

Department of Financial Services

Virtual Currency Licensing

Report 2022-S-18 | January 2024

OFFICE OF THE NEW YORK STATE COMPTROLLER

Thomas P. DiNapoli, State Comptroller

Division of State Government Accountability



Audit Highlights

Objective

To determine whether the Department of Financial Services (DFS) provides adequate oversight of the applications for, and the supervision and examination of, virtual currency licensees to ensure compliance with New York Codes, Rules and Regulations (NYCRR) Title 23, Part 200. The audit covered the period from July 2018 through July 2023.

About the Program

DFS is New York State's financial services regulator, and its Superintendent is responsible for ensuring the safety and soundness of the State's financial services industry and promoting the elimination of fraud, abuse, and unethical conduct within financial institutions licensed to operate in the State. DFS supervises and regulates the activities of nearly 3,000 financial institutions with assets totaling more than \$9.1 trillion (as of December 31, 2022), including 21 virtual currency licensees with assets totaling more than \$175 billion. For this report, we reviewed a list provided by DFS in October 2022 that contained 22 active virtual currency licensees.

In June 2015, DFS issued NYCRR Title 23, Part 200 (Part 200) to regulate virtual currency. According to Part 200, virtual currency is "any type of digital unit that is used as a medium of exchange or a form of digitally stored value. Virtual currency shall be broadly construed to include digital units of exchange that have a centralized repository or administrator; are decentralized and have no centralized repository or administrator; or may be created or obtained by computing or manufacturing effort." To engage in virtual currency business activities in the State, businesses must obtain a license (BitLicense) from DFS. DFS' Virtual Currency Unit is responsible for the intake and preparation of applications and reviewing and monitoring BitLicensees in accordance with the requirements of Part 200.

Key Findings

We found there is limited assurance that DFS is adequately performing its oversight responsibilities related to the application for and supervision of BitLicenses in the State, creating the risk that licenses could be granted to applicants whose financial stability has not been thoroughly verified or that, once licensed, businesses may not maintain financial or cybersecurity standards. For example:

- Two of the eight sampled BitLicense applicants did not fully complete the fingerprinting process that DFS uses to assess the backgrounds of applicants' major shareholders and officers prior to application approval.
- For its review of BitLicense applicants, DFS stated it used a website to search for tax warrants but could not document this action and did not provide documentary evidence that it was sufficiently verifying applicants' tax obligations.
- We discovered lags between the submission of required anti-money laundering risk assessments and the granting of licenses – with one application approval coming nearly 4 years after the assessment – creating the possibility that outdated information could be used to approve BitLicenses.
- DFS did not ensure that licensees submitted all required financial reports used to assess the safety and soundness of their business operations, including those related to maintaining a minimum net worth to protect against unexpected losses, nor could DFS provide documentation of its analysis of the reports that were submitted.

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- BitLicensees were also not in compliance with DFS' cybersecurity regulations, although in some cases they self-certified that they were.
 - On average, we found a 3-year gap between biennial examinations to determine licensees' financial condition and the safety and soundness of their business, and DFS could not demonstrate it tracked and followed up on issues discovered during the examinations that were completed.

Key Recommendations

- Continue to take steps to ensure that all BitLicense applications are complete and comply with Part 200 requirements, any issues are addressed prior to approval, and decisions and actions taken on applications are documented.
- Continue to develop and implement procedures and tools to collect and analyze required information to ensure the safety and soundness of BitLicensee operations.
- Continue to develop and implement policies and procedures to ensure safety and soundness examinations are conducted in a timely manner.
- Establish formal policies and procedures for the examination follow-up process to ensure issues are addressed promptly.



**Office of the New York State Comptroller
Division of State Government Accountability**

January 2, 2024

Adrienne A. Harris
Superintendent
Department of Financial Services
1 State Street
New York, NY 10004

Dear Superintendent Harris:

The Office of the State Comptroller is committed to helping State agencies, public authorities, and local government agencies manage their resources efficiently and effectively. By so doing, it provides accountability for the tax dollars spent to support government operations. The Comptroller oversees the fiscal affairs of State agencies, public authorities, and local government agencies, as well as their compliance with relevant statutes and their observance of good business practices. This fiscal oversight is accomplished, in part, through our audits, which identify opportunities for improving operations. Audits can also identify strategies for reducing costs and strengthening controls that are intended to safeguard assets.

Following is a report of our audit entitled *Virtual Currency Licensing*. This audit was performed pursuant to the State Comptroller's authority under Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

This audit's results and recommendations are resources for you to use in effectively managing your operations and in meeting the expectations of taxpayers. If you have any questions about this report, please feel free to contact us.

Respectfully submitted,

Division of State Government Accountability

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Glossary of Terms

Term	Description	Identifier
DFS	Department of Financial Services	<i>Auditee</i>
BitLicense	License to engage in virtual currency business activity in New York State	<i>Key Term</i>
BitLicensee	Virtual currency license holder	<i>Key Term</i>
BSA/AML	Bank Secrecy Act/Anti-Money Laundering	<i>Key Term</i>
Certification	Part 500 Certification	<i>Key Term</i>
Checklist	Nationwide Multistate Licensing System and Registry BitLicense New Application Checklist	<i>Key Term</i>
CPA	Certified public accountant	<i>Key Term</i>
Manual	Virtual Currency Unit BitLicense Application Manual	<i>Key Term</i>
NYCRR	New York Codes, Rules and Regulations	<i>Regulation</i>
Part 200	NYCRR Title 23, Part 200, Virtual Currency Regulation	<i>Regulation</i>
Part 500	NYCRR 500 Cybersecurity Requirements for Financial Services Companies	<i>Regulation</i>
ROE	Report of Examination	<i>Key Term</i>
SME	Subject matter expert	<i>Key Term</i>
Superintendent	Superintendent of Financial Services	<i>Key Term</i>
Tax and Finance	Department of Taxation and Finance	<i>State Agency</i>
VCU	Virtual Currency Unit	<i>Key Term</i>

Background

The Department of Financial Services (DFS) is New York State's financial services regulator, and its head, the Superintendent of Financial Services (Superintendent), is responsible for ensuring the safety and soundness of New York's financial services industry and for promoting the elimination of fraud, abuse, and unethical conduct within financial institutions licensed to operate in the State. The Superintendent has the authority to conduct investigations, bring enforcement proceedings, levy monetary penalties, and revoke the licenses of entities that violate relevant laws and regulations. DFS supervises and regulates the activities of nearly 3,000 financial institutions with assets totaling more than \$9.1 trillion (as of December 31, 2022), including 21 virtual currency licensees with assets totaling more than \$175 billion. For this report, we reviewed a list provided by DFS in October 2022 that contained 22 active virtual currency licensees.

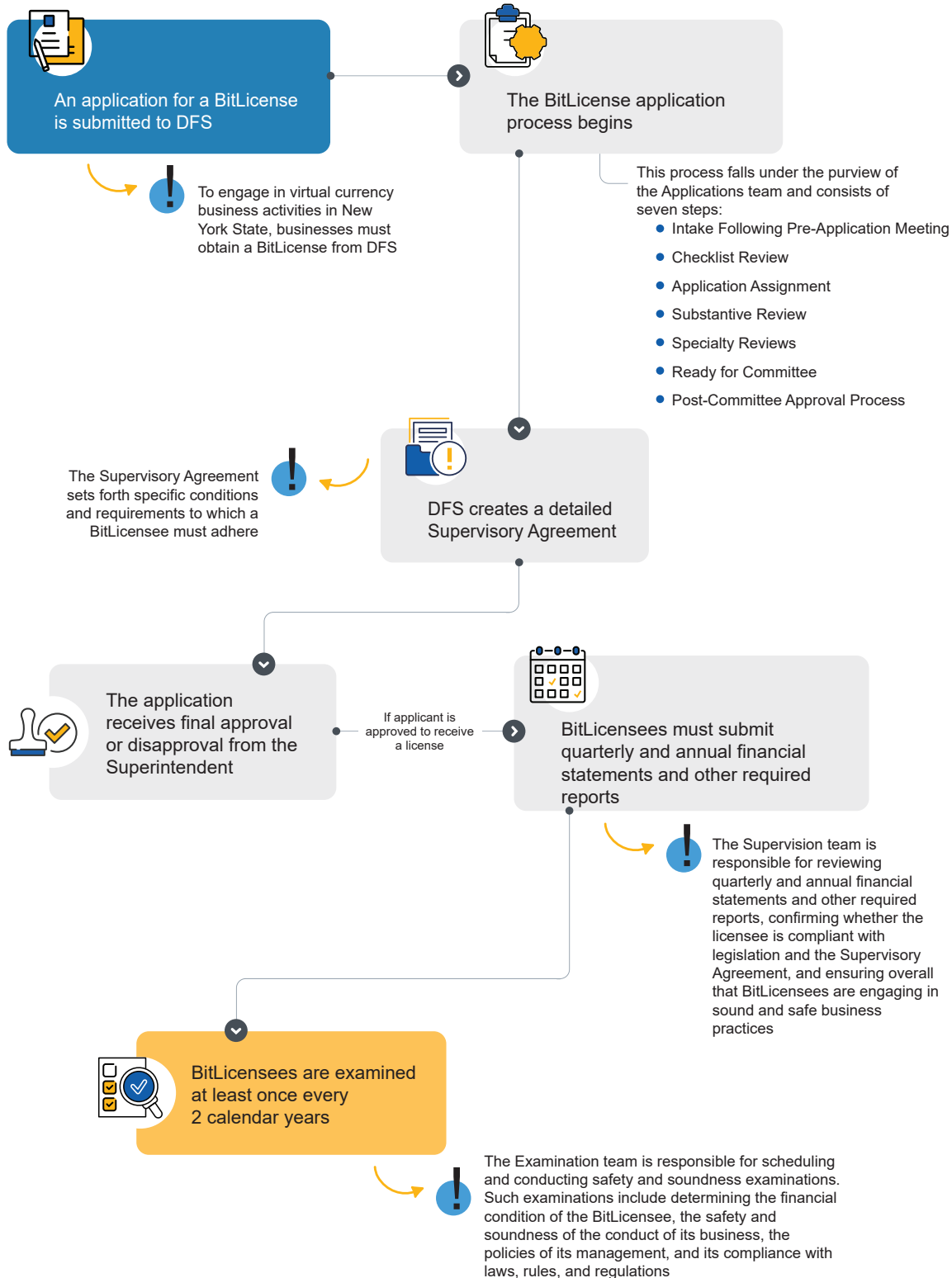
In June 2015, DFS issued New York Codes, Rules and Regulations (NYCRR) Title 23, Part 200, Virtual Currency Regulation (Part 200). According to Part 200, virtual currency is "any type of digital unit that is used as a medium of exchange or a form of digitally stored value. Virtual currency shall be broadly construed to include digital units of exchange that have a centralized repository or administrator; are decentralized and have no centralized repository or administrator; or may be created or obtained by computing or manufacturing effort."

Part 200 requires businesses to obtain a license (BitLicense) to engage in virtual currency business activities in New York. Businesses do not require a BitLicense if they are chartered under New York Banking Law and approved by the Superintendent to engage in virtual currency business activity or if a merchant/consumer uses virtual currency solely for the purchase or sale of goods and services or for investment purposes. Applications must be submitted to and approved by DFS, and the application process consists of several steps, including Substantive and Specialty Reviews. DFS' Virtual Currency Unit (VCU) includes the Applications, Supervision, and Examination teams, who are responsible for overseeing applications and reviewing and monitoring virtual currency licensees. DFS reviews of BitLicense applications include assessments of the applicant's Bank Secrecy Act/Anti-Money Laundering (BSA/AML) program, financial strength, business model, cybersecurity policies and procedures, and major shareholders' and officers' background. The Applications Committee, which is made up of DFS officials, recommends final approval or disapproval, which is granted by the Superintendent.

Upon BitLicense approval, DFS creates a detailed Supervisory Agreement that sets conditions and requirements tailored to the specific risks presented by the applicant's business model. Part 200 requires each virtual currency license holder (BitLicensee) to submit quarterly and annual financial statements to DFS, along with other annual written assessments regarding different aspects of the security and integrity of its business and electronic systems.

Part 200 also requires that BitLicensees permit DFS to conduct an examination at least every 2 calendar years to determine the BitLicensee's financial condition, the safety and soundness of the conduct of its business, its management's policies, and its compliance with laws, rules, and regulations.

The following infographic details the application and review process for virtual currency licenses.



Audit Findings and Recommendations

We found that DFS needs to do more to ensure BitLicenses are granted to financially stable applicants and to ensure the safety and soundness of licensees' ongoing operations. For example, we found documentation required by Part 200 was incomplete in BitLicense applications, including fingerprints that DFS uses to assess the major shareholders' and officers' backgrounds. Further, DFS did not ensure compliance with the Department of Taxation and Finance's (Tax and Finance) tax obligations, instead using a website to search for tax warrants that may not have supplied sufficiently reliable information regarding applicants' tax obligations. DFS has also not ensured that BitLicensees submit all financial statements and reports as required, including documents related to maintaining a minimum net worth to protect against unexpected losses and support ongoing operations, nor could DFS provide documentation of its analysis of the reports that were submitted. BitLicensees were also not in compliance with DFS' cybersecurity regulations, although in some cases they self-certified that they were. We also found, on average, a 3-year gap between required biennial examinations, with DFS unable to demonstrate that it tracked and followed up on issues noted during the examinations.

Application Process Policies and Oversight

We found that DFS had not formalized policies and procedures related to the application process until June 2022 – 7 years after the virtual currency regulation was issued. In addition, the application packages we reviewed did not comply with all Part 200 requirements.

