"

[10] We understand, separately, that DFS does not expect the Entity entering into an SLA with the Conditional Licensee to directly offer all of the services of all of its Conditional Licensees. We reference the Memorandum of Understanding with SUNY, as we do not believe it is the intent of that MOU that SUNY's licensed entity will directly provide the services of the Conditional Licensees. Memorandum of Understanding between the NYDFS and SUNY (June 18, 2020), https://www.dfs.ny.gov/system/files/documents/2020/06/mou_dfs_suny_20200618.pdf.

framework, will invariably be expected to seek the same licensure as the principal (this does not typically occur in bank service provider relationships); (2) the principal-agency relationship is, by design, temporary and not likely to see perpetual renewals; and (3) the temporary nature of the principal-agent relationship suggests the principal will need incentive to expend regular time and effort onboarding new agents, maintaining existing ones, and offloading licensed agents.

Initial Due Diligence

At a minimum, we suggest DFS make clear it will not require Entities to engage in greater due diligence than DFS will perform when considering whether to grant a Conditional License to an Applicant.[11] Thus, for example, the document list requested by DFS at the Document Review stage should suffice as a document request list for Entities looking to onboard Applicants.

An Entity deciding to onboard a new Applicant will need to consider the financial incentive to the Entity, the Entity's ability to perform oversight of the Applicant, and other relevant risks to the Entity.[12] With respect to initial due diligence:

- We suggest DFS elaborate on specific risk areas relevant to the initial due diligence process when an Entity decides to sponsor an Applicant; and
- We suggest DFS elaborate on whether an Applicant either located overseas, or with beneficial owners residing overseas, may become an Applicant or a Conditional Licensee.

Ongoing Due Diligence

A Conditional Licensee will effectively have two supervisors: the Entity and DFS. The ultimate goal will be for the Conditional Licensee to obtain a BitLicense, and thus only have one supervisor: DFS. Thus, we view the role of the Entity as a temporary sponsor meant to supplant some of the supervisory functions of DFS, while preparing the Conditional Licensee for full supervision by DFS. With respect to ongoing due diligence, we believe DFS should be able to set clear milestones that would allow for an Entity to progressively transfer the supervisory role to DFS. To this end, regarding ongoing due diligence:

- We suggest DFS make clear it will not require Entities to engage in greater ongoing due diligence than DFS in its capacity as a supervisor to entities with a BitLicense;
- We suggest DFS provide an expected timeline for transitioning a Conditional Licensee into a licensee;
- We suggest DFS, if unable to provide a strict timeline, at a minimum provide examples of specific milestones that may be set in a supervisory agreement (e.g., dollar amount of assets under management; number of retail customers; transaction or volume thresholds) to determine when any supervisory function delegated to an Entity should return to DFS;

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[11] DFS may request a range of documents from the Entity to properly vet the leadership team, compliance program, funding, assess an appropriate capital requirement, etc.

[12] We also note an Applicant may wish to conduct due diligence on its Entity sponsor. For instance, the Entity's data privacy policies around sale, storage, or erasure of personal data, cybersecurity history, and compliance history may be relevant to the Applicant.

- DFS should clarify which of its ongoing supervisory functions it is willing to delegate (we do not recommend delegation of review of a Conditional Licensee's cybersecurity or consumer protection policies or procedures, or of the Conditional Licensee's financial health,[13] but do not see many risks in allowing delegation of review of compliance policies, transaction monitoring, terms of service, customer receipts, customer compliant management, management of ongoing litigation, and other operational functions); and
- We suggest DFS clarify how long a Conditional Licensee can, at a maximum, operate as a Conditional Licensee prior to obtaining a BitLicense.

Conflicts of Interest

We believe an external law firm would be best situated to resolve conflicts of interest. Law firms typically have protocols that require them to check – for each new client – whether a conflict exists as between the parties. Ethical issues arising from conflicts checks are commonplace for law firms. We recommend the following:

- DFS should require any potential conflicts identified in the due diligence process to be cleared by an independent third party, which may be the law firm representing either entity; and
- Where an Applicant and Entity are direct competitors, DFS should require the independent third party to identify whether waiver of the conflict should be permitted, considering any significant competitive disadvantage that may flow to either party as a result of the sponsorship.[14]

In the alternative, DFS may wish to completely bar direct competitors from entering into an Entity-Conditional Licensee arrangement.

