

January 12, 2024

Re: Invitation for Comments on Proposed Application-Related Rulemaking Under the Digital Financial Assets Law (PRO 02-23)

Chainalysis welcomes the Department of Financial Protection and Innovation’s invitation for comments on the newly enacted Digital Financial Asset Law (DFAL). We are grateful for the opportunity to provide this submission in response to the DFPI’s questions related to the licensing process and stablecoin requirements under the DFAL.

Chainalysis is the leading provider of blockchain data and analysis. Our perspective in making this submission is based on our extensive experience providing data, software, services, and research to government agencies, exchanges, financial institutions, and insurance and cybersecurity companies in over 70 countries. Our data powers investigation, compliance, and market intelligence software that has been used to solve some of the world’s most high-profile criminal cases and grow consumer access to cryptocurrency safely.

Background

In this submission, we highlight the need for the DFPI to ensure that the regulatory framework in California appropriately leverages the unique attributes of digital financial assets to accomplish the stated customer and investor protection goals of the DFAL.

One of the central novel features of transacting on blockchains is the inherent transparency of the technology. All on-chain transactions are publicly broadcast and stored on an immutable ledger such that anyone can monitor transaction activity in real-time. However, this data is not easy to analyze in its raw form and lacks the context of information from outside the blockchain network, such as identifying information. At Chainalysis, we augment this raw data with attributions of cryptocurrency addresses to specific services and group together addresses belonging to each service or wallet in a process we call clustering. We then provide this augmented data to both government and private sector customers through various software and services designed to monitor transaction activity, investigate potentially suspicious transactions, and gain other enhanced insights into blockchain activity.

Use of blockchain analysis platforms, such as those provided by Chainalysis, has become best practice for most well-run crypto businesses. Blockchain analysis tools are often integrated into processes around conducting customer due diligence, transaction monitoring, sanctions screening, and other important compliance functions. For this reason, other regulatory bodies, including the New York Department of Financial Services (NYDFS), have issued guidance recognizing the important role that

blockchain analysis plays in meeting compliance obligations under their respective regulatory regimes for digital financial assets.¹

Regulators are also able to leverage blockchain analysis platforms to monitor digital financial asset activity at licensees and throughout the broader blockchain ecosystem. This allows regulators to have an objective view of a licensee’s operations and provides greater insight as part of the licensing, supervision, and examination process, as well as easier collaboration with licensees related to investigations into potentially suspicious activity.

With this context in mind, our recommendations below are intended to ensure that the regulatory framework under the DFAL maximizes the ability to leverage blockchain analysis.

1. Financial Code section 3203, subdivision (a)(2)(X) requires the license application to include “any other information” the DFPI reasonably requires by rule. In addition to the information that is listed in the law, what other information should the application include?

Recommendation 1: Chainalysis recommends that DFPI consider requiring license applicants to provide information demonstrating an ability to meet industry standards relating to customer due diligence, transaction monitoring, and sanctions screening, with an expectation that applicants will be leveraging blockchain analysis for those processes.

Financial Code Section 3203, subdivision (a)(2)(U) requires an applicant to submit the “plans through which the applicant will meet its obligations under Chapter 7 (commencing with Section 3701).” Section 3701 lays out the required policies and procedures that licensees must have in place in order to prevent such activity as fraud, money laundering, and terrorist financing. However, this section does not explicitly address the unique manner in which most digital asset businesses leverage blockchain analytics as part of a compliance regime.

At this stage in the development of the industry, it is well-accepted that platforms should be conducting sophisticated blockchain analysis as part of a compliance program in order to mitigate fraud, money laundering, and other illicit activity. As highlighted by the NYDFS in guidance from April 2022, the transparent and immutable nature of blockchain networks “present new possibilities for control

¹ NYDFS, Guidance on Use of Blockchain Analytics (Apr. 28, 2022) (https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics); Joint statement from UK financial regulatory authorities on sanctions and the cryptoasset sector (Mar. 11, 2022) (recommending that firms consider leveraging blockchain analytics) (<https://www.fca.org.uk/news/statements/uk-financial-regulatory-authorities-sanctions-cryptoasset-sector>); Dubai Virtual Asset Regulatory Authority, Rulebook Part I.F. (<https://rulebooks.vara.ae/node/177>).

measures that leverage these new technologies.”² Specifically, the NYDFS emphasized the ability to leverage blockchain analysis to augment “Know Your Customer” controls, conduct transaction monitoring of on-chain activity, and conduct sanctions screening of wallet addresses.

DFPI should ensure as part of the licensing process that applicants have appropriate risk-based policies and procedures based on the types of tools and information available to digital financial asset business. For example, there is a large distinction between using a publicly available block explorer to trace transactions when alerted to suspicious activity, and using a sophisticated blockchain analysis platform that provides augmented data in the manner described above. DFPI should ensure that applicants are following best practices by requiring the plans submitted under subdivision (a)(2)(U) to explain how an applicant will leverage blockchain analysis as part of their compliance program.

Recommendation 2: Chainalysis also recommends that DFPI consider requiring applicants to proactively identify the primary wallet addresses they use to hold and transfer digital financial assets. This would allow DFPI to leverage blockchain analysis to develop an independent view into the operations of a licensee, which would strengthen DFPI’s oversight abilities.

DFPI could use the wallet address information to help assess the health of the licensee’s operations by, for example, monitoring inflows and outflows for potential liquidity concerns at the licensee. Most licensees will be custodial customer assets, and as demonstrated by the collapse of FTX, ensuring that a platform is properly managing custody and not using customer funds for unreported purposes is paramount to ensuring the protection of customer assets. By requiring applicants to provide wallet address information, DFPI will be in a better position to monitor custodial assets and potentially identify issues before they become systemic and without needing to rely on examinations or periodic licensee reporting.