Application Policies and Procedures

DFS formalized policies and procedures for its application process in the Virtual Currency Unit BitLicense Application Manual (Manual). However, the Manual was not finalized or used until June 2022 – 7 years after the virtual currency regulation was issued. In response to our preliminary findings, DFS officials stated that, prior to the adoption of the Manual, they followed the standardized process established through the Nationwide Multistate Licensing System and Registry BitLicense New Application Checklist (Checklist). However, this is merely a checklist of documents that applicants need to submit; it does not provide formal policies and procedures for DFS staff to use during the intake and review of BitLicense applications. In addition, certain Part 200 requirements are not included in the Checklist, such as the verification from Tax and Finance that the applicant complies with all State tax obligations.

Review of Application Packages

Part 200 requires BitLicense applications to contain 15 various requirements, including the following:

- Applicant's exact name, type and date of organization, and jurisdiction where organized or incorporated

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- A list of all the applicant's affiliates and an organization chart illustrating the relationship between the applicant and the affiliates
 - A background report prepared by an independent investigatory agency for each of the applicant's primary stakeholders
 - A set of completed fingerprints for each of the applicant's primary stakeholders and for each employee who has access to customer funds
 - An organization chart of the applicant and its management structure
 - Verification from Tax and Finance that the applicant is compliant with all New York State tax obligations

We reviewed a sample of BitLicense application packages for eight of the 22 active licensees, as of October 2022, along with supporting documentation provided by DFS. We found two BitLicensees did not fully complete the fingerprinting process that allows DFS to assess the major shareholders' and officers' background before application approval. In one case, a parent company director did not submit their fingerprints. In the other, results of the fingerprinting for six primary stakeholders were not received prior to application approval. We also found that four BitLicensees did not provide an organization chart of their management structure. Without this information, we question whether DFS is able to adequately assess the backgrounds of applicants' major shareholders and officers and their organization structure prior to application approval.

When we requested documentation regarding verification of applicant compliance with all State tax obligations, DFS replied that the VCU does not request such information and it does not involve Tax and Finance in the application review process. DFS noted that the Applications team reviews the New York State Tax Warrants search website for outstanding tax warrants filed for applicants. However, the website contains a disclaimer regarding the limitations of the information, including a warning that searchers should not rely on search results to determine credit worthiness. The website also does not provide a record of applicants' tax obligations. Further, DFS was unable to provide documentation of these tax warrant searches; therefore, we question how DFS adequately ensures an applicant's compliance with this requirement. In response to our preliminary findings, DFS stated it is working with Tax and Finance to develop a process to directly obtain summaries of applicants' tax standing. DFS subsequently revised the Manual, effective May 2023, to include verification from Tax and Finance in the application review process.

As part of the BitLicense application process, Specialty Reviews include a subject matter expert's (SME) assessment of audited financial statements and the applicant's business plan to assess financial stability. Interviews with a financial SME revealed that DFS has not established formal written guidance for the financial Specialty Review. In addition, we requested but were not provided with documentation to support the assessment of applicants' financial stability for each license in our sample. Therefore, we could not determine how DFS ensured appropriate assessments of applicants' financial stability. It is imperative that each applicant's financial stability is assessed formally and adequately to ensure

BitLicenses are granted to financially stable applicants. According to the financial SME, DFS is in the process of finalizing a standardized template for the financial Specialty Review process, which will include qualitative and quantitative measures to document assessments of applicants' financial stability. We asked for the most current templates and any other versions used in the past, and the earliest version we received was dated November 2022, indicating that there was no formal financial review process for applications for more than 7 years after Part 200 was issued.

BitLicensees are also required to conduct an annual risk assessment that establishes, maintains, and enforces an AML program based on operational risks associated with the licensee's activities, services, customers, counterparties, and geographic location. Part 200 requires BitLicensees to conduct assessments of their AML program on an annual basis, or more frequently as risks change. In addition, according to the Manual, the Specialty Review includes an SME's review of the applicant's BSA/AML policy and related procedures, risk assessment, and risk assessment methodology. However, during our review of the eight application packages, we found that three BitLicensees' initial BSA/AML risk assessments were completed over 12 months prior to their approval date. Of those three, one performed an initial BSA/AML risk assessment in 2015 when it started the application process; however, the BitLicense wasn't granted until 2019, nearly 4 years later. While we understand that it can be a lengthy process to complete all the application requirements, the business environment changes rapidly – especially in a volatile market like virtual currency – and risk assessments should be contemporaneous to address risks due to financial, political, and technological changes. Otherwise, an outdated, inaccurate risk profile could cause DFS to approve an applicant with unanticipated risks.

In addition, three BitLicensees were required in their Supervisory Agreement (completed during the Application phase) to conduct and submit a formal revised BSA/AML risk assessment approved by the BitLicensee's Board and based on operating history no later than 6 months after licensure. However, only one of the three licensees complied with the requirement. Nine months after approval, one licensee provided the updated assessment but with no indication it was approved by the BitLicensee's Board. Instead of a formal risk assessment, the third licensee provided a third-party BSA/AML attestation report indicating that it complied with applicable industry rules and federal regulations. This was provided almost a year after the BitLicense was approved and did not indicate Board approval.

In response to our preliminary findings, DFS noted that it is developing a process to transition newly licensed entities from the application process to the supervision stage for ongoing monitoring, which will also include procedures for follow-up on interim provisions in the Supervisory Agreement.

A more detailed review of the eight application packages revealed four with at least one of the following issues: financial losses from hacking and litigation, SEC violations, lack of a risk assessment, and an incomplete Specialty Review of the BSA/AML program. Despite these red flags, the Applications Committee recommended approval of these applications. According to DFS officials, because

the Applications Committee’s meeting minutes were not formally documented until January 2022, DFS was unable to provide evidence that the required documentation was reviewed or that the red flags were sufficiently addressed. In addition, we requested documentation showing communications between the Deputy Superintendent, other management, and the Applications Committee regarding their approval process and the identified issues’ effect on their decision. However, DFS did not provide any response.

Approving a BitLicense before the application and review process has been fully completed – especially regarding criteria such as the analysis of the entity’s BSA/AML program – increases the risk of DFS granting BitLicenses to entities with higher-risk profiles than intended. Further, approving a BitLicense application with financial and legal red flags increases the risk of financial instability and legal issues.

In response to our preliminary findings, DFS acknowledged that, under prior administrations, certain BitLicense applications appear to have been approved without consistent procedures and record-keeping protocols in place. DFS also acknowledged insufficient record-keeping practices for the application decision process. However, the current administration has implemented improvements in the application process and has stated it will continue to take steps to ensure that all BitLicense applications are complete and compliant with Part 200 requirements.

Recommendations

1. Continue to take steps to ensure that all BitLicense applications are complete and comply with Part 200 requirements, any issues are addressed prior to approval, and decisions and actions taken on applications are documented.
2. Develop formal, written guidance for Specialty Reviews to ensure comprehensive and consistent application reviews.

Supervision of BitLicensees

DFS was unable to provide all required quarterly and annual financial statements and reports for the eight BitLicensees in our sample. In addition, the documentation that was provided did not include all the information specified in Part 200. Further, DFS has not established a means to analyze the financial reports. Some BitLicensees also were not in compliance with DFS’ cybersecurity regulations despite, in two cases, self-certifying that they were.

The Supervision team is responsible for reviewing quarterly and annual financial statements and other required reports, confirming whether the licensee is compliant with legislation and the Supervisory Agreement, and ensuring overall that BitLicensees are engaging in sound and safe business practices. The Supervision team also uses Financial, BSA/AML, and Cybersecurity SMEs to assist in their review of documentation submitted by BitLicensees.

Part 200 requires each BitLicensee to submit information to DFS to support the safety and soundness of their business operations and compliance with regulations,

including quarterly financial statements complete with a statement of the financial condition; audited annual financial statements, along with an opinion and attestation by an independent certified public accountant (CPA) regarding the effectiveness of the BitLicensee's internal control structure; a written report of the annual assessment and testing of the compliance and effectiveness of the AML program; and an annual report assessing the availability, functionality, and integrity of the BitLicensee's electronic systems, identifying relevant cyber risks, assessing the cybersecurity program, and proposing steps to address any inadequacies identified.

According to Part 200, each BitLicensee is also required to maintain sufficient capital to ensure the financial integrity of the licensee and its ongoing operations based on an assessment of its specific risks. This requirement is determined in the Supervisory Agreement between the BitLicensee and DFS during the application process, based on each BitLicensee's specific business operations. The Supervisory Agreement also requires each BitLicensee to immediately notify DFS if, at any time, its positive net worth falls below 110% of the required minimum positive net worth and/or the net worth falls below the minimum positive net worth requirement.

Quarterly and Annual Financial Reporting

We requested both quarterly and annual financial statements for the eight BitLicensees in our sample for the period of July 1, 2018 to September 30, 2022 to determine whether DFS ensured their compliance with Part 200's reporting requirements. We found:

- Two BitLicensees provided no quarterly financial statements to DFS until the third quarter of 2021, although the licensees were approved in May 2018 and June 2016, respectively. Therefore, DFS could not adequately track the financial stability of these two licensees for 3 and 5 years, respectively.
- One licensee, approved in April 2019, was missing statements for the last three quarters of 2019. DFS officials explained that, during the time in question, their informal practice was to allow a 6- to 9-month grace period for new BitLicensees, during which they were not required to file quarterly financial statements. However, this is inconsistent with the other BitLicensees reviewed.

Further, the quarterly financial statements DFS provided for the eight BitLicensees did not meet all Part 200 requirements. None of the quarterly financial statements included the following required items that would allow DFS to fully assess the licensees' financial stability: cash flow statement, statement of net liquid assets, financial projections and strategic business plans, off-balance sheet items, and a chart of accounts. In response, DFS officials informed us that the licensees submit quarterly data through a DFS system with designated financial accounts. However, the documents DFS provided for the BitLicensees in our sample included only balance sheets and income statement information. We requested all other required information, but DFS officials did not provide any additional documentation. Therefore, there is limited assurance that DFS was adequately ensuring BitLicensees' ongoing financial stability.

DFS officials stated that BitLicensees submit quarterly regulatory capital data within 45 days of the end of each quarter, which officials use to determine if the BitLicensees have the minimum amount of capital they are required by DFS to hold (capitalization requirements). We requested this information for the eight sampled BitLicensees for July 2018 through March 2023; however, DFS provided only regulatory capital data starting in January 2022. DFS acknowledged that inconsistent record-keeping practices under prior administrations prevented it from providing the documents from before 2022.

To further determine if DFS monitored the regulatory capital data during the safety and soundness examinations, we reviewed 12 biennial Reports of Examination (ROEs) for seven of the BitLicensees in our sample. (One BitLicensee's ROE was in progress and had not been completed.) According to the ROEs, two BitLicensees did not meet their capitalization requirements and had not submitted the required quarterly data.

- One failed to report falling below the minimum positive net worth requirement to DFS as required.
- One failed to maintain a positive net worth and, as a result, did not meet the minimum capital requirement required by Part 200 and its Supervisory Agreement for three consecutive quarters of the review period.

Virtual currencies are a risky asset class with significant price volatility. A breach of capital requirements indicates that an institution is undercapitalized and is not maintaining an appropriate buffer to protect against unexpected losses and support the safety and soundness of its ongoing operations. Therefore, there is a need for better oversight and transparency. DFS should consistently monitor licensees' positive net worth to ensure financial integrity and stability and not rely on the BitLicensees to self-report non-compliance. In response to our preliminary findings, DFS provided a recently finalized version of its Regulatory Capital Oversight Procedure, dated June 2023. We note this procedure was put in place 14 months after we engaged this audit and 8 years after Part 200 was issued.

For the eight sampled BitLicensees, 32 annual financial statements were required for the audit period. DFS provided the 32 statements, but we found that none included the required assessment by the BitLicensee's management of compliance with applicable laws, rules, and regulations, and 25 did not include a required certification by an officer or director attesting to the truth and correctness of the statements.

The financial statements also must include an opinion and attestation by an independent CPA regarding the effectiveness of the BitLicensee's internal control structure. According to a DFS official, the independent annual AML audit report satisfies this requirement. We requested the AML reports for the eight sampled BitLicensees for our scope period, and DFS provided the 2021 reports for seven BitLicensees and the 2019 report for one but no other AML reports for any of the eight licensees for any other year in our scope period. Therefore, the requirement for an opinion and attestation by an independent CPA was not met. Moreover, Part 200's requirement to provide an annual report to support the assessment and testing of

the compliance and effectiveness of the AML program was also unmet. DFS needs to ensure each BitLicensee submits required financial statements, reports, and information to DFS as required to support the safety and soundness of its business operations and compliance with regulations. As virtual currencies can present illicit financial risks, including money laundering, DFS should also ensure BitLicensees have established, and comply with, an appropriate AML program.

We also found DFS has not established formal procedures or tools to analyze BitLicensees' financial reports, which could lead to inconsistencies in identifying and addressing red flags and could cause it to overlook critical financial risks, such as lack of liquidity. DFS reviews hard copies of quarterly and annual financial statements, using a highlighter and pen to note any possible red flags. Besides reviewing the financials, DFS also reviews the Notes to the financials as well as any other non-accounting information about the business.

According to DFS, VCU staff track and collect quarterly financial statements and use them for analysis, including assessments of overall financial condition. As part of this process, in March 2023, VCU compiled reports dating back to the fourth quarter of 2021. The quarterly financial analysis is a new tool to help identify trends and, according to DFS, it is working with its Accounting and Data Governance teams to develop formal processes to incorporate the information into ongoing monitoring. However, the highlighted variances or red flags do not trigger any specific actions. Further, DFS stated that the VCU Accounting team is developing a template that includes analysis of annual financial data.

In response to our preliminary findings, DFS stated that administrations prior to 2022 did not consistently track quarterly and annual reports. Upon joining DFS in December 2021, the Deputy Superintendent of Virtual Currency immediately enhanced record-keeping processes to ensure proper collection and retention of all annual reports for 2021 and later, as well as all quarterly reports for the fourth quarter of 2021 and later. Additionally, VCU has drafted Required Reporting Procedures that will provide a detailed process for reviewing the annual and quarterly financial statements specified in Part 200 and to address the collection, tracking, and analysis of all required reports, including quarterly financials, quarterly capital calculations, and independent AML audit reports. However, this process has not been finalized.