Adverse Impact on Markets

The risk of adverse impacts on the markets due to collaboration should first be identified by DFS prior to setting forth any guidelines. In our view, where an Entity and Conditional Licensee collaborate and they share the same data infrastructure, their consumers face enhanced cybersecurity risk. Where both parties are competitors, there is also an increased risk of collusion or fixing of fees. Where both parties share the same method of custodianship over customer funds or co-manage the same pool of funds, there is an increased risk of attack to steal those funds.

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[13] The conditional licensee may even want to keep certain aspects of its business confidential from the sponsor Entity. It is possible they may request DFS to play a supervisory role in some respects to avoid certain proprietary information from flowing to the sponsor Entity.

[14] Further, where an Applicant and Entity are direct competitors, we would encourage the two parties to detail provisions in the SLA regarding (1) the transfer, access and use of data between the entities; (2) priority of compliance staff where the Entity will be using compliance staff to serve both itself and the Applicant (or other Applicants); and (3) priority over use of other Entity resources that may be jointly used and subject to scarcity.

Notwithstanding the need to identify risks, we believe insider trading presents a well-defined risk in this space. We recommend DFS consider whether it would be appropriate to require the insider trading policies of the Entity to also apply to the employees of the Conditional Licensee.

5. SLAs[15]

As mentioned above, the relationship between the Entity and the Conditional Licensee is temporary by design. DFS expects Conditional Licensees to eventually apply for a BitLicense. As a result, the terms of the SLA will likely include an end date to the relationship. While the relationship between banks and third-party service providers may be similar to that of an Entity and a Conditional Licensee, the former typically contemplate ongoing arrangements. Thus, SLAs between an Entity and Conditional Licensee will likely become formulaic, standardized, and/or less customized than those between a bank and a bank partner. However, as mentioned above, we recommend they provide for performance milestones that would trigger a transition from supervision by the Entity to supervision by DFS.

6. Services and Limits[16]

Here we cover three topics on which we request clarification from DFS: (a) the extent to which an applicant can provide service offerings beyond those offered by the Entity; (b) the type of support an Entity can provide to a Conditional Licensee; and (c) limitations on capital requirements and sponsorships support.

Service Offerings Beyond Entity Lines of Business

An Applicant may want to provide complex services or business models not offered by the Entity. In a traditional principal-agent relationship, agents can and do act outside of the principal's scope. For instance, a state bank may wish to offer a product or service – say, an innovative debit card offering – solely through an affiliated entity through a partnership that leverages the bank's state charter. The affiliate may thus offer a payments product that the bank typically does not offer. It is our understanding that SUNY's licensed entity will not offer the same service offerings of the Applicants it will sponsor, and that such expanded service of the Applicant will likely come with enhanced supervision from either DFS or the Entity. It is not clear whether the Entity is expected to perform enhanced oversight and consideration of the risk in these relationships, or if DFS plans

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[15] This section responds to Question 8 in the Request: "What would be the most appropriate way to divide, apportion, and share responsibilities, obligations, and liabilities between a VC Entity and an Applicant for a Conditional License? For example, how should the responsibility or liability associated with any potential failure to meet statutory, regulatory, or other obligations be divided, apportioned, or shared, and what would be the mechanics for achieving that?"

[16] This section responds to Questions 3 and 4 in the Request: "What types of services and support should a VC Entity provide to a Conditional Licensee with the ultimate goal of enabling the Conditional Licensee to obtain a regular non-conditional BitLicense from DFS?" and "What limits should be placed on the types and levels of services and support a VC Entity may provide to a Conditional Licensee, including capital infusion, guarantees, day-to-day management and operations, board representation, policy making decisions, and control of the Conditional Licensee and the reasoning?"

on engaging in such additional supervision. We suggest DFS clarify the expected supervisory capacity of the Entity in this situation.

Where the Entity and Conditional Licensee have relatively similar business offerings, the Entity may be better suited to provide supervisory assistance in lieu of DFS. Where the proposed offering is new to the Entity, DFS may wish to play a larger supervisory role.

Entity Support for the Conditional Licensee

An Entity can and should provide support to an Applicant's general compliance efforts (e.g., transaction monitoring, SAR filing), as well as cybersecurity efforts, insofar as the Entity and Conditional Licensee have similar offerings and the Conditional Licensee is able to outsource these functions. Additionally, the Entity may support the Conditional Licensee in communications with DFS regarding its supervisory agreement, and with respect to examinations that occur during the conditional licensing period.