DFPI could also use the wallet address information to enhance its review of a license application and its examination of a licensee’s compliance program by gaining insight into transaction flows into and out of the platform. For example, Financial Code Section 3303 requires licensees to produce comprehensive records about customer transactions as part of an examination. To the extent that those transactions involve on-chain transfers of digital financial assets, by having information about the internal wallets used by the platform, DFPI is in a better position to verify the accuracy of the reported transactions. Moreover, Financial Code Section 3701 requires licensees to have compliance policies in place to prevent fraud and other illicit activity. By having the wallet address for a licensee, DFPI can use blockchain analysis to get an independent picture as to the amount of illicit activity that is being

² NYDFS, Guidance on Use of Blockchain Analytics (Apr. 28, 2022) (https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220428_guidance_use_blockchain_analytics)

conducted through a licensee’s platform and therefore get a more complete and independent picture of the licensee’s compliance program.

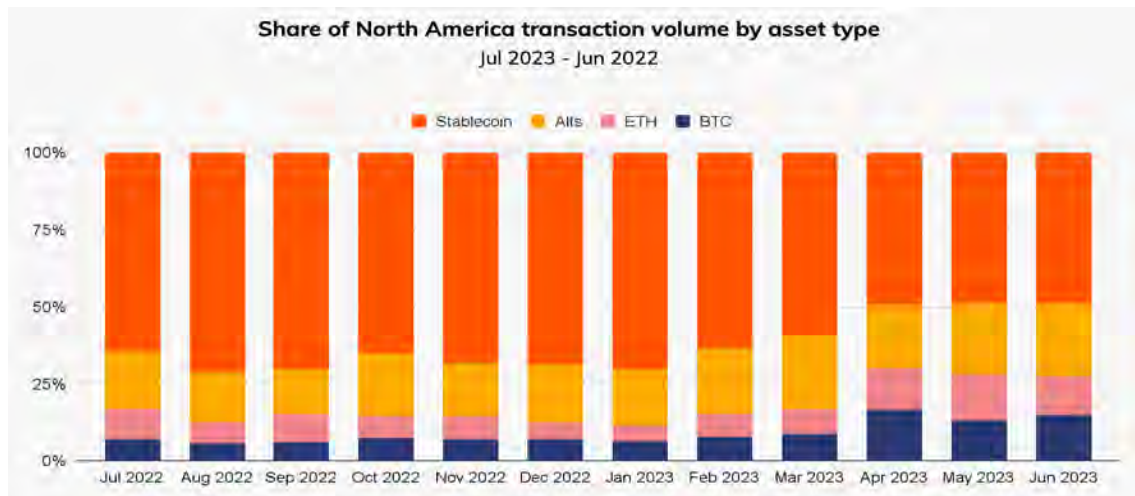
A requirement for applicants to provide wallet addresses is even more relevant in the current context, in which many of the applicants are likely to be companies already in operation and DFPI will necessarily be conducting a certain level of analysis on past activity by the applicants. Using blockchain analysis, DFPI will be able to do a more thorough analysis of an application based on a review of the ongoing activity by a platform.

11. Under Financial Code section 3603, subdivision (b)(2)(F), in determining whether to approve a stablecoin, the Commissioner must consider “any other factors the commissioner deems material to making their determination.”

b. What “other factors” should the DFPI consider?

Chainalysis recommends that approval for a stablecoin should be in part dependent on the issuer having a demonstrated process for analyzing the flows of their stablecoin in the secondary market.

Although assets like Bitcoin and Ethereum still dominate when looking at the total market capitalization of all digital financial assets, however, stablecoins are now the backbone of the digital asset economy in terms of total transaction activity. Chainalysis data shows that stablecoins account for approximately 50% of all value transacted in North America on blockchain networks. The ability to seamlessly transact on a blockchain combined with the stability of a currency like the US dollar has led to a significant shift over the past few years towards stablecoins becoming the primary currency of blockchain networks.



Unlike Bitcoin and similar unbacked assets, stablecoins typically have a central issuer that, in addition to managing reserves and customer redemptions, also has the technical ability to mint and remove stablecoins from circulation. This ability is usually used as part of normal operations involving customers

depositing or redeeming dollars from the issuer. However, this ability also allows stablecoin issuers to freeze stablecoins in circulation when, for example, those stablecoins end up in the wallet of a sanctioned entity.

Best practice among stablecoin issuers has evolved to involve monitoring the use of their stablecoin in secondary markets as well as their direct counterparties, and to proactively intercede to freeze assets in response to illicit or sanctioned activity in conjunction with law enforcement. This form of monitoring is possible due to the inherent transparency of blockchain networks and, as discussed above, the use of blockchain analysis to track illicit transactions and similar activity.

DFPI can play an important role in protecting California customers by only approving stablecoins in which issuers have established a robust process for leveraging blockchain analysis to monitor their stablecoin activity and for working with regulators and law enforcement to take action to freeze stablecoins when necessary. This requirement could involve a certification from the licensee or the issuer that the issuer employs a blockchain analysis process for monitoring the ecosystem of users transacting in their stablecoin as well as a compliance process for identifying and responding to potential illicit activity utilizing the stablecoin. This compliance process is not a substitute for the processes at a licensee that have a more direct relationship to the customers using the stablecoins but would serve an important role in protecting California customers downstream from the purchase or sale of a stablecoin on a licensed platform.

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Chainalysis thanks the DFPI for the opportunity to comment on this important consultation and would be happy to provide more information behind our recommendations above if helpful. Moreover, we look forward to future invitations for comments on other portions of the regulatory framework that DFPI will be adopting as part of the DFAL.

For further inquiry, please contact:

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