Cybersecurity Program Compliance

DFS officials stated that they evaluate a BitLicensee's cybersecurity program with a focus on the requirements of NYCRR Part 500 Cybersecurity Requirements for Financial Services Companies (Part 500), which encompasses all substantive cybersecurity requirements of Part 200. However, Part 200 requires a BitLicensee to submit an annual report – prepared by the Chief Information Security Officer and presented to the board of directors – assessing the availability, functionality, and integrity of the BitLicensee's electronic systems; identifying relevant cyber risks to the licensee; assessing the licensee's cybersecurity program; and proposing steps to address any inadequacies identified. This is not required under Part 500.

DFS provided a schedule of Part 500 Certifications (Certifications) for the eight licensees in our sample, and we found:

- In Certifications filed for 2021, three of the eight BitLicensees acknowledged they were not in compliance and that remediation plans were underway to achieve compliance.
 - Two of the three that were not compliant had not submitted prior years' Certifications to DFS.
 - The other BitLicensee filed that it was compliant with Part 500 in 2018, 2019, and 2020. However, during 2019 and 2022 examinations, DFS found that the BitLicensee was not in compliance. The 2019 ROE specifically noted that, because periodic assessments of products, services, and operational or cybersecurity risks were not being conducted, there was a possibility that critical risks may not be identified, and the processes to measure and monitor risks in place at the time may be deficient. The 2022 ROE noted that the BitLicensee's IT and cybersecurity policies still did not fully comply with the requirements and needed management's immediate attention. The BitLicensee continued to be non-compliant with all sections of Part 500; however, the licensee submitted Certifications for 2019 and 2020.
- Another BitLicensee certified compliance with Part 500 in 2019, 2020, and 2021. However, a 2021 ROE indicated it was not in compliance with Part 200 or Part 500, stating the licensee exhibited a degree of supervisory concern due to a combination of moderate to severe weaknesses. The ROE also noted that, although management certified compliance with all requirements of Part 500 for the scope of the review, there were concerns that, based on the examination findings, the BitLicensee was not in full compliance with all applicable sections of the regulations and should not have certified compliance.

In the 12 ROEs we reviewed for seven of the licensees in our sample, we found system and technology issues, including non-compliance with Part 200 and/or Part 500. DFS should require BitLicensees to submit the annual cybersecurity report assessing the availability, functionality, and integrity of the licensee's electronic systems, identifying relevant cyber risks, assessing the licensee's cybersecurity program, and proposing steps to address inadequacies as required in Part 200, rather than relying on BitLicensees to self-certify compliance with Part 500.

In response to our preliminary findings, DFS stated that, in practice, the Part 500 certification alone does not meet the Part 200 requirement. DFS' cybersecurity oversight goes beyond certification and includes real-time monitoring and in-depth examinations. However, DFS is conducting a review of Part 200 to determine the appropriate approach to reconciling any conflicting or redundant requirements in Part 500.

Recommendations

3. Take steps to ensure BitLicensees provide all information as required by Part 200 and the Supervisory Agreements.
4. Continue to develop and implement procedures and tools to collect and analyze required information to ensure the safety and soundness of BitLicensee operations.

Examinations and Follow-Up

Part 200 requires that BitLicensees permit DFS to conduct an examination at least every 2 calendar years to determine the BitLicensee's financial condition, the safety and soundness of the conduct of its business, its management's policies, and its compliance with laws, rules, and regulations. However, we found DFS did not conduct these examinations for all BitLicensees every 2 years. In addition, findings and issues identified in the examinations were not tracked and followed up on.

The Examination team is responsible for scheduling and conducting safety and soundness examinations. The Examination team tests virtual currency transactions, performs walk-throughs of the BitLicensee's operations, and reviews relevant processes, including any that are automated, as well as policies and procedures. They assess a BitLicensee's Financial Condition, Internal Controls and Auditing, Legal and Regulatory Compliance, Management, and Systems and Technology. Accounting is tested for data accuracy by the Financial SME. Cybersecurity SMEs are used during the examination process to ensure that licensees comply with cybersecurity regulations.

Safety and Soundness Examinations

We reviewed the BitLicense Examination Roster and found, on average, a 3-year gap between each exam for the 22 active licensees. Of the 22, five BitLicensees were examined more than 2 years after their approval date. One BitLicensee, approved in September 2015, was not reviewed until 2019. Moreover, the 2023 Virtual Currency Supervisory Plan revealed that one BitLicensee was scheduled for its first exam in 2023 – 4½ years after its application was approved in June 2018. In addition, three BitLicensees had not been reviewed due to limited activity in New York State, although they were all licensed more than 2 years prior. The three were scheduled for review in 2023. DFS officials advised that a decision to postpone an examination is not made based on a standard threshold but rather on a case-by-case basis. DFS further explained that it took a risk-based approach and dedicated limited staff resources to entities with a higher-risk profile, such as those with the greatest amount of activity in the State or those that interact with the most retail consumers.

It is imperative that DFS promptly conduct required safety and soundness examinations because DFS reviews only policies and procedures provided during the application process. To ensure that these policies and procedures are implemented by the BitLicensees, and to measure the effectiveness of their internal

controls, DFS should perform the examinations within a reasonable time frame after the BitLicensee's approval.

Follow-Up on Examination Findings

The safety and soundness examinations identified issues documented in the ROEs. The Examination team is not involved in following up on issues and findings noted in the ROE; however, they are responsible for making the final determination on whether a finding is resolved. Six months into the audit, DFS advised us that management had recently expanded Supervision's resources to enhance interim monitoring of BitLicensees, creating a ROE follow-up process (including quarterly meetings), independent of the Examination team. We requested documentation, such as the quarterly meeting agendas, to support that the Supervision team followed up on issues identified in the ROEs. However, DFS responded that it does not retain notes from these quarterly meetings because the agenda process is an internal coordination exercise.

DFS identified findings tracking as an area in need of remediation under the current administration. Currently, the Supervision team is testing a new process for proactive interim monitoring of examination findings using a Status Tracker Template. DFS provided the template for one BitLicensee and stated that a pilot of the new documentation and follow-up processes began in the first quarter of 2023. VCU is assessing the effectiveness of the pilot and is working to implement it.

We reviewed ROEs for seven of the eight BitLicensees in our sample. (One BitLicensee's first ROE was in progress and, therefore, could not be reviewed.) Of the seven, five had more than one ROE. Of those five BitLicensees, four had repeat findings in their second ROE. These repeat findings were in the areas of Internal Controls and Auditing, Legal and Regulatory Compliance, Management, and Systems and Technology. In several instances, the repeat findings were elevated from Matters Requiring Attention to Matters Requiring Immediate Attention.

For one BitLicensee, the Examination team found corrective actions had not been taken for 16 of the 22 repeat findings. The repeat findings included seven in Systems and Technology that were elevated to Matters Requiring Immediate Attention. The remaining nine Matters Requiring Attention were in Management Oversight and Legal and Compliance. As a result, the Examination team recommended supervisory enforcement action to better monitor management's progress in addressing the findings. When examination findings remain unresolved for multiple years, we question the effectiveness and timeliness of the ROE follow-up process.

If examinations are not conducted and identified issues aren't addressed in a timely manner, there is a risk that DFS will be unable to identify red flags or poor internal controls in time to prevent negative financial, legal, and cybersecurity consequences for the BitLicensee and its investors.

In response to our preliminary findings, DFS stated that, while the virtual currency industry has grown in size and complexity, it has been unable to add to its staff

commensurately to address VCU's increasing workload. DFS cited several reasons for this, including a statewide government hiring freeze, limited agency resources, and a challenging hiring environment, with private sector and other financial regulators competing for talent. DFS further noted that the focus of its new leadership team in 2021 was fourfold: hire significantly more staff to VCU, including dedicated SMEs across key subdomains; enhance and formalize internal policies, processes, and procedures; make clear DFS' expectations of licensees through timely, external-facing policy guidance; and triage and address backlogs, particularly with respect to the aging of BitLicense applications and timeliness of the examinations cycle.

Recommendations

5. Continue to develop and implement policies and procedures to ensure safety and soundness examinations are conducted in a timely manner.
6. Establish formal policies and procedures for the examination follow-up process to ensure issues are addressed promptly.

Audit Scope, Objective, and Methodology

The objective of our audit was to determine whether DFS provides adequate oversight of the applications for, and supervision and examination of, virtual currency licensees to ensure compliance with NYCRR Title 23, Part 200. The audit covered the period from July 2018 through July 2023.

To accomplish our objective and assess related internal controls, we reviewed State laws and regulations, the Manual, and the Checklist. We also interviewed DFS officials, including VCU staff in Applications, Supervision, and Examination, as well as SMEs. We reviewed application packages and ROEs as well as quarterly financial statements, annual financial statements, and other annual reports/certifications the BitLicensees were required to submit to DFS.

We used a non-statistical sampling approach to provide conclusions on our audit objective and to test internal controls and compliance. We selected judgmental samples. However, because we used a non-statistical sampling approach for our tests, we cannot project the results to the respective populations. Our samples, which are discussed in detail in the body of our report, include a judgmental sample of eight of the 22 active licensees, as of October 2022, based on factors such as number of years between examinations and number of years between the approval date and the first safety and soundness examination. We did not obtain computer-generated data from DFS and, therefore, did not test for reliability.

Statutory Requirements

Authority

The audit was performed pursuant to the State Comptroller's authority as set forth in Article V, Section 1 of the State Constitution and Article II, Section 8 of the State Finance Law.

We conducted our performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

In addition to being the State Auditor, the Comptroller performs certain other constitutionally and statutorily mandated duties as the chief fiscal officer of New York State. These include operating the State's accounting system; preparing the State's financial statements; and approving State contracts, refunds, and other payments. These duties could be considered management functions for purposes of evaluating organizational independence under generally accepted government auditing standards. In our professional judgment, these duties do not affect our ability to conduct this independent performance audit of DFS' oversight and administration of virtual currency licensing.

Reporting Requirements

We provided a draft copy of this report to DFS officials for their review and formal comment. Their comments were considered in preparing this final report and are attached in their entirety at the end of it. In general, DFS officials agreed with our audit recommendations and indicated actions they have taken and will take to address them, but took exception to certain statements in the report. Our responses to certain remarks are embedded within DFS' response as State Comptroller's Comments.

Within 180 days after final release of this report, as required by Section 170 of the Executive Law, the Superintendent of the Department of Financial Services shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons why.

Agency Comments and State Comptroller's Comments



[Response to OSC's Draft Virtual Currency Licensing Report](#)

[September 17, 2023](#)

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Note: Due to the embedding of our State Comptroller's Comments, the referenced page numbers above may have shifted.

Executive Summary

The Office of the State Comptroller (“OSC”) commenced an audit of the New York State Department of Financial Services (“DFS”) Virtual Currency Unit (“VCU”) in April 2022. On August 18, 2023, OSC provided its draft report arising from this audit (the “Draft Report”). This response provides relevant context and information to both respond to and clarify the findings contained in the Draft Report. DFS appreciates the opportunity to respond and respectfully requests that OSC take this information into account in its final report.

DFS values OSC’s work in undertaking this review and the findings contained in the Draft Report. Indeed, as discussed below, under Superintendent Harris’ leadership, DFS self-identified and began remediating most of these issues before the audit. As a result of this work, DFS remediated, or was in the process of remediating, most of the findings contained in the Draft Report by the time the audit closed. Accordingly, the findings raised in the report as cause for concern almost entirely (1) long-predate the tenure of current DFS management, and, more importantly, (2) have been identified and addressed by the current DFS administration.

Despite robust action by DFS to implement a comprehensive, nation leading virtual currency regulatory regime, the Draft Report makes the unwarranted statement that there is “limited assurance that DFS is adequately performing its oversight responsibilities.” This statement does not accurately reflect DFS’s work to address historical issues and is not supported by the findings or recommendations set forth in the Draft Report. Indeed, the fact that DFS has already been addressing the issues raised in the report is acknowledged by OSC’s recommendations, three of which encourage DFS to “continue” with what it is already doing, while the other three recommend DFS adopt policies, procedures, and templates that DFS independently identified and either adopted or was in the process of adopting before the close of the audit period and provided to the OSC for review. Where the ultimate recommendations are to continue doing what DFS is already doing or adopt policies and procedures that have already been adopted, the statement in the Draft Report that there is “limited assurance” DFS is adequately overseeing its licensees is unwarranted and unsupported.

State Comptroller’s Comment – Our overall conclusion is accurate and supported by our findings. As our audit report details, and DFS readily agreed, for much of our audit scope period, policies and procedures were not in place to provide assurance that DFS’ oversight of the application, supervision, and examination of BitLicensees was appropriate. In its response, DFS asserted that since August 2021 it has overhauled VCU practices, policies, and procedures and more than tripled virtual currency staff. However, our audit found biennial examinations were not conducted every 2 years as required through 2023. In fact, four BitLicensees were scheduled for their first safety and soundness examination in 2023 despite their licenses having been issued in 2018, 2019, and 2020. Two BitLicensees had not been scheduled for the required biennial safety and soundness examination for more than 4 years. In addition, DFS is only now working with Tax and Finance to develop a process to verify applicants are compliant with all New York State tax obligations. Therefore, we concluded that, although DFS has taken steps under the current administration to improve its oversight of BitLicensing, additional steps are still required to ensure DFS’ oversight is adequate.

