

Statement of

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before the

**SUBCOMMITTEE ON DIGITAL ASSETS, FINANCIAL TECHNOLOGY, AND
INCLUSION**

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Good morning, Chairman McHenry, Ranking Member Waters, Subcommittee Chairman Hill, Subcommittee Ranking Member Lynch, and members of the Subcommittee on Digital Assets, Financial Technology, and Inclusion. I am Adrienne Harris, Superintendent of New York's Department of Financial Services (DFS or the Department). Thank you for inviting me to today's hearing.

Strengthening the nation's regulatory oversight of virtual currency is critical to protecting consumers and ensuring the safety and soundness of institutions. I look forward to sharing with you DFS's expertise in the space as a prudential regulator of virtual currency since 2015. New York's virtual currency regulatory framework is the most comprehensive in the country, built on the model of full-scope banking supervision (including, *e.g.*, capitalization requirements, transaction monitoring and reporting obligations, and consumer protection requirements), but tailored for the unique considerations of the industry. It has served well to protect New York consumers, keep virtual currency entities safe and sound, and hold bad actors to account. I look forward to sharing with you some key features of the DFS framework and to offering continued assistance as you and your teams work to develop an appropriate framework for virtual currency regulation on a national level. State and federal regulators each have unique strengths that must be harnessed in developing a comprehensive regulatory framework for virtual currencies.

Before I speak to the specifics about how DFS regulates stablecoin issuers, I'd like to spend a moment to share with you how the Department's overall virtual currency framework is constructed. The Department has a wide range of tools to regulate the virtual currency industry, including licensing, supervision, examination, and enforcement.

Unlike states that license virtual currency entities as money transmitters, New York has two distinct licensing and chartering regimes for entities engaging primarily in virtual currency activities—the BitLicense and the limited purpose trust company (LPTC) charter—which allow for different types of activity and operate with guardrails tailored to the specific risks that virtual currency creates.

The BitLicense regulation¹, which was enacted in 2015 under the New York Financial Services Law, enables companies that can pass New York’s rigorous licensing standards to engage in a wide variety of virtual currency activities—subject to additional DFS approvals—including storing, holding or maintaining virtual currency on behalf of others; buying and selling virtual currencies; or performing exchange services on behalf of customers.

Importantly, for a BitLicensee to engage with the fiat or traditional money transmission space, even in service of a virtual currency business activity, a separate money transmission license also is required. This provides the Department the ability to review and supervise against the unique risks of these distinct activities.

LPTCs, regulated under the New York Banking Law, are held to the same virtual currency-specific standards as BitLicensees but have additional powers and therefore additional

¹ 23 NYCRR Part 200.

supervisory expectations arising under the Banking Law. Specifically, an LPTC may act as a fiduciary, while a BitLicensee does not have fiduciary powers.²

Approval for a license or charter requires that companies meet the standards of DFS's comprehensive assessment of controls regarding financial crimes, cybersecurity, capitalization, financial/accounting, character and fitness of controlling parties, operational risk, consumer disclosures, and more.

In addition, when an entity is approved to be licensed or chartered, DFS creates a detailed supervisory agreement that is tailored to the specific risks presented by the company's business model. Licensed and chartered entities also are subject to ongoing supervision and are regularly examined for compliance with broadly applicable virtual currency regulations and other rules, as well as with their supervisory agreements. Supervisory agreements are updated on an as-needed basis to take account of changing business models, market conditions, or other relevant considerations. Licensed companies also must get approval from the Department for material changes of business, including for new product offerings and stablecoin issuance.

DFS also regularly issues guidance to regulated entities to make transparent more specific regulatory expectations and guardrails. In such a fast-moving industry, these pieces of guidance are critical to respond in a timely manner to market developments.

² An LPTC also is permitted to engage in money transmission without having to separately obtain a money transmission license.

The Department also regularly examines our virtual currency entities, including to assess that the institutions have virtual currency-specific controls in place to protect consumers, that are appropriately tailored to the risks presented by the entity's business model.

The Department supplements such examinations through proactive supervision. Staff assigned evaluate each entity against regulatory requirements and bespoke supervisory agreements. Upon identification of supervisory gaps or deficiencies, the Department can require remedial actions³ to swiftly address issues.

In the year and a half since my arrival, DFS also has strengthened this responsive oversight by acquiring technologies, onboarding specialized experts, and enhancing training to support more real-time supervisory awareness of our entities. For example, the Department now has a trained team in place who can review wallet addresses and transaction hashes associated with DFS-regulated entities and their counterparties to identify potential illicit finance activity.

If through our supervision we find that a regulated entity is not in compliance with our rules, our supervisory team can quickly refer cases to DFS's enforcement division to investigate and take appropriate enforcement actions⁴ to ensure that companies pay penalties for violations, remediate issues, and where applicable, return lost funds to customers.