Limits on Capital Requirement/Financial Obligations

In general, we understand DFS, like other regulators, aims to avoid a prescriptive approach to their regulatory and supervisory oversight. However, for some areas, DFS may wish to put in place limitations to ensure an Applicant does not rely too heavily on the Entity for financial support or safety and soundness.[17] We suggest DFS clarify when a Conditional Licensee may rely solely on an Entity to fulfill financial or capital requirements, and when a Conditional Licensee must meet such capital requirements on its own.

Limits on Sponsored Conditional Licensees

We request DFS clarify whether it will set out to limit Entity sponsorship of numerous Applicants. It is possible a "BitLicense as a Service" concept may emerge from this framework much in the vein of "Banking as a Service," which is not in itself untoward, and has led to substantial innovation, but highlights a correlated risk that without sufficient guardrails in place by DFS, profit motives may threaten to dominate such partnerships.[18] Put simply, an Entity has finite resources, and thus should only be able to sponsor a finite number of Conditional Licensees. Further to this point, we request DFS clarify whether it will put in place any limits on use of human resources (e.g., Entity compliance staff) and Entity capital reserve support.

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[17] See also Section 7 below.

[18] See, e.g., Press Release, Sigue Corp. and Sigue, LLC of California to Pay $15 Million to U.S. Government for Anti-Money Laundering Program Deficiencies, Financial Crimes Enforcement Network (Jan. 28, 2008), https://www.fincen.gov/sites/default/files/news_release/20080128.pdf (announcing a civil money penalty against a remittance business that had more than 7000 authorized delegates for failing to establish BSA compliant AML program).

7. Safety and Soundness[19]

One way for DFS to ensure safety and soundness of Conditional Licensees is for DFS to understand the company's financial statements and the contractual commitments between it and the Entity. DFS may also want to amend its Supervisory Agreement with the Entity to reflect the heightened importance of the Entity's safety and soundness as it oversees Conditional Licensees. However, such updates may become burdensome for both DFS and the Entity, as the Supervisory Agreement would need amending for each new sponsored Applicant. Therefore, we request (a) DFS clarify whether the Supervisory Agreement will make mention of the Entity's oversight of Applicants, (b) whether or not that mention can be broad enough to cover all current and future Applicants and Conditional Licensees engaged in partnerships with the Entity, and (c) whether any sponsorship activity can simply be addressed in an addendum to the Supervisory Agreement.

8. Additional Concerns[20]

While the Conditional License framework may help small-scale innovation in New York, the BitLicense framework remains more burdensome than the money transmitter licensing regime of most other states. While we understand complete elimination of the BitLicense might appear to have a drastic impact on DFS's oversight function, we believe transitioning away from the BitLicense to requiring licensure under New York's existing money transmitter license and oversight via existing cybersecurity regulations would – as it has in other states – provide for sufficient state oversight of virtual currency business activity.

Finally, we request clarification from DFS on the following points:

- If an Entity loses its BitLicense, what effect will that have on a Conditional Licensee?
- Will DFS provide any incentives to larger, healthy Entities who do not sponsor Conditional Licensees to encourage them to do so?
- How will a company's status as a money transmitter licensed in New York affect – if at all – its status as a Conditional Licensee? For instance, will DFS be more likely to allow a licensed money transmitter to be a Conditional Licensee for a longer period of time, or be willing to defer more oversight functions to the Entity?
- Does DFS plan on providing reciprocity to states with BitLicense-like regimes, such as Louisiana?[21]
- Does DFS plan on harmonizing the examination process or renewal costs for Entities that possess both a money transmitter license and a BitLicense?

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[19] This section responds to Question 5 in the Request: "How should a VC Entity ensure that its own safety and soundness, including operations, controls, and compliance with its supervisory agreement would not be adversely impacted by these collaborative arrangements, including caps and limits on the total number of such arrangements for the VC Entity?"

[20] This section responds to Question 11 in the Request: "In addition to the proposed framework, what other methods might DFS consider to safely and effectively facilitate entry into, and growth into, New York's virtual currency marketplace?"

[21] Louisiana Rev. Stat. tit. 6, ch. 21, § 1382 (10).

- Will DFS make public any rejections of Applicants, or will it keep that information confidential?

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We sincerely thank DFS for initiating this dialogue with the industry, and we appreciate the opportunity to comment.

Respectfully,

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Hailey Lennon, CAMS
Principal, Lennon Legal Consulting

Jenny Leung
Attorney, Ketsal