As the Draft Report acknowledges, after being nominated as Superintendent in August 2021, Adrienne A. Harris began identifying and addressing deficiencies throughout DFS, including in VCU. She promptly hired new management, which assessed and began remediating inadequate operations in the unit. Since then, DFS has overhauled VCU practices, policies, and procedures; more than tripled virtual currency staff with new expert hires; released six industry-shaping regulatory guidance documents (with additional guidance forthcoming); and procured several new tools and technology for blockchain analytics and market surveillance.

Accordingly, any suggestion that the Draft Report findings generally remain outstanding is incorrect. As detailed below, six of the findings (five of which were independently identified) were remediated before the close of the audit. Another three, as DFS indicated to OSC, were in the process of being remediated when the audit closed and have since been fully remediated by DFS. Seven of these nine findings were self-identified by the current DFS administration independently of the OSC audit. Other than a finding with which DFS disagrees, DFS is working actively to address the remaining two findings. In short, the remediation process, which was undertaken by this administration before the audit began, addresses the Draft Report findings.

State Comptroller's Comment – DFS officials disagreed with one of our findings; however, they agreed with all of our recommendations and have taken steps or plan to take steps to implement them. DFS officials repeatedly stated throughout their response that they independently identified many of our findings prior to our audit; however, remediation efforts for many of the issues occurred toward the end of or after our scope period.

DFS is at the vanguard of regulating in this space; building on the detail contained in Part 200 by issuing a series of nation-leading industry regulatory guidance, developing detailed new internal policies and procedures, acquiring new technology to enhance oversight, and making significant investments in hiring and training expert staff dedicated to the topic. DFS has made unparalleled progress in developing and implementing a comprehensive regulatory regime for this industry. The DFS framework has become a global model. In the last two years, Superintendent Harris and DFS staff have met frequently with regulators from other states and around the world to share insight as other jurisdictions work to adopt virtual currency regulations inspired by New York's framework. Among others, DFS has worked closely with regulators and other leaders from Canada, Denmark, the European Union, France, Germany, Japan, Nigeria, Singapore, Switzerland, Taiwan, the United Arab Emirates, and the United Kingdom. In addition, federal elected officials from both parties have frequently cited DFS's framework as a national model as they work to adopt federal regulations for virtual currencies.¹

As the Draft Report acknowledges and this response will further illustrate, over the last two years DFS has cemented its position as the premier regulator of virtual currencies in the nation and remains committed to further strengthening its efforts.

¹ See U.S. House Financial Services Committee. (2023, April 19). *Hearing Entitled: Understanding Stablecoins' Role in Payments and the Need for Legislation* [Video]. YouTube. <https://www.youtube.com/watch?v=ti0CDUxTAWI> and U.S. House Financial Services Committee. (2023, July 27). *Markup of H.R. 4766, H.R. 4841, H.R. 4790, H.R. 4767, H.R. 4823, H.R. 4655, H.J. Res. 66* [Video]. YouTube. <https://www.youtube.com/watch?v=642bus8WC6s>

Key Takeaways

As noted in the executive summary, out of the 12 substantive findings contained in the report (in addition to six general recommendations to continue implemented improvements to oversight processes), six of the findings were remediated before the close of the audit. Another three were, as DFS indicated to OSC, in the process of being remediated when the audit closed and have since been fully remediated by DFS. Seven of the nine findings that have already been remediated were self-identified by the new DFS administration independently of the OSC audit. DFS disagrees with one of OSC’s findings related to cybersecurity, and is working diligently to address the remaining two open findings. One of those findings was previously identified by the current administration for remediation, towards which DFS has made significant progress by more than tripling its staff and examiner-in-charge pool, and the other of which DFS is working to address. DFS’s response to the findings at issue are summarized below:

<i>Draft Report Finding Topic</i>	<i>Status</i>
<i>Formalized application procedures</i>	Remediated as of June 2022 by the adoption of the BitLicense Application Manual. The Draft Report, in the language of the finding, acknowledges this finding was remediated.
<i>Application documentation</i>	Remediated as of the second quarter of 2022 by adoption of process to ensure applications are checked for completeness and maintained in a central repository.
<i>Process to verify state tax compliance</i>	Addressing. DFS agrees with this finding. As acknowledged in the Draft Report, DFS formalized its use of the DTF website by adding this step to the Application Manual. DFS will continue to work with DTF to enhance this process.
<i>Formal application financial review process</i>	Remediated as of November 2022 when DFS adopted its Financial Applications Review Template. The Draft Report acknowledges the Financial Applications Review Template, which DFS independently adopted to remediate this issue, but the Draft Report still notes the finding as if it is unremediated.
<i>Duration between initial BSA/AML risk assessments and approval of applications</i>	Remediated as of June 2022 by the adoption of the BitLicense Application Manual. The three entities referenced by the Draft Report were licensed between 2016 and 2019, predating the current administration.

Follow-up on licensee compliance with supervisory agreement requirements

Remediated after the close of the audit period by the implementation of a formal transition process between the Applications and Supervision team. The three entities referenced by the Draft Report were licensed between 2017 and 2018, predating the current administration.

Documentation of DFS's consideration of application issues

Remediated by central maintenance of Applications Committee meeting minutes documenting decisions and actions taken on applications, and updated Operating Procedures for the Applications Committee. The four entities referenced by the Draft Report were licensed between 2016 and 2019, predating the current administration.

Required financial statements filings for licensees

Remediated by the adoption of Periodic Reporting Procedures in September 2023.

Formal procedures to analyze financial reports and to document such analysis

Remediated by the adoption of Periodic Reporting Procedures in September 2023 and the adoption of a Regulatory Capital Oversight Procedure in June 2023.

Cybersecurity certifications; collection of CISO report

Unfounded. As discussed below, the first part of this finding reflects DFS's successful implementation of its examination program, which entails robust verification of self-certifications. The more comprehensive cybersecurity filings DFS requires negate the need for collecting the certifications identified by the Draft Report. DFS's current requirements are more robust than the Draft Report's recommendations.

Examination frequency

This finding omits critical context. DFS uses a risk-based analysis to prioritize examinations. Under the current administration, DFS has more than tripled virtual currency staff (to over 60 professionals) in 18 months in order to improve operations and expand its examination capacity.

Monitoring and follow-up on examination findings

Remediated as of April 2023 by the adoption of a BitLicense Examination Findings Tracking Procedure.

As noted in the executive summary, DFS's successful remediation of the findings is reflected in the recommendations contained in the Draft Report. Three of these recommendations encourage DFS to "continue" with what it is already doing, while the other three state that DFS should adopt policies, procedures, and templates that DFS independently identified and adopted or was in the process of adopting before the close of the audit period and provided copies to the OSC.

<i>Draft Report Recommendation Topic</i>	<i>Status</i>
<i>Application and decision documentation</i>	Remediated by the adoption of the BitLicense Application Manual in June 2022; by adoption of process in the second quarter of 2022 to ensure applications are checked for completeness and maintained in a central repository; and by central maintenance of Applications Committee meeting minutes documenting decisions and actions taken on applications.
<i>Formal guidance for specialty reviews</i>	Remediated as of November 2022 when DFS adopted its Financial Applications Review Template. OSC acknowledges it received the Financial Applications Review Template, yet presses this recommendation as if the related finding is unremediated.
<i>Required financial statements filings for licensees</i>	Remediated by the adoption of Periodic Reporting Procedures in September 2023.
<i>Procedures and tools to analyze financial reports and to document such analysis</i>	Remediated by the adoption of Periodic Reporting Procedures in September 2023 and the adoption of a Regulatory Capital Oversight Procedure in June 2023.
<i>Examination frequency</i>	Omits critical context. Working with limited resources, DFS uses a risk-based analysis to schedule examinations. Under the current administration, DFS has more than tripled virtual currency staff (to over 60 professionals) in 18 months in order to improve operations and expand its examination capacity.
<i>Monitoring and follow-up on examination findings</i>	Remediated as of April 2023 by the adoption of a BitLicense Examination Findings Tracking Procedure.

State Comptroller’s Comment – Throughout its response to the draft audit report, DFS noted that our findings predate the tenure of the current DFS administration and that DFS self-identified many of our findings prior to the conclusion of our audit. Our audit covered the period July 2018 through July 2023. Government auditing standards (Standards) require that we communicate the results of our audits to those charged with governance and the appropriate officials of the audited entity and report conclusions based on the audit objectives and findings. Therefore, we are required to report our audit findings for the scope period. Throughout the report, we acknowledge actions DFS has taken and plans to take to remediate some of the findings. However, as DFS itself noted, several issues have not been remediated. Further, in its response, DFS cited steps taken through September 2023, which is outside of our audit scope and after the draft report was issued.

Background and Developments Under New DFS Leadership

Background on OSC Audit

According to OSC, the audit originally was intended to address the following questions:

- Does DFS fully comply with 23 NYCRR Part 200 in its review and issuing of licenses, and receipt of application fees for persons or entities engaging in virtual currency business activity?
- Does DFS ensure that licensees file the required annual reports?
- Does DFS examine each licensee at least once every two years, including examining controls over cybersecurity and information security?
- Has DFS verified with the New York State Department of Taxation and Finance that the applicants and licensees are compliant with all New York State tax obligations?

However, at the July 19, 2023 audit closing conference, OSC indicated for the first time that the objective was being changed to “determin[ing] whether the Department of Financial Services (DFS) provides adequate oversight of the applications for, and the supervision and examination of, virtual currency licensees to ensure compliance with New York Codes, Rules and Regulations (NYCRR) Title 23, Part 200.”

State Comptroller’s Comment – While we condensed the wording of our audit objective for reporting purposes, all the original components are encompassed in the updated objective, and the purpose and intent of our audit – to determine whether DFS provided adequate oversight of the application, supervision, and examination of BitLicenses and complied with Part 200 – did not change. We also note that Part 200 requires DFS to verify that applications are compliant with all New York State tax obligations; therefore, we did not need to state that separately in our objective.

The audit covered VCU’s operations, including Applications, Supervision, and Examinations, with an audit period beginning July 2018 through the end of field work. Throughout the 15-month duration of the audit, VCU responded diligently to approximately 200 requests for information, documents, and related materials. OSC conducted extensive interviews with key staff members in each area, including the Deputy Superintendent of Virtual Currency, Head of Supervision, the Applications Lead, the Examinations Lead, and several subject matter experts. DFS has held biweekly meetings to ensure oversight and insight into the OSC audit process and VCU’s responsiveness.

State Comptroller’s Comment – Regarding the 15-month duration of the audit, we note that the opening conference was held May 3, 2022. However, prior to providing information for the audit, DFS required a confidentiality agreement, which was not fully executed until August 19, 2022. In addition, DFS took excessive time – in some cases more than 4 months and in one case almost

6 months – to provide the information necessary for us to assess if DFS ensures licensees' compliance with Part 200, and in some instances failed to provide it altogether. DFS agreed to hold the biweekly status meetings referenced in its response. However, we often used these meetings to repeatedly follow up with DFS on requested information that was still outstanding.

The resulting audit report contains 12 findings and six recommendations. As discussed below, as part of an internal self-assessment initiated under Superintendent Harris and prior to the start of this audit, DFS identified eight of the 12 issues subsequently identified by OSC and began the process of remediation. Furthermore, DFS had already identified and acted to remediate, or was in the process of remediating, all six of the OSC recommendations before the audit period closed. Before the close of the audit period, DFS fully remediated six of the 12 findings and provided supporting documentation to OSC. Another three findings were in the process of being remediated by DFS when the audit closed and have since been fully remediated by DFS. One finding, relating to cybersecurity, is unfounded. That leaves two findings for which remediation is in progress, one of which omits the critical context that DFS has more than tripled its staff and examiner-in-charge pool, which enables DFS to perform examinations in a reasonable timeframe. DFS is working actively to address the other finding.

Background on DFS's Virtual Currency Regulation

In 2015, DFS established the nation's first comprehensive virtual currency regulatory regime, adopted under the New York Financial Services Law, codified at 23 NYCRR Part 200, and commonly referred to as the "BitLicense" regulation. Under the BitLicense regulation, before a person may engage in any "virtual currency business activity," that person must obtain a BitLicense, unless a licensing exemption applies. As the first prudential regulator with digital asset-specific authority, DFS is the most experienced virtual currency regulator in the United States. DFS provides a model—based on full-scope banking supervision but tailored to virtual-currency-specific risks—for meaningful regulation of this industry as the parallel federal scheme continues to develop.

Approval for a BitLicense 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. When a virtual currency entity ("VCE") is approved to be licensed, DFS creates a detailed supervisory agreement that is tailored to the specific risks presented by the VCE's business model. Supervisory agreements are updated on an as-needed basis to take account of changing business models, market conditions, or other relevant considerations. DFS's regulatory framework for VCEs imposes robust requirements around capital adequacy, risk and transactional disclosures, changes of control, new business activities, books and records, and financial and event reporting. In addition, DFS mandates that VCEs implement strong internal controls to verify that activity is conducted in a safe and sound manner.

DFS targets biennial examinations of licensed VCEs. Examinations are tailored to the risks presented by each VCE's business model to evaluate that entity's compliance with the supervisory

agreement and applicable laws and regulations. DFS conducts ongoing monitoring between each examination, reviewing requested changes of control and material changes of business, following up on previous exam findings, tracking of coin listing, and meeting with VCEs on an established cadence. Upon identification of deficiencies through examination or supervision, DFS requires remedial actions to swiftly address issues and/or can refer matters to the DFS enforcement division for action.

Developments Under New DFS Leadership

Governor Hochul nominated Superintendent Harris in August 2021. Superintendent Harris began serving as Acting Superintendent in September 2021. In December 2021, Superintendent Harris hired Peter Marton, an established and recognized leader in the virtual currency space, to run VCU. Further building out this new management team, Superintendent Harris hired Kaitlin Asrow as Executive Deputy Superintendent to oversee the Research & Innovation Division, which includes VCU. Kaitlin Asrow was previously a senior advisor within the Federal Reserve System with deep experience in financial institution supervision and examination. Since these hires, DFS has built out the VCU management team by hiring a team of deputies from federal regulators and the private sector with deep regulatory experience.