³ *Notice Regarding Paxos-Issued BUSD*. New York Department of Financial Services. https://www.dfs.ny.gov/consumers/alerts/Paxos_and_Binance

⁴ New York Department of Financial Services. (2023, January 4). *Superintendent Adrienne A. Harris Announces \$100 Million Settlement with Coinbase, Inc. after DFS Investigation Finds Significant Failings in the Company's Compliance Program* [Press release]. https://www.dfs.ny.gov/reports_and_publications/press_releases/pr202301041

The core provisions of the DFS regulatory and supervisory framework, which is frequently cited by domestic and foreign regulators as the gold standard, are robust capital and financial standards, strong consumer protections, sophisticated cybersecurity requirements, and strong anti-money laundering provisions.

Virtual currency entities also are subject to custody and capital requirements designed to industry-specific risks necessary for sound, prudential regulation. For example, entities must hold virtual currency of the same type and amount, on a one-to-one basis, as that owed or obligated to a consumer. This is distinct from traditional banking based on a fractional reserve system, which enables entities to maintain only a portion of assets deposited by consumers and lend or use the rest for their own business.

The Department further underpinned these regulatory requirements with additional guidance in January 2023 reiterating expectations for sound custody and disclosure practices, and the paramount importance of the equitable and beneficial interest in the asset always remaining with the customer. Entities must have in place policies, processes, and procedures to appropriately segregate customer funds and provide appropriate disclosures.

In addition to requirements related to holding of customer assets, DFS-regulated virtual currency entities must have capital on hand to mitigate risk associated with cyber events, market volatility, or other exogenous events. The required capital amount is calculated based on specific risks presented by each entity's business model and other safety and soundness factors, such as custody (cold storage and hot wallets); transmitted assets (volume and value); and projected wind-down costs. Once the capital amount is initially determined with the Department, entities must maintain at least 110% of that amount at all times. Entities must submit reports to evidence

they are meeting the minimum required amount against changes to the entity's business. If an entity falls below the 110% threshold at any time, they must notify DFS immediately.

DFS's virtual currency regulation also includes specific consumer protection requirements, including for advertising and marketing practices, proper disclosures, transaction receipts, and fraud prevention. Entities also are required to have policies, processes, and procedures to resolve complaints in a fair and timely manner.⁵

All virtual currency entities regulated by DFS are subject to our cybersecurity regulation,⁶ as are our traditional banking institutions and insurance companies. Furthermore, our virtual currency regulation includes specific provisions to ensure individuals and their data are protected from the rise of hacks—a particularly salient concern with respect to virtual currency.

Lastly, from the development of the BitLicense regime and in the time since, the Department has prioritized addressing the inherently high risk that virtual currency business activity presents with respect to illicit transactions. These safeguards include requirements for annual risk assessments and independent testing, and annual certifications of compliance with transaction monitoring and filtering programs through the Department's Part 504 certification

⁵ 23 CRRNY § 200.20(a).

⁶ DFS's cybersecurity regulation has become the model for other state and federal regulators since it was enacted in 2017. Recently, the Department has proposed amendments to our existing framework, taking into account new and evolving cybersecurity threats with the most effective controls and best practices.

requirements.⁷ For example, in April 2022, the Department produced guidance to emphasize to all virtual currency business entities 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. The Department uses such tools itself as part of supervision.

The issuance of stablecoins is just one of many business activities in which a DFS-regulated entity might engage. Employing DFS's robust virtual currency regulatory framework described above, we use additional regulations, guidance, and company-specific supervisory agreements to tailor our oversight to the nuances of specific products and services. Our regulation and oversight of stablecoins is a prime example of how we develop specific guardrails for novel activity. DFS was the first agency to provide regulatory clarity for these products, which has helped protect New York consumers and provided the industry needed confidence and direction to create a strong, resilient market for these businesses in the state.

There are many different kinds of stablecoins, including fiat-backed, commodity-backed, and algorithmic.⁸ As noted above, in addition to licensing entities to do business in New York, DFS also must approve separately each product a company seeks to offer, including the issuance of any stablecoins. The Department has not approved the issuance of any algorithmic

⁷ 3 NYCRR § 504.3(a)(2)

⁸ Algorithmic stablecoins attempt to maintain their peg by using algorithms that automatically adjust the circulating supply in response to market dynamics. The largest and most famous example of this was UST, which imploded in Summer 2022 and led to billions in losses across the cryptocurrency space. These algorithmic stablecoins in particular generally fail to meet the key defining characteristic of a stablecoin (stability) and should be viewed with utmost caution.

stablecoins, which have very different characteristics in terms of design, backing, and issuance. The collapse of the algorithmic stablecoin, Terra, was well-reported in the news last year and had a ripple effect across the cryptocurrency ecosystem, ultimately leading to the bankruptcy of fintech firms Celsius and Voyager (neither of which was licensed or chartered in New York) and hedge funds such as Three Arrows Capital. However, the Department’s strict coin listing requirements mitigated the impact of the Terra collapse to New Yorkers in a manner that cannot be said for any other jurisdictions because Terra had not been approved by DFS for custody or listing in New York State.

