

Background

FinCEN, a division of Treasury, put forth a rule on Friday, December 19, 2020, that would adopt recordkeeping, verification, and reporting requirements on Virtual Asset Service Providers (VASPs) for deposits and withdrawals greater than \$3,000 involving wallets not hosted by a financial institution or hosted by a financial institution in certain jurisdictions identified by FinCEN.

Summary of the rule:

- The rule would impose new obligations on virtual asset service providers (VASPs) that are registered with FinCEN as money service businesses (MSBs) such as exchanges and custodians.
- For deposits and withdrawals greater than \$3,000 involving unhosted wallets and wallets hosted in FinCEN-identified jurisdictions (e.g., Burma, Iran, and North Korea), MSBs would have to record **the name and physical address of the wallet owner of its customer’s counterparty**.
- For any deposits and withdrawals greater than \$10,000, MSBs would also have to report to FinCEN in the form of a currency transaction report (CTR).

Key takeaways

Codifies existing best practices. This regulation will not change how regulated cryptocurrency operators conduct business. The proposal is in-line with best practices for KYC/AML. There is an additional reporting and maintenance of information requirement that will require technology vendors to build solutions.

Cash parity. The regulation brings MSB and Banks compliance, monitoring and reporting programs for cryptocurrency to a cash equivalent level.

Regulatory clarity. This action removes regulatory uncertainty at the US Treasury and FinCen level, which may de-risk allocation decisions for asset managers.

MSBs and Banks are the Focus. The primary impact will be on MSBs who transact on others behalf. They will see an increased burden in their operations and reporting when interacting with non-custodial wallets and customers. There are questions on what this means for the Wyoming chartered SPDI banks of Avanti and Kraken, as well as FinTechs like Square that have pursued banking licenses.

Businesses not Blockchains. Cryptocurrencies themselves are unaffected by the regulation. The regulation does not address peer to peer transactions, which are the native transaction method of blockchains. It also does not address crypto native activity of node operation or mining.

What is certain:

- Financial Services Equivalents:
 - The regulation is clear in cases with 1-to-1 technical and business model equivalents to existing financial services like third party Bitcoin custody.
- Transaction Types:
 - Hosted to Hosted: FinCEN is proposing an exemption to the reporting requirement that would make this requirement inapplicable to transactions between hosted wallets held at financial institutions subject to the BSA.
 - Unhosted to Hosted or Hosted to Unhosted: Hosted service providers must comply with the proposed rule.
 - Unhosted to Unhosted: Are not covered by the proposed rule.

What is uncertain:

- What Constitutes Adequate Collection and Confirmation of Customer Counterparty Information:
 - Under the proposed rule, banks and MSBs would be required to verify and record the identity of their customer engaged in a reportable transaction. In addition, at a minimum, a Bank or MSB must collect the name and physical address of each customer's counterparty "and other information the Secretary may prescribe on the reporting form" and may need to take steps to confirm the accuracy of the customer counterparty information. ***There is an open question regarding what other information Treasury may prescribe on the reporting form and how this information will be obtained.***
 - Consistent with their AML/CFT (Combatting Financial Terrorism) program, banks and MSBs would need to follow "risk-based procedures" with regards to the above. These procedures would be based on the bank's or MSB's assessment of the relevant risks, including those presented by the nature of their relationship with their hosted wallet customer, the transaction activity, and other activity associated with each counterparty and the assets. ***There is an open question regarding what the regulatory expectations will be regarding these risk-based procedures given the industry is viewed as higher risk. Will information collection requirements converge to the most conservative?***
- DeFi/Smart Contracts:
 - The regulation has uncertainty around crypto native use cases like smart contract deposits and decentralized finance (DeFi) applications.

Justification for the rule. FinCEN says the rule is necessary to combat the financing of global terrorism and address money laundering.

What is next? The narrow 15-day public comment period is cause for concern. Typically, agencies give the public at least 60 days for "significant" rules. Galaxy Digital is actively working with groups that it is a member to submit a comment letter for consideration.

What this means for Galaxy Digital

Galaxy Digital is a regulated and publicly traded financial institution. Galaxy Digital, and similar businesses, have exercised an abundance of caution in following FinCEN guidance to date for the activities covered in the Proposal. There will be potentially increased reporting cost and burden for operating the business, but **best practices already involve gathering the information and reporting suspicious activity to the relevant agencies.**

Definitions

- ***Hosted Wallet:*** Custodial private key management, user funds are controlled by third parties.
- ***Unhosted Wallet:*** Non-Custodial private key management, user control the funds.
- ***Covered Wallet:*** Wallets that are held at a financial institution that is designated by FinCEN as jurisdictions of primary money laundering concern (e.g., Burma, Iran, and North Korea).
- ***Verification Requirement:*** Allows for methods analogous to those permitted for verification of hosted wallet customers in relation to transactions subject to the proposed CVC/LTDA transaction reporting requirement.
- ***Monetary Instruments:*** The set of instruments BSA has purview over, basically anything that can function as money. This act makes CVCs and LTDAs Monetary Instruments.
- ***Bearer Asset:*** Monetary Instruments share the feature that they are not the right to an underlying asset, but rather that title to the asset passes upon delivery, that is, whoever possess the instrument is considered its owner, aka bearer assets.
- ***Currency Agnostic:*** The rule is not written differently for BTC, ETH, or USDC. It applies equally to all of them.

- Convertible Virtual Currency (CVC): Currency that acts as a medium of exchange but lacks legal tender status, BTC and ETH are CVCs.
- Legal Tender Digital Assets (LTDA): Digital assets with legal tender status.
- Bank Secrecy Act (BSA): The law being extended and clarified. Currency and Foreign Transactions Reporting Act of 1970 and Patriot Act of 2001 sets of Treasury designation to FinCEN to enforce. Set-ups compliance and reporting regimes for Banks and MSBs.
- Money Services Businesses (MSBs): In 2011, FinCEN defined MSBs as a person who functions as, among other things, a “money transmitter”. In 2013, Guidance from FinCEN identified the participants to generic CVC arrangements, including an “**exchanger**,” “**administrator**,” and “**user**,” and further clarified that **exchangers** and **administrators** generally qualify as money transmitters under the BSA and must register as an MSB, while **users** do not. FinCEN also provided guidance in the 2019 regarding specific business models involving CVC. Accordingly, P2P exchangers, hosted wallet providers, CVC kiosks, Decentralized Applications (DApps), and certain mining pools with hosted wallets are considered money transmitters required to comply with the BSA rules. Unhosted wallet providers, investors; and certain mining pools that do not use hosted wallets are not considered money transmitters.
- Currency Transaction Reports (CTRs): Current requirement of BSA for transaction over \$10,000.
- Suspicious Activity Reports (SARS): Must be filed for any transaction that the financial institution “knows, suspects, or has reason to suspect” is suspicious.
- Chain Surveillance and Analysis: Explicitly mentioned, in the proposed rule, as a forensics tool in criminal investigations but highlighted as having limited usefulness. No regulations apply here.
- Anonymity-Enhanced Cryptocurrency (AEC): Cryptos that intentionally shield transaction information and history like Monero, ZCash, Grin, Beam, etc. They are explicitly mentioned, in the proposed rule, as at-risk but no guidance is provided (yet).

Sources

Primary Sources

<https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf>
<https://public-inspection.federalregister.gov/2020-28437.pdf>

Analysis

<https://www.coincenter.org/how-i-learned-to-stop-worrying-and-love-unhosted-wallets/>
<https://www.coincenter.org/a-midnight-rule-for-cryptocurrency-transaction-reports/>

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