The immediate focus of this new leadership team was fourfold: (1) hire significantly more staff to VCU, including dedicated subject matter experts across key sub-domains; (2) enhance and formalize internal policies, processes, and procedures; (3) make clear DFS's expectations of VCEs through timely, external-facing policy guidance; and (4) triage and address historical backlogs, particularly with respect to the aging of BitLicense applications and timeliness of the examinations cycle. Over the past 21 months under the new DFS leadership, VCU has made immense progress in each of these areas, in addition to other key activities, including developing systems and technology, enforcement, interagency coordination, and stakeholder engagement.

Tripled Staff to Over 60 Experts

Upon Superintendent Harris's arrival, VCU had approximately 18 staff and had to rely on other divisions within DFS to conduct certain supervisory functions. Over the preceding two years, during the height of the COVID-19 pandemic, the virtual currency sector had grown significantly in terms of market capitalization, types of coins in circulation, and services offered. While the industry grew in size and complexity, DFS had been unable to grow its staff commensurately to meet the increasing workload of VCU. There were a number of reasons for this, including a State-wide government hiring freeze, limited agency resources, and a challenging hiring environment where DFS was competing with the private sector and other financial regulators for talent.

Upon Superintendent Harris's appointment, and with the hiring freeze lifted, growing VCU's staff became an immediate priority. To that end, Superintendent Harris has more than tripled the headcount of staff focused on virtual currency oversight, from 18 in December 2021 to over 60

staff² as of August 31, 2023, hiring specialized expertise in financial crimes, accounting, and data governance, alongside significant increases in the three “verticals” of Applications, Supervision, and Examinations—with further growth anticipated. The newly hired staff have a wide range of backgrounds and experiences, including professionals with direct experience in the virtual currency industry.

Superintendent Harris also has taken steps to ensure the long-term sustainability of VCU’s staffing levels, working with Governor Hochul and the Legislature to secure authority to levy assessments for BitLicensees in the FY22-23 state budget.³ Entities regulated under the New York Banking and Insurance Laws have been assessed by DFS for operating expenses stemming from regulation and supervision. Under Superintendent Harris’s tenure, DFS sought and received authority to assess VCEs as it does other regulated entities. Once that authority was granted, DFS adopted final regulations for the assessments on April 19, 2023, finalized its [processes for VCU assessment billing](#) soon thereafter, and began issuing invoices to BitLicensees. The collection of BitLicense assessments enables DFS to continue building and improving its oversight capability for this market. Moreover, the FY23-24 budget provided the cash appropriation needed to properly staff VCU.

This significant staff growth has allowed VCU to build out a robust and sustainable organizational structure. Importantly, VCU now has more staff than any other state, federal, or foreign regulator with a similar remit. VCU has developed a roster of subject matter experts in eight key areas that extend horizontally across the three vertical teams: accounting, financial crimes, capitalization, internal controls, cybersecurity, financials, legal, and data governance. The new VCU team is frequently cited by other regulators (state, federal and international) and legislators as a gold standard in overseeing virtual currency, and DFS is regularly called upon to provide guidance and feedback to state, federal, and foreign counterparts.

Implemented Comprehensive Process and Policy Enhancements

In parallel with the development of this organizational structure and growth in staffing, VCU undertook a comprehensive effort to evaluate and improve upon pre-existing processes by (1) identifying process gaps and necessary improvements, (2) enhancing and formalizing existing processes, and (3) establishing and codifying new procedures. As a result of this effort, VCU has updated and memorialized key processes in the following documents:

- A VCU Application Manual and Operating Procedures of the Virtual Currency Applications Committee;
- A VCU BitLicense Supervision Manual, BitLicense Examination Findings Tracking

² Inclusive of staff members with a focus on virtual currency activity within limited purpose trusts.

³ Due to the support of Governor Kathy Hochul and the New York State Legislature, in addition to including new authority to collect supervisory costs from licensed virtual currency businesses, the New York’s adopted FY23 Budget, enacted in 2022, fully funded DFS for the first time in its history, allowing the agency to hire staff that had been needed for years. *See* S.8000-E / A.9000-E (2022).

Procedure, and Matter Requiring Attention (“MRA”) Status Tracker Template; and

- An Examinations Manual and First-Day Letter Checklist/Tracker.

VCU has held multiple trainings to ensure staff understand and are following the new processes and will conduct testing to ensure ongoing compliance with enhanced procedures over time. Other key process enhancements implemented include:

- Updated and clarified roles and responsibilities for staff;
- A hand-off process between vertical functions such as Applications and Supervision; and
- New hire onboarding.

Adopted Series of Innovative Regulatory Guidance

In a fast-evolving industry, DFS tracks emerging trends and issues guidance to provide clarity to industry on regulatory expectations, promote compliance, ensure VCEs are aware of emerging risks and trends, and create transparency for consumers. Over the last 21 months, DFS-issued guidance has addressed several key areas, providing direction to the industry and thought leadership for other regulators on relevant issues including:

- [Escalating Situation in Ukraine and Impact to Financial Sector](#) (February 25, 2022);
- [Use of Blockchain Analytics](#) (April 28, 2022);
- [Issuance of U.S. Dollar-Backed Stablecoins](#) (June 8, 2022);
- [Notice Regarding Ethereum’s Upcoming Protocol Change](#) (September 14, 2022);
- [Prior Approval for Banking Organizations’ Virtual Currency-Related Activity](#) (December 15, 2022); and
- [Guidance on Custodial Structures for Customer Protection in the Event of Insolvency](#) (January 23, 2023).

DFS continues to monitor the virtual currency market and will issue further guidance as appropriate.

Strengthened Applications, Supervision, and Examinations

With the growth in staff and enhanced processes and policies in place, VCU has achieved significant outcomes in each of its three verticals.

- Applications: DFS is committed to operational excellence, creating a more efficient and

transparent application process without sacrificing regulatory rigor. In addition to formalizing governance, process flows, and clearly delineated roles and responsibilities through the Application Manual and Operations Procedures, applications undergo a standardized specialty review process for AML, financials/accounting, and cybersecurity. Since January 2022, DFS has issued five new BitLicenses, all for VCEs with varying business models, as well as the first transition from conditional approval to a full license. During the same time period, VCU also has declined to process applications that did not meet the standards required to obtain a BitLicense, including for one of the high-profile VCE bankruptcy filings in 2022. For context, in the 18 months prior to January 2022, DFS approved one new BitLicense. DFS has effectively increased both rigor and efficiency in its applications process.

- **Supervision:** DFS actively monitors its licensed VCEs, overseeing changes to VCEs' businesses and helping the industry grow responsibly, where appropriate, and taking supervisory action when necessary to eliminate bad practices. In addition, pursuant to formal procedures, Supervision teams are directed to ensure licensees establish plans and deadlines that effectively remediate each exam finding, and submit timely and detailed documentation evidencing such remediation. Supervision teams also address issues found during ongoing monitoring.
- **Examinations:** From January 2022 to August 2023, DFS has completed ten full scope safety and soundness examinations of BitLicensees, with four additional exams that have commenced. In comparison, during the prior 18 months from July 2020 to December 2021 four full scope safety and soundness examinations of BitLicensees were completed. The VCU has also formalized additional reviews around financial soundness, capital requirements, and safeguards to detect potential illicit finance activity, among other measures, as part of its ongoing monitoring between team examination visits. These comprehensive examinations ensure New Yorkers are protected and VCEs remain safe and sound. As a result of the examinations completed since 2022, DFS has issued about 220 matters requiring attention and matters requiring immediate attention. Moreover, in that same time period DFS has taken four enforcement actions and a supervisory action—as set forth in greater detail below—each of which has resulted from examinations.

Other Key Developments

Systems and Technology

Under Superintendent Harris's leadership, DFS is leveraging technology to streamline communications, increase transparency, and create enhanced supervision.

As noted above, on April 28, 2022, DFS issued guidance emphasizing the importance of blockchain analytics tools to effective policies, processes, and procedures, including, for example, those relating to customer due diligence, transaction monitoring, and sanctions screening. In 2022, VCU expanded on its own usage of blockchain analytics tools to assist in Bank Secrecy Act/anti-

money laundering and sanctions-related subject matter expert reviews during the applications and examination processes, as well as ongoing supervision. In February 2023, DFS announced the implementation of enhanced VCU market surveillance tools to proactively identify insider trading and market manipulation related to token listing for supervised VCEs. In April 2023, VCU formalized its internal Blockchain Analytics Procedures, codifying its use of these critical tools.

VCU is currently pursuing additional technology initiatives to improve its oversight capabilities, including (1) developing an application programming interface to intake daily transaction data to monitor VCEs' compliance with Part 200.15; (2) initiating the procurement process for a provider of crypto market data on which to run analysis and obtain insights into coins supported by DFS-regulated entities; (3) initiating the procurement process for a business intelligence software that will be used to create dashboards and visualize various data sources, and (4) onboarding additional customer due diligence screening tools to enhance investigative efforts and conduct ongoing screening of key personnel of our licensed entities.

Enforcement

VCEs that fail to comply with applicable laws and regulations are subject to enforcement action. In the last year, DFS has undertaken the following significant enforcement actions. These are the first virtual currency enforcement actions taken by DFS, all under the current leadership.

- In August 2022, DFS [ordered Robinhood Crypto, LLC](#) to pay a \$30 million penalty to New York State for significant BSA/AML and cybersecurity failures;
- In January 2023, DFS [ordered Coinbase, Inc.](#) to pay a \$50 million penalty to New York State for significant failures in its compliance program and to invest an additional \$50 million in its compliance function over the next two years. This is one of the largest enforcement actions ever settled in the virtual currency space;
- In February 2023, DFS was the first regulator in the world to address safety and soundness concerns related to Binance, [ordering that Paxos Trust Company, LLC](#) cease minting Paxos-issued BUSD, and oversaw the first orderly winddown of a stablecoin. After DFS took this supervisory action, federal and foreign regulators quickly followed in DFS's footsteps;
- In March 2023, DFS [ordered BitPay, Inc.](#) to pay a \$1 million penalty to New York State for failure to maintain an effective AML program and to comply with DFS's Cybersecurity Regulation; and
- In May 2023, DFS [ordered bitFlyer USA, Inc.](#) to pay a \$1.2 million penalty to New York State for failure to comply with DFS's Cybersecurity Regulation and to maintain an effective cybersecurity program.

Interagency Coordination and Stakeholder Engagement

As a leader in this space, DFS maintains a robust dialogue regarding virtual currency regulation with state, federal, and international counterparts. Through these discussions, DFS shares insights from its supervisory experience and gathers information from its counterparts. Under the current administration, DFS has executed memoranda of understanding with counterpart regulators including the Office of the Comptroller of the Currency, multiple state regulators, the U.K. Financial Conduct Authority, Ontario Securities Commission, and Taiwan Financial Supervisory Commission to facilitate these ongoing conversations, enable the sharing of confidential information, and ensure appropriate coordination on regulatory and supervisory matters.

DFS also convenes the Virtual Currency Advisory Board (“VCAB”), an external advisory group of leading industry experts drawn from academics, law firms, consultants, and VCE practitioners. The VCAB serves as a forum for DFS on a range of emerging issues to virtual currencies and blockchain technologies more broadly. The VCAB helps DFS understand evolving applications of virtual currencies and blockchain technologies, advises DFS with regard to supervisory and enforcement responsibilities for VCEs, and advises DFS on strategies to implement guidance, rules and regulations. The Board has met four times since October 11, 2022, and has discussed critical topics including the effects of the FTX bankruptcy,⁴ custody of VC, proof of reserves, VCE resolution and wind down, and activities at other regulators.

Findings, Recommendations, Remediation, and Response

Over the last 21 months, DFS has been executing a detailed strategy to enhance processes, procedures, and documentation standards and ensure a robust and well-documented framework for oversight of our BitLicensees. DFS values the OSC audit team’s independent evaluation of DFS’s operations. This process has complemented the ongoing work of DFS to evaluate and improve VCU operations and validated certain issues DFS previously identified. Throughout the audit process, DFS has tracked all requests, compared areas of concern and findings with issues already identified by VCU, and ensured that any needed corrective measures align with the ongoing process and policy enhancements initiated under current DFS leadership. While a helpful independent evaluation, the Draft Report does not reflect the comprehensive oversight regime implemented by the current administration. DFS has reviewed the Draft Report and describes the actions already taken or underway which address the draft findings and provide other relevant context.

Applications

- OSC Finding: “DFS formalized policies and procedures for its application process in the Virtual Currency Unit BitLicense Application Manual (Manual). However, the Manual was not finalized or used until June 2022 – 7 years after the virtual currency regulation

⁴ While it has been publicly covered that FTX had filed an application with DFS, the Department has not licensed FTX Trading Ltd. or any of its affiliates to conduct virtual currency business activity in New York State.

was issued. In response to our preliminary findings, DFS officials stated that, prior to the adoption of the Manual, they followed the standardized process established through the Nationwide Multistate Licensing System and Registry BitLicense New Application Checklist (Checklist). However, this is merely a checklist of documents that applicants need to submit; it does not provide formal policies and procedures for DFS staff to use during the intake and review of BitLicense applications. In addition, certain Part 200 requirements are not included in the Checklist, such as the verification from Tax and Finance that the applicant complies with all State tax obligations.”

- DFS Response: **This finding is stale. The current DFS administration independently identified the lack of formalized policies and procedures, started drafting the VCU BitLicense Application Manual (“Application Manual”) before the audit began and adopted the Application Manual a year ago. The Draft Report contains no adverse finding regarding the Application Manual.**

In 2021, as part of overall process uplift and procedure formalization, the new VCU Management identified policies and procedures as an area for remediation and immediately began developing the Application Manual, which was subsequently finalized in June 2022 and updated several times to reflect evolving practice throughout the scope period. The Application Manual further refines the applications process and provides enhanced direction to Applications staff. The Applications Team Lead is responsible for coordinating with the Deputy Superintendent of Virtual Currency to update this Application Manual to reflect any material changes and ongoing process improvements.