Currently, DFS regulates five fiat-backed stablecoins and one gold-backed stablecoin. In June 2022, DFS provided guidance related to the issuance of U.S. Dollar⁹-backed stablecoins (DFS Stablecoin Guidance)¹⁰. The DFS Stablecoin Guidance makes public the baseline requirements DFS expects from regulated entities, based on the work DFS has done in stablecoin supervision since 2018.

There are three key elements to the DFS Stablecoin Guidance: strict reserve requirements, confidence in redeemability, and transparency. Any stablecoin approved by the Department and issued by a DFS-regulated virtual currency entity must be one-to-one backed at all times by cash or cash equivalents held in custody with U.S. state- or federally-chartered

⁹ The guidance on U.S. Dollar-backed stablecoins is noteworthy because DFS approves and regulates GMO-Z which issues GYEN—a stablecoin backed by the Japanese Yen. The industry guidance also does not reflect Paxos’ gold-backed stablecoin. The guidance is attached here in the Appendix.

¹⁰ The DFS Stablecoin Guidance is attached here in the Appendix.

depository institutions with deposits insured by the Federal Deposit Insurance Corporation and/or with asset custodians approved in advance by DFS. Entities must adopt clear, conspicuous policies which allow for “timely” redemption not more than two full business days after the issuer receives a redemption request (*i.e.*, “T+2” conversion in response to redemption requests). Lastly, issuers are required to undergo monthly audits by an independent certified public accountant (CPA) and provide public bi-monthly attestations on the underlying reserves to provide the marketplace with the transparency needed to have confidence in their assets.

Beyond the DFS Stablecoin Guidance and individual supervisory agreements, the Department is actively augmenting regular reporting requirements to assess an entity’s capital and liquidity. Stablecoin issuers are also required to report bi-weekly their bank partnership relationships, asset reserve mix, and flows related to minting and burning.

Together, these stablecoin-specific requirements, combined with the constellation of regulatory requirements unique to the Department, provide a level of transparency for existing and would-be issuers for how to responsibly build their business in a regulated environment.

Far from creating a disincentive to enter the market, strong regulation has drawn virtual currency companies to do business in New York. Crypto startups based in New York City have consistently raised more capital than companies in any other region of the country, including Silicon Valley and Miami. In 2021, nearly half of that capital was raised by New York-based

companies.¹¹ The Department continues to receive applications from a variety of companies which understand the critical need for a robust regulatory framework that is designed to ensure their safety and soundness and the protection of their customers. Further, other jurisdictions, regulators, and economic development agencies recognize the value of the DFS framework and are seeking to replicate it. From Illinois and California; to the United Kingdom, United Arab Emirates, and Singapore; DFS is engaged with regulators around the world seeking to build a regulatory framework that leverages DFS’s expertise and experience.

Recent market events have demonstrated that DFS’s regulatory framework is operating as intended. Now, more than ever, customers need to know that their assets are protected. In addition, industry needs clarity on how to develop innovative products in a responsible and compliant manner. Nonetheless, we are well aware of the significant risks virtual currency can pose to consumers and to the U.S. financial system, and we would welcome the opportunity for continued collaboration to help build a comprehensive and thoughtful state and federal framework that mirrors the mature and well-functioning regulatory system for more traditional financial institutions.

As members of this Committee contemplate federal legislation for stablecoins, I believe the best path forward is to build on the well-established dual banking regulatory system – where state and federal regulators share supervisory and regulatory authority. The dual banking system

¹¹ Bellusci, M. (2022, February 1). Global VC Funding for Blockchain Firms Surged to Record \$25B in 2021: CB Insights. *Coindesk*. <https://www.coindesk.com/business/2022/02/01/global-vc-funding-for-blockchain-firms-surged-to-record-25b-in-2021-cb-insights/> citing: CB Insights “2021 State of Blockchain Report.”

takes advantage of the comparative strengths of federal and state regulators. Federal regulators are able to comprehensively address macroprudential considerations and establish foundational consumer and market protections. Meanwhile, states can act more nimbly to respond to industry developments and support responsible innovation given their ability to modernize regulations more quickly and leverage their more immediate understanding of consumer needs.

Ultimately, we share the goal of establishing a national framework to protect consumers across the country without preempting the states' ability to regulate innovative financial services.

I am proud of the work DFS has done to develop a comprehensive supervisory framework and to foster a well-regulated virtual currency industry in the state, and we would welcome further collaboration with you to take advantage of our lessons learned and develop a comprehensive national regulatory framework.

Thank you, and I look forward to your questions.