As the Draft Report notes, DFS has previously stated that under prior administrations, the applications process was performed according to the NMLS BitLicense New Application Checklist. The Application Manual was drafted and adopted to address the reliance by previous administrations on the NMLS Checklist for processing applications. Accordingly, DFS has already addressed this finding.

State Comptroller’s Comment – The Application Manual, finalized in June 2022, was subsequently updated three times, with newer versions effective in April, May, and June 2023, during the course of our audit. These versions include guidance for verifying applicants’ compliance with all New York State tax obligations, which was absent in the initial version of the Application Manual. The updated Application Manual versions also provide additional guidance for Specialty Reviews and references to DFS’ updated policies and checklists. Notably, all of these issues were prominent findings, which we discussed with VCU officials throughout our audit.

- OSC Finding: “We reviewed a sample of BitLicense application packages for eight of the 22 active licensees, as of October 2022, along with supporting documentation

provided by DFS. We found two BitLicensees did not fully complete the fingerprinting process that allows DFS to assess the major shareholders and officers' background before application approval. In one case, a parent company director did not submit their fingerprints. In the other, results of the fingerprinting for six primary stakeholders were not received prior to application approval. We also found that four BitLicensees did not provide an organization chart of their management structure. Without this information, we question whether DFS is able to adequately assess the backgrounds of applicants' major shareholders and officers and their organization structure prior to application approval."

- DFS Response: **Although the report refers to applications "as of October 2022," the applications referenced in this finding were approved at least four years ago. The current DFS administration independently identified and remediated this issue and, therefore, this finding does not reflect the current state of the applications review process.**

The five BitLicense applications described in this finding were approved between 2015 and 2019, under previous DFS administrations. Based on those old examples, the Draft Report misleadingly "question[s] whether DFS is able to adequately assess the backgrounds of applicants[] . . . and their organization structure prior to application approval." In fact, DFS currently ensures that all application packages received are complete and contain all required documents.

In 2021, the new VCU Management identified record retention under prior administrations as an area for remediation and put in place record keeping protocols by the second quarter of 2022. Under the current administration, all documents received from an applicant are maintained in a central location. Prior to submission to the Virtual Currency Applications Committee, all required application materials, including fingerprints and organization charts, are obtained and thoroughly vetted. Accordingly, DFS has already addressed this finding.

- OSC Finding: "When we requested documentation regarding verification of applicant compliance with all State tax obligations, DFS replied that the VCU does not request such information and it does not involve Tax and Finance in the application review process. DFS noted that the Applications team reviews the New York State Tax Warrants search website for outstanding tax warrants filed for applicants. However, the website contains a disclaimer regarding the limitations of the information, including a warning that searchers should not rely on search results to determine credit worthiness. The website also does not provide a record of applicants' tax obligations. Further, DFS was unable to provide documentation of these tax warrant searches; therefore, we question how DFS adequately ensures an applicant's compliance with this requirement. In response to our preliminary findings, DFS stated it is working with Tax and Finance to develop a process to directly obtain summaries of applicants' tax standing. DFS

subsequently revised the Manual, effective May 2023, to include verification from Tax and Finance in the application review process.”

- DFS Response: **This finding reflects an area where DFS has made improvements and is working to further enhance its process.**

The VCU Applications team currently uses the New York State Tax Warrants website, conducting a search of all licensees for potential tax warrants, and is also working to establish a formal process to obtain tax information directly from the Department of Taxation and Finance (“DTF”).

DFS acknowledges that there was previously an incomplete review of applicants’ tax obligations. DFS appreciates the partnership with OSC to identify this issue and further strengthen the application process. Moreover, to further enhance this process DFS is currently working with DTF to implement a process by which a summary of an applicant’s tax standing can be obtained directly. Based on discussions with DTF, DFS is aiming to implement this enhanced process within 180 days of OSC’s final report.

- OSC Finding: “As part of the BitLicense application process, Specialty Reviews include a subject matter expert’s (SME) assessment of audited financial statements and the applicant’s business plan to assess financial stability. Interviews with a financial SME revealed that DFS has not established formal written guidance for the financial Specialty Review. In addition, we requested but were not provided with documentation to support the assessment of applicants’ financial stability for each license in our sample. Therefore, we could not determine how DFS ensured appropriate assessments of applicants’ financial stability. It is imperative that each applicant’s financial stability is assessed formally and adequately to ensure BitLicenses are granted to financially stable applicants. According to the financial SME, DFS is in the process of finalizing a standardized template for the financial Specialty Review process, which will include qualitative and quantitative measures to document assessments of applicants’ financial stability. We asked for the most current templates and any other versions used in the past, and the earliest version we received was dated November 2022, indicating that there was no formal financial review process for applications for more than 7 years after Part 200 was issued.”
 - DFS Response: **Notwithstanding any suggestion to the contrary, DFS has a standard financial review process and template for each applicant, implemented in 2022 after current DFS leadership independently identified this area for improvement.**

As part of the overall process uplift and procedure formalization, VCU Management identified financial reviews as an area for process enhancement, because under the prior administration, VCU did not have a formal process for

financial review nor a formalized template for this specialty review process. VCU management developed a Financial Applications Review Template in November 2022, which implemented a standard process for conducting financial specialty reviews for each applicant.

The team responsible for Applications reviews successfully noted financially unstable companies that have since declared bankruptcy and did not grant them licenses. Under the current administration, financial condition assessments are documented by completion of the template and are issued by a financial SME. While the Draft Report erroneously states that there is no “formal written guidance for the financial Specialty Review,” in fact, guidance for completion of the template is embedded in the template itself. Similarly, specialty reviews of an applicant’s AML and Cyber programs are conducted and documented with the use of an established format to ensure consistency. Accordingly, DFS has already addressed this finding.

State Comptroller’s Comment – In April 2023, DFS provided a copy of a [template for financial Specialty Reviews dated November 2022](#). However, prior to this, and for most of our audit period, DFS had no formal, written guidance for financial Specialty Reviews. In addition, as noted in the audit report, DFS was unable to provide documentation of such reviews for the BitLicensees in our sample.

- OSC Finding: “BitLicensees are also required to conduct an annual risk assessment that establishes, maintains, and enforces an AML program based on operational risks associated with the licensee’s activities, services, customers, counterparties, and geographic location. Part 200 requires BitLicensees to conduct assessments of their AML program on an annual basis, or more frequently as risks change. In addition, according to the Manual, the Specialty Review includes an SME’s review of the applicant’s BSA/AML policy and related procedures, risk assessment, and risk assessment methodology. However, during our review of the eight application packages, we found that three BitLicensees’ initial BSA/AML risk assessments were completed over 12 months prior to their approval date. Of those three, one performed an initial BSA/AML risk assessment in 2015 when it started the application process; however, the BitLicensee wasn’t granted until 2019, nearly 4 years later. While we understand that it can be a lengthy process to complete all the application requirements, the business environment changes rapidly – especially in a volatile market like virtual currency – and risk assessments should be contemporaneous to address risks due to financial, political, and technological changes. Otherwise, an outdated, inaccurate risk profile could cause DFS to approve an applicant with unanticipated risks.”
 - DFS Response: **This finding is based on information relating to applications approved at least four years ago and does not reflect the current state of the**

review process as implemented under current leadership.

The Draft Report references the initial BSA/AML risk assessments of three entities that were licensed between 2016 and 2019. Starting in 2021, the current administration introduced a more efficient and transparent application process without sacrificing regulatory rigor, which also means that risk assessments remain more current throughout the applications process. Under the updated process, applicant risk assessments are reviewed based on current market conditions and related risks during the applications process, prior to recommending BitLicense approval.

The Draft Report warns that “an outdated, inaccurate risk profile could cause DFS to approve an applicant with unanticipated risks.” While true, this statement misleadingly suggests that DFS currently uses outdated or inaccurate risk profiles. In fact, VCU’s current application review entails a detailed analysis of the proposed BSA/AML program, as outlined in the Application Manual provided to OSC. After that review is conducted and assessed by the Financial Crimes team, VCU identifies weaknesses to the applicant and, depending on the severity of the deficiency, the applicant may be required to change their policies, procedures or processes in order to mitigate the identified risks. An application will only be approved after the review process is complete and the applicant has adequately addressed material weaknesses. Accordingly, DFS has already addressed this finding.

- OSC Finding: “In addition, three BitLicensees were required in their Supervisory Agreement (completed during the Application phase) to conduct and submit a formal revised BSA/AML risk assessment approved by the BitLicensees Board and based on operating history no later than 6 months after licensure. However, only one of the three licensees complied with the requirement. Nine months after approval, one licensee provided the updated assessment but with no indication it was approved by the BitLicensees Board. Instead of a formal risk assessment, the third licensee provided a third-party BSA/AML attestation report indicating that it complied with applicable industry rules and federal regulations. This was provided almost a year after the BitLicense was approved and did not indicate Board approval.

In response to our preliminary findings, DFS noted that it is developing a process to transition newly licensed entities from the application process to the supervision stage for ongoing monitoring, which will also include procedures for follow-up on interim provisions in the Supervisory Agreement.”

- DFS Response: **This finding relates to applications approved at least five years ago and does not reflect the current state of the applications review process, which current DFS leadership independently identified as requiring**

improvement in this regard.

The Draft Report references three entities that were licensed in 2017 and 2018. DFS has implemented a formal transition process between the Applications team and the Supervision team. This process transfers newly licensed entities from the Applications team to the Supervision team for ongoing monitoring. The current DFS administration previously identified the need for a transition process from Applications to Supervision and began implementing such a process, which now explicitly includes active follow-up on interim provisions in the Supervisory Agreement for newly licensed entities. Accordingly, DFS has already addressed this finding.

- OSC Finding: “A more detailed review of the eight application packages revealed four with at least one of the following issues: financial losses from hacking and litigation, SEC violations, lack of a risk assessment, and an incomplete Specialty Review of the BSA/AML program. Despite these red flags, the Applications Committee approved these applications. According to DFS officials, because the Applications Committee’s meeting minutes were not formally documented until January 2022, DFS was unable to provide evidence that the required documentation was reviewed or that the red flags were sufficiently addressed. In addition, we requested documentation showing communications between the Deputy Superintendent, other management, and the Applications Committee regarding their approval process and the identified issues’ effect on their decision. However, DFS did not provide any response.

Approving a BitLicense before the application and review process has been fully completed – especially regarding criteria such as the analysis of the entity’s BSA/AML program – increases the risk of DFS granting BitLicenses to entities with higher-risk profiles than intended. Further, approving a BitLicense application with financial and legal red flags increases the risk of financial instability and legal issues.

In response to our preliminary findings, DFS acknowledged that under prior administrations, certain BitLicense applications appear to have been approved without consistent procedures and recordkeeping protocols in place. DFS also acknowledged insufficient recordkeeping practices for the application decision process. However, the current administration has implemented improvements in the application process and has stated it will continue to take steps to ensure that all BitLicense applications are complete and compliant with Part 200 requirements.”

- DFS Response: **This finding relates to applications approved at least four years ago and does not reflect the current state of the applications review process, which current DFS leadership independently identified as requiring improvement in this regard.**

The Draft Report references four entities that were licensed between 2016 and 2019. As the Draft Report notes, the current administration has implemented comprehensive improvements in the application process. As part of these improvements, DFS ensures that all application documents are centrally stored and maintained. In addition, formal Applications Committee minutes are maintained for each meeting, as required by the Operating Procedures of the Virtual Currency Applications Committee, and are housed in a designated location on our system.

As acknowledged in the Draft Report, the current DFS administration previously identified the issues raised by OSC and implemented these improvements to remediate the application process. Accordingly, DFS has already addressed this finding.

State Comptroller's Comment – We conduct post audits of agencies' compliance with relevant laws, statutes, and regulations and their observance of good business practices. There was a limited number of approved BitLicenses to select from to review DFS' compliance with Part 200 requirements for applications, supervision, and examinations of BitLicenses. Recently approved BitLicenses would not have been required to meet many of the requirements under Part 200. Further, as detailed in our audit report, DFS did not have an Application Manual prior to June 2022 and revised the Application Manual three times during our audit to remediate some of our findings. Further, at the time of this report, DFS continues to take steps to address issues with the application process identified by our audit.

- OSC Recommendation: “Continue to take steps to ensure that all BitLicense applications are complete and comply with Part 200.4 requirements, any issues are addressed prior to approval, and decisions and actions taken on an application are documented.”
 - DFS Response: **As acknowledged in the Draft Report, DFS has already addressed this recommendation by adopting new and strengthened applications processes and procedures, after current DFS leadership independently identified this area for improvement.**

As discussed in response to the specific findings above, beginning in 2021 after the nomination of Superintendent Harris, DFS has implemented a series of improvements in the applications process and continues (and will continue) to take steps to ensure that all BitLicense applications are complete and compliant with Part 200.4 requirements. DFS has formalized applications processes and procedures in the Application Manual, which was finalized in June 2022 and updated several times to reflect evolving practice throughout the scope period. These processes and procedures ensure that applications are thoroughly and effectively reviewed and that issues identified in the applications review process

are addressed prior to approval. Decisions and actions taken on applications are documented in the form of Applications Committee meeting minutes which are centrally maintained.

- OSC Recommendation: “Develop formal, written guidance for Specialty Reviews to ensure comprehensive and consistent application reviews.”
 - DFS Response: **DFS has already addressed this recommendation by adopting a new Financial Applications Review Template that is completed by a financial SME during the review process, after current DFS leadership independently identified this area for improvement.**

As discussed in response to the specific findings above, under the current administration, as part of the process improvements and formalization of procedures, financial condition assessments are documented by completion of the Financial Applications Review Template and are issued by a financial SME. Guidance for completion of the Template is embedded in the Template itself. Similarly, specialty reviews of an applicant’s AML and Cyber programs are conducted and documented with the use of an established format to ensure consistency.

State Comptroller’s Comment – As previously noted, our audit scope period was July 2018 through July 2023. Our objective, in part, was to determine if DFS’ oversight of the BitLicense application process was adequate for that time period. Throughout the report, we acknowledge steps DFS has taken to strengthen its oversight of BitLicensees. However, our Standards require that we report our findings and conclusions to those charged with governance and the appropriate officials of the audited entity. In addition, in its response to our preliminary findings report, DFS acknowledged that under prior administrations certain BitLicense applications appear to have been approved without consistent procedures and record-keeping protocols in place.

Supervision

- OSC Finding: “We requested both quarterly and annual financial statements for the eight BitLicensees in our sample for the period of July 1, 2018 to September 30, 2022 to determine whether DFS ensured their compliance with Part 200’s reporting requirements. We found:
 - Two BitLicensees provided no quarterly financial statements to DFS until the third quarter of 2021, although the licensees were approved in May 2018 and June 2016, respectively. Therefore, DFS could not adequately track the financial stability of these two licensees for 3 and 5 years, respectively.
 - One licensee, approved in April 2019, was missing statements for the last three

quarters of 2019. DFS officials explained that, during the time in question, their informal practice was to allow a 6-9 month grace period for new BitLicensees, during which they were not required to file quarterly financial statements. However, this is inconsistent with the other BitLicensees reviewed.

Further, the quarterly financial statements DFS provided for the eight BitLicensees did not meet all Part 200 requirements. None of the quarterly financial statements included the following required items that would allow DFS to fully assess the licensees' financial stability: cash flow statement, statement of net liquid assets, financial projections and strategic business plans, off-balance sheet items, and a chart of accounts. In response, DFS officials informed us that the licensees submit quarterly data through a DFS system with designated financial accounts. However, the documents DFS provided for the BitLicensees in our sample included only balance sheets and income statement information. We requested all other required information, but DFS officials did not provide any additional documentation. Therefore, there is limited assurance that DFS was adequately ensuring BitLicensees' ongoing financial stability.

DFS officials stated that BitLicensees submit quarterly regulatory capital data within 45 days of the end of each quarter, which officials use to determine if the BitLicensees have the minimum amount of capital they are required by DFS to hold (capitalization requirements). We requested this information for the eight sampled BitLicensees for July 2018 through March 2023; however, DFS provided only regulatory capital data starting in January 2022. DFS acknowledged that inconsistent recordkeeping practices under prior administrations prevented it from providing the documents from before 2022.

To further determine if DFS monitored the regulatory capital data during the safety and soundness examinations, we reviewed 12 biennial Reports of Examination (ROE) for seven of the BitLicensees in our sample. (One BitLicensee's ROE was in progress and had not been completed.) According to the ROEs, two BitLicensees did not meet their capitalization requirements and had not submitted the required quarterly data.

- One failed to report falling below the minimum positive net worth requirement to DFS as required.
- One failed to maintain a positive net worth and, as a result, did not meet the minimum capital requirement required by: Part 200 and its Supervisory Agreement for three consecutive quarters of the review period.

Virtual currencies are a risky asset class with significant price volatility. A breach of capital requirements indicates that an institution is undercapitalized and is not maintaining an appropriate buffer to protect against unexpected losses and support the safety and soundness of its ongoing operations. Therefore, there is a need for better oversight and transparency. DFS should consistently monitor licensees' positive net worth to ensure financial integrity and stability and not rely on the BitLicensees to self-report non-compliance. In response to our preliminary findings, DFS provided a recently finalized

version of its Regulatory Capital Oversight Procedure, dated June 2023. We note this procedure was put in place 14 months after we engaged this audit and 8 years after Part 200 was issued.

For the eight sampled BitLicensees, 32 annual financial statements were required for the audit period. DFS provided the 32 statements, but we found that none included the required assessment by the BitLicensee’s management of compliance with applicable laws, rules, and regulations, and 25 did not include a required certification by an officer or director attesting to the truth and correctness of the statements.

The financial statements also must include an opinion and attestation by an independent CPA regarding the effectiveness of the BitLicensee’s internal control structure. According to a DFS official, the independent annual AML audit report satisfies this requirement. We requested the AML reports for the eight sampled BitLicensees for our scope period, and DFS provided the 2021 reports for seven BitLicensees and the 2019 report for one but no other AML reports for any of the eight licensees for any other year in our scope period. Therefore, the requirement for an opinion and attestation by an independent CPA was not met. Moreover, Part 200’s requirement to provide an annual report to support the assessment and testing of the compliance and effectiveness of the AML program was also unmet. DFS needs to ensure each BitLicensee submits required financial statements, reports, and information to DFS as required to support the safety and soundness of its business operations and compliance with regulations. As virtual currencies can present illicit financial risks, including money laundering, DFS should also ensure BitLicensees have established, and comply with, an appropriate AML program.”

- DFS Response: **DFS has remediated this finding by adopting enhanced record keeping processes and new procedures, after current DFS leadership independently identified this area for improvement.**

Currently DFS uses Periodic Reporting Procedures. These procedures provide a detailed process for reviewing the annual and quarterly financial statements specified in 200.14 (a) and (b), and address the collection, tracking and use/analysis of all required reports, including quarterly financials, Quarterly Capital Calculations, and Independent AML Audit Reports. Moreover, as the Draft Report notes, DFS finalized a Regulatory Capital Oversight Procedure in June 2023 to ensure consistent review of quarterly capital reports. VCU has now formalized a uniform report for comprehensive financial review, which is in the process of being rolled out.

VCU’s current processes for financial review are thus comprehensive and robust. The Draft Report states that there is “limited assurance that DFS was adequately ensuring BitLicensees’ ongoing financial stability.” But this statement fails to acknowledge recent improvements. Even if it were true that under prior administrations that DFS’s practices were somehow insufficient, this is no longer the case.

Upon joining DFS in December 2021, the Deputy Superintendent of Virtual Currency immediately enhanced record keeping processes and procedures to ensure that all annual reports for 2021 and later, as well as all quarterly reports for Q4 2021 and later, were collected and stored properly. Accordingly, DFS has already addressed this finding.

As the Draft Report notes, DFS has previously acknowledged to OSC that, prior to 2022 and under prior administrations, the quarterly and annual reports were not consistently tracked and maintained.

- OSC Finding: “We also found DFS has not established formal procedures or tools to analyze BitLicensees’ financial reports, which could lead to inconsistencies in identifying and addressing red flags and could cause it to overlook critical financial risks, such as lack of liquidity. DFS reviews hard copies of quarterly and annual financial statements, using a highlighter and pen to note any possible red flags. Besides reviewing the financials, DFS also reviews the Notes to the financials as well as any other non-accounting information about the business.

According to DFS, VCU staff track and collect quarterly financial statements and use them for analysis, including assessments of overall financial condition. As part of this process, in March 2023, VCU compiled reports dating back to the fourth quarter of 2021. The quarterly financial analysis is a new tool to help identify trends and, according to DFS, it is working with its Accounting and Data Governance teams to develop formal processes to incorporate the information into ongoing monitoring. However, the highlighted variances or red flags do not trigger any specific actions. Further, DFS stated that the VCU Accounting team is developing a template that includes analysis of annual financial data.

In response to our preliminary findings, DFS stated that administrations prior to 2022 did not consistently track quarterly and annual reports. Upon joining DFS in December 2021, the Deputy Superintendent of Virtual Currency immediately enhanced recordkeeping processes to ensure proper collection and retention of all annual reports for 2021 and later, as well as all quarterly reports for the fourth quarter of 2021 and later. Additionally, VCU has drafted Required Reporting Procedures that will provide a detailed process for reviewing the annual and quarterly financial statements specified in Part 200 and to address the collection, tracking, and analysis of all required reports, including quarterly financials, quarterly capital calculations, and independent AML audit reports. However, this process has not been finalized.”

- DFS Response: **The current administration adopted formal procedures and appropriate tools to analyze financial reports before the close of the audit.**

DFS currently tracks and collects quarterly financial statements and uses them to generate quarterly financial analysis, including directional trending, revision analysis, and assessments of overall financial condition. The current administration

identified inconsistent financial report tracking analysis as an area for remediation. As part of this process, reports dating back to Q4 2021 were reviewed and analyzed. To further enhance the financial analysis process, VCU formalized a uniform report for comprehensive financial review, which is in the process of being rolled out.

While the Draft Report states that “variances or red flags do not trigger any specific actions,” this is misleading in that DFS previously noted that quarterly financial analysis is used by Examinations staff for the pre-exam scoping and risk assessment process. DFS is at the vanguard of this space and there is limited historic precedent to understand how the financial models of the entities will perform. It is not yet possible, or appropriate, to pre-set specific actions against variances. Instead DFS takes a more effective approach of holistically assessing the entities’ overall financial condition.

Quarterly analysis is used by Supervision Staff as part of the ongoing monitoring of licensees between examinations, including with respect to regulatory capital through a Regulatory Capital Oversight Procedure. Accordingly, DFS has already addressed this finding.

State Comptroller’s Comment – According to DFS, pre-exam scoping is conducted by the Examination team once a year to plan the subsequent year’s examination schedule. However, analysis of quarterly financial statements should be conducted for each quarter and guidance should be provided to address variances or red flags rather than solely for pre-exam scoping.

- OSC Finding: “DFS officials stated that they evaluate a BitLicensee’s cybersecurity program with a focus on the requirements of NYCRR Part 500 Cybersecurity Requirements for Financial Services Companies (Part 500), which encompasses all substantive cybersecurity requirements of Part 200. However, Part 200 requires a BitLicensee to submit an annual report – prepared by the Chief Information Security Officer and presented to the board of directors – assessing the availability, functionality, and integrity of the BitLicensee’s electronic systems; identifying relevant cyber risks to the licensee; assessing the licensee’s cybersecurity program; and proposing steps to address any inadequacies identified. This is not required under Part 500.

DFS provided a schedule of Part 500 Certifications (Certifications) for the eight licensees in our sample, and we found:

- In Certifications filed for 2021, three of the eight BitLicensees acknowledged they were not in compliance and that remediation plans were underway to achieve compliance.
 - Two of the three that were not compliant had not submitted prior years’ Certifications to DFS.

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- The other BitLicensee filed that it was compliant with Part 500 in 2018, 2019, and 2020. However, during 2019 and 2022 examinations, DFS found that the BitLicensee was not in compliance. The 2019 ROE specifically noted that, because periodic assessments of products, services, and operational or cybersecurity risks were not being conducted, there was a possibility that critical risks may not be identified, and the processes to measure and monitor risks in place at the time may be deficient. The 2022 ROE noted that the BitLicensee’s IT and cybersecurity policies still did not fully comply with the requirements and needed management’s immediate attention. The BitLicensee continued to be non-compliant with all sections of Part 500; however, the licensee submitted Certifications for 2019 and 2020.
 - Another BitLicensee certified compliance with Part 500 in 2019, 2020, and 2021. However, a 2021 ROE indicated it was not in compliance with Part 200 or Part 500, stating the licensee exhibited a degree of supervisory concern due to a combination of moderate to severe weaknesses. The ROE also noted that, although management certified compliance with all requirements of Part 500 for the scope of the review, there were concerns that, based on the examination findings, the BitLicensee was not in full compliance with all applicable sections of the regulations and should not have certified compliance.

In the 12 ROEs we reviewed for seven of the licensees in our sample, we found system and technology issues, including non-compliance with Part 200 and/or Part 500. DFS should require BitLicensees to submit the annual cybersecurity report assessing the availability, functionality, and integrity of the licensee’s electronic systems; identifying relevant cyber risks; assessing the licensee’s cybersecurity program; and proposing steps to address inadequacies as required in Part 200, rather than relying on BitLicensees to self-certify compliance with Part 500.

In response to our preliminary findings, DFS stated that, in practice, the Part 500 certification alone does not meet the Part 200 requirement. DFS’ cybersecurity oversight goes beyond certification and includes real-time monitoring and in-depth examinations. However, DFS is conducting a review of Part 200 to determine the appropriate approach to reconciling any conflicting or redundant requirements in Part 500.”

- DFS Response: **DFS disagrees with the Draft Report’s finding that compliance with the more rigorous requirements of Part 500 is insufficient as DFS’s current requirements are more rigorous than those recommended in the Draft Report; this finding otherwise reflects DFS’s successful implementation of its cybersecurity examination program.**

As discussed with the audit team, 23 NYCRR Part 500 implements comprehensive cybersecurity requirements that encompass and go beyond the substantive

requirements of the earlier-promulgated 23 NYCRR Section 200.16. For purposes of required reporting, DFS monitors and tracks compliance with the Part 500 certification requirement, and is also continuing to roll-out an updated supervisory agreement, which requires an independent cyber audit report. There thus is no reason to require VCEs to submit a CISO report that is not required by Part 500 and is less rigorous than the combined requirements of Part 500 and the supervisory agreements. Nor is there any basis to conclude that the CISO report would address the instances DFS identified in which VCEs certified compliance with the Part 500 requirements before DFS examinations identified issues.

Otherwise, this finding reflects the rigorous and successful implementation of the on-site examination process conducted by DFS to ensure that cybersecurity certifications reflect the true state of the company. The system and technology issues described as having been found by OSC consist of findings *DFS* made as part of the examination process that had been reported to the relevant VCEs for remediation. As appropriate, this administration has held licensees to account and taken aggressive enforcement actions against entities who fail to comply with DFS's cybersecurity rules. For example, the Robinhood consent order highlighted significant gaps and deficiencies, including with respect to an improper cybersecurity certification. As part of remediation, the entity was required to hire an independent monitor and provide regular reporting on progress to ensure New Yorkers are protected. Further, two of the entities referenced by the Draft Report ultimately agreed in consent orders to pay large fines and remediate deficiencies, and DFS has been following up to ensure they are doing so.

State Comptroller's Comment – Our finding stands. The annual report of the BitLicensee's cybersecurity program prepared by the Chief Information Security Officer and approved by the board of directors is required by Part 200. Applying Part 500, which DFS believes is more comprehensive, does not absolve DFS from complying with the Part 200 requirement for BitLicensees to provide an annual report that assesses the availability, functionality, and integrity of their electronic systems, identifies cyber risks, assesses their cybersecurity programs, and proposes steps to address any identified inadequacies. Moreover, while the Part 500 cyber requirements may be more comprehensive, the initial control employed by DFS to ensure compliance is a simple self-certification that can be signed by either the chairperson of the board of directors or a senior officer. The annual report, which is prepared by the Chief Information Security Officer, is a more comprehensive and contemporaneous document than self-certification and, therefore, puts more accountability on the BitLicensees than self-certification and biennial on-site examinations. Further, our findings do not reflect the successful implementation of DFS' cybersecurity examination program, as DFS states in its response. DFS relied on BitLicensees to self-report compliance with Part 500 and, as highlighted in the report, we found in some cases BitLicensees certified compliance with Part 500 when, in fact, they were not. As we also point out in our report, DFS is not fully compliant with the biennial examination requirements.

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- OSC Recommendation: “Take steps to ensure BitLicensees provide all information as required by Part 200 and the Supervisory Agreements.”

- DFS Response: **DFS has already addressed this recommendation by adopting enhanced processes and Periodic Reporting Procedures, after current DFS leadership independently identified this area for improvement.**

As discussed in response to the specific findings above, currently DFS uses Periodic Reporting Procedures. These procedures provide a detailed process for reviewing the annual and quarterly financial statements specified in 200.14 (a) and (b), and address the collection, tracking and use/analysis of all required reports, including quarterly financials, Quarterly Capital Calculations, and Independent AML Audit Reports. DFS previously identified this issue and has taken proactive steps under this administration to ensure licensees provide all information as required.

State Comptroller’s Comment – Our recommendation encompasses not only adopting policies and procedures but also implementing and improving the processes to ensure adequate supervision of BitLicensees. Further, during an interview with DFS officials on March 27, 2023, we inquired whether any documented guidelines were available for the Supervision team and, in the absence of a response, identified this issue in a written preliminary report to DFS on June 16, 2023. We were not informed of any formalized policies and procedures until DFS’ response to our preliminary findings on June 30, 2023. We also note that, as of July 19, 2023, according to DFS officials, the Periodic Reporting Procedures were still in draft, with a creation date of June 20, 2023.

- OSC Recommendation: “Continue to develop and implement procedures and tools to collect and analyze required information to ensure the safety and soundness of BitLicensee operations.”

- DFS Response: **DFS has already addressed this recommendation by introducing quarterly financial analysis, a report for comprehensive financial review, and other enhanced tools.**

As discussed in response to the specific findings above, starting in 2021 and continuing today DFS instituted processes whereby quarterly financial statements are tracked, collected, and used to generate quarterly financial analysis, including directional trending, revision analysis, and assessments of overall financial condition. This process covers reports dating back to Q3 2021. Quarterly financial analysis is used by Supervision Staff as part of the ongoing monitoring of licensees between examinations, including with respect to regulatory capital through a Regulatory Capital Oversight Procedure. Quarterly financial analysis is also available to Examinations staff for consideration in the pre-exam scoping process.

To further enhance the financial analysis process, VCU has now formalized a

uniform report for comprehensive financial review, which is in the process of being rolled out.

Moreover, in February 2023, DFS announced the implementation of enhanced VCU market surveillance tools to proactively identify insider trading and market manipulation related to token listing for supervised VCEs. This effort builds on the DFS's deployment in 2022 of additional blockchain analytics coverage to augment its existing supervisory capabilities specific to the cryptocurrency space. In April 2023, VCU formalized its internal Blockchain Analytics Procedures following socialization with several other regulators operating in the virtual currency space, codifying its use of these critical tools. VCU is currently pursuing additional initiatives to augment its capabilities, including by coordinating closely with law enforcement and state, federal, and foreign regulatory counterparts.

State Comptroller's Comment – We requested quarterly and annual financial statements for eight BitLicensees for the period July 1, 2018 through September 30, 2022, which, in some cases, either DFS was unable to provide or the statements were incomplete. In its response to our preliminary findings report, DFS acknowledged that prior to 2022, quarterly and annual reports were not consistently tracked and maintained. While DFS indicated new processes and procedures were recently put in place and are currently in the process of being rolled out, this occurred at the end of or after our fieldwork and therefore was not tested. As previously noted, our Standards require that we communicate the results of our audits to those charged with governance and the appropriate officials of the audited entity and report conclusions based on the audit objectives and findings for our audit period, which is clearly stated in the report.

Examinations

- OSC Finding: “We reviewed the BitLicense Examination Roster and found, on average, a 3-year gap between each exam for the 22 active licensees. Of the 22, five BitLicensees were examined more than 2 years after their approval date. One BitLicensee, approved in September 2015, was not reviewed until 2019. Moreover, the 2023 Virtual Currency Supervisory Plan revealed that one BitLicensee was scheduled for its first exam in 2023 – 4 1/2 years after its application was approved in June 2018. In addition, three BitLicensees had not been reviewed due to limited activity in New York State, although they were all licensed more than 2 years prior. The three are scheduled for review in 2023. DFS officials advised that a decision to postpone an examination is not made based on a standard threshold but rather on a case-by-case basis. DFS further explained that it took a risk-based approach and dedicated limited staff resources to entities with a higher risk profile, such as those with the greatest amount of activity in the State or those who interact with the most retail consumers.

It is imperative that DFS promptly conduct required safety and soundness examinations because DFS reviews only policies and procedures provided during the application process. To ensure that these policies and procedures are implemented by the BitLicensees, and to

measure the effectiveness of their internal controls, DFS should perform the examinations within a reasonable time frame after the BitLicensee’s approval.”

- DFS Response: **DFS agrees with the importance of prompt examinations, which the current administration independently identified, and has worked to address this issue by tripling virtual currency staff to expand examination capacity.**

Every year, VCU staff review and update the examination schedule for the coming fiscal year. As the Draft Report acknowledges, this update occurs through a risk-based analysis, which prioritizes inclusion of VCEs that have not been examined in the past two years as well as VCEs that have the highest risk profiles—such as those with the greatest New York activity or who interact with the most retail consumers. The schedule is further updated no less than semi-annually based on scheduling and resource issues that may arise, and any changes require a written justification.

As noted, VCU has operated under significant resource constraints until recently. Under the current administration, DFS has more than tripled virtual currency staff in 18 months in order to improve operations and expand its capacity to examine entities every two years. Importantly, VCU now has tripled its pool of examiners-in-charge for BitLicensees, onboarding two additional examiners-in-charge where there was only one in place upon arrival of the current management regime in early 2022.

- OSC Finding: “The safety and soundness examinations identified issues documented in the ROEs. However, the Examination team is not involved in following up on issues and findings noted in the ROE. Six months into the audit, DFS advised us that management had recently expanded Supervision’s resources to enhance interim monitoring of BitLicensees, creating a ROE follow-up process (including quarterly meetings), independent of the Examination team. We requested documentation, such as the quarterly meeting agendas, to support that the Supervision team followed up on issues identified in the ROEs. However, DFS responded that it does not retain notes from these quarterly meetings because the agenda process is an internal coordination exercise.

DFS identified findings tracking as an area in need of remediation under the current administration. Currently, the Supervision team is testing a new process for proactive interim monitoring of examination findings using a Status Tracker Template. DFS provided the template for one BitLicensee and stated that a pilot of the new documentation and follow-up processes began in the first quarter of 2023. VCU is assessing the effectiveness of the pilot and is working to implement it.

We reviewed ROEs for seven of the eight BitLicensees in our sample. (One BitLicensee’s first ROE was in progress and, therefore, could not be reviewed.) Of the seven, five had more than one ROE. Of those five BitLicensees, four had repeat findings in their second ROE. These repeat findings were in the areas of Internal Controls and Auditing, Legal and

Regulatory Compliance, Management, and Systems and Technology. In several instances, the repeat findings were elevated from Matters Requiring Attention to Matters Requiring Immediate Attention.

The Examination team found, for one BitLicensee, corrective actions had not been taken for 16 of the 22 repeat findings. The repeat findings included seven in Systems and Technology that were elevated to Matters Requiring Immediate Attention. The remaining nine Matters Requiring Attention were in Management Oversight and Legal and Compliance. As a result, the examination team recommended supervisory enforcement action to better monitor management's progress in addressing the findings. When examination findings remain unresolved for multiple years, we question the effectiveness and timeliness of the ROE follow-up process.

If examinations are not conducted and identified issues aren't addressed in a timely manner, there is a risk that DFS will be unable to identify red flags or poor internal controls in time to prevent negative financial, legal, and cybersecurity consequences for the BitLicensee and its investors.

In response to our preliminary findings, DFS stated that, while the virtual currency industry has grown in size and complexity, it has been unable to add to its staff commensurately to address VCU's increasing workload. DFS cited several reasons for this, including a statewide government hiring freeze, limited agency resources, and a challenging hiring environment with private sector and other financial regulators competing for talent. DFS further noted that the focus of its new leadership team in 2021 was fourfold: hire significantly more staff to VCU, including dedicated SMEs across key subdomains; enhance and formalize internal policies, processes, and procedures; make clear DFS' expectations of licensees through timely, external-facing policy guidance; and triage and address backlogs, particularly with respect to the aging of BitLicense applications and timeliness of the examinations cycle."

- **DFS Response: As acknowledged by the finding, DFS adopted a template to track follow-up on examination findings, after current DFS leadership independently identified this area for improvement. DFS also instituted formal procedures to follow-up on examination findings.**

In early 2022, DFS began hiring staff and developing processes to enhance monitoring in between exams. In April 2023, DFS implemented a BitLicense Examination Findings Tracking Procedure, by which DFS's supervisory points of contact monitor remediation of examination findings, including MRAs and Matters Requiring Immediate Attention ("MRIAs"), between exams. These points of contact evaluate licensee responses to ROE findings, review supporting documentation submitted by BitLicensees and directly engage with them regarding any follow-up questions. Outstanding MRAs and MRIAs are tracked, documented, and followed up on using a new MRA Status Tracker Template.

The Draft Report’s statement that “the Examination team is not involved in following up on issues and findings noted in the ROE” is incorrect as the examination team is involved in closing out such findings, and are an important resource for supervision points of contact between exams. A finding from an exam is formally closed by the Examination function as part of a subsequent exam if the Examination function determines that the finding has been properly addressed and fully remediated by the entity. DFS uses a number of different tools to address a regulated VCE’s failure to address examination findings in a timely manner. In particular, depending on the nature of the finding and other relevant circumstances, a VCE may be downgraded, referred to the enforcement division, or both.

State Comptroller’s Comment – We have amended the audit report to reflect that, while the Examination team is not involved in following up on issues and findings noted in the ROE, it is responsible for making the final determination on whether a finding is resolved.

DFS further notes that the quarterly agenda process noted to OSC is an internal coordination exercise. Notes from these meetings were not retained as a matter of record-keeping. VCU is continuing to remediate the coordination across supervision and examinations.

- OSC Recommendation: “Continue to develop and implement policies and procedures to ensure safety and soundness examinations are conducted in a timely manner.”
 - DFS Response: **DFS has made significant progress toward addressing this recommendation by tripling its VCU staff and examiner-in-charge pool, after current DFS leadership independently identified this area for improvement.**

As discussed in response to the specific findings above, the current administration has taken proactive steps to ensure examinations are conducted timely in accordance with Part 200. DFS is continuing to build toward a steady-state level of staffing to fulfill the Part 200 two-year requirement and has increased its staff focused on virtual currency by more than 40 employees from December 2021 to present. Importantly, under this DFS administration, VCU developed, approved, and distributed a new examination manual and onboarded two additional examiners-in-charge for BitLicensees where there was only one in place upon arrival of the current management regime in early 2022. VCU also refreshes the examination calendar on at least a semi-annual basis.

- OSC Recommendation: “Establish formal policies and procedures for the examination follow-up process to ensure issues are addressed promptly.”
 - DFS Response: **DFS has already addressed this recommendation by adopting formal policies and procedures for ROE follow-up, after current DFS leadership independently identified this area for improvement.**

As discussed in response to the specific findings above, the current administration has established formal policies and procedures for the ROE follow-up process to ensure issues are addressed adequately and timely. In April 2023, DFS implemented a BitLicense Examination Findings Tracking Procedure, by which DFS's supervisory points of contact monitor remediation of exam issues between exams. These points of contact evaluate licensee responses to ROE findings, review supporting documentation and directly engage with BitLicensees regarding any follow-up questions. Outstanding MRAs and MRAs are tracked, documented, and followed up on using a new MRA Status Tracker Template. A finding from an exam is formally closed by the Examination function as part of a subsequent exam if the Examination function determines that the finding has been properly addressed and fully remediated by the entity. If MRAs are repeatedly left unresolved, a VCE may be downgraded, referred to the enforcement division, or both.

State Comptroller's Comment – In response to our preliminary audit report, DFS provided an MRA Status Tracker (Tracker) template to track, document, and follow up on matters noted in safety and soundness examinations. According to DFS, the Supervision team was testing the Tracker. We requested the Tracker for the eight BitLicensees in our sample; however, DFS was only able to provide the Tracker for one BitLicensee and advised us that it was assessing the effectiveness of the pilot program and working to implement the process. We acknowledge the improvements DFS has made to the examination process; however, we were unable to audit the new process as our audit scope was through July 2023, and its new procedures and processes were still being tested.

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