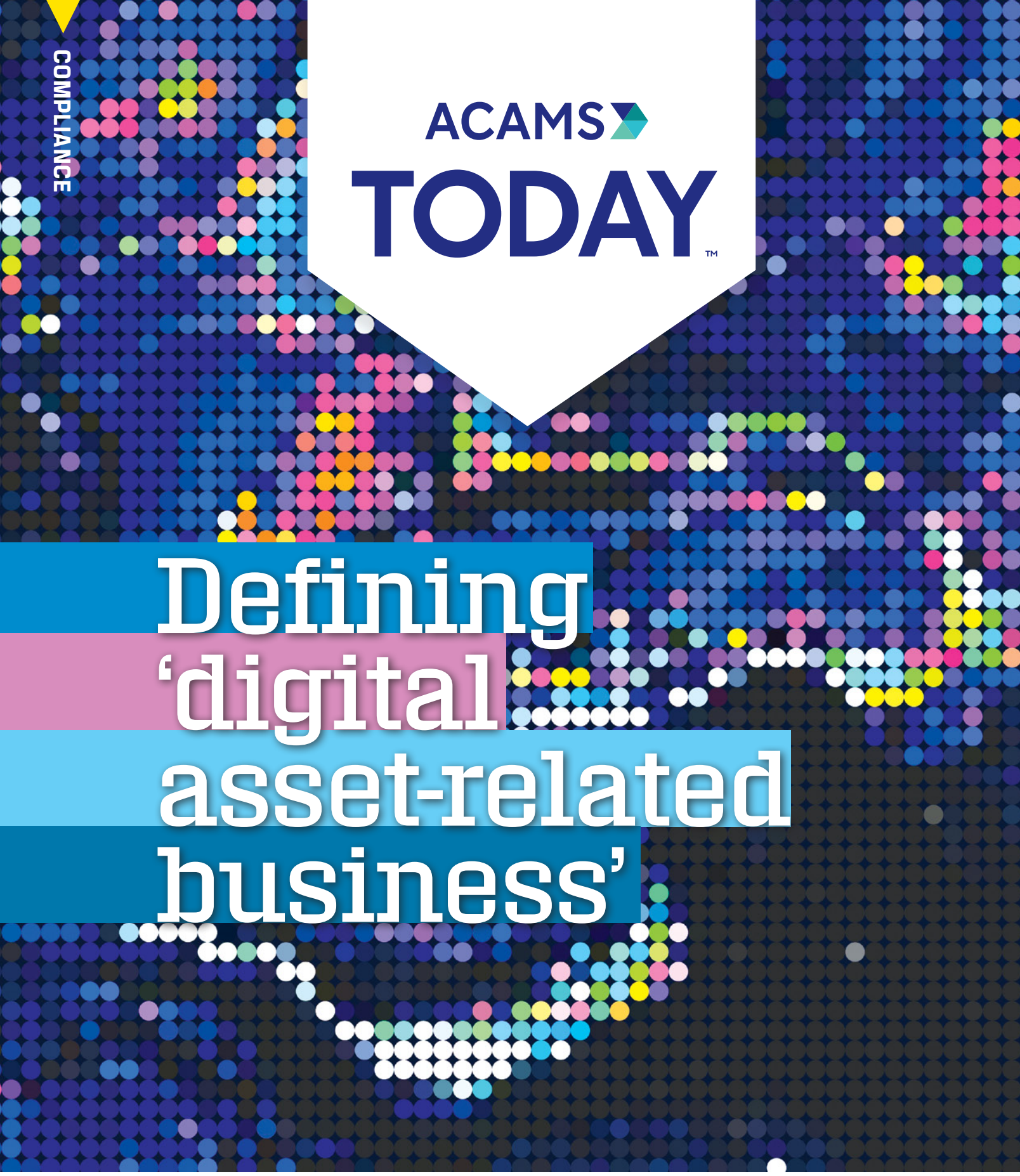

Defining 'digital asset-related business'

ACAMS

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ACAMS Today March–May 2023, Vol. 22 No. 2,
an ACAMS publication. © 2023
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CRB Monitor

What is a digital asset-related business (DARB)? All financial institutions (FIs) must have a clear answer to this question and take a vested interest in this complex asset class to effectively manage risk and monetize the opportunity. Regardless of an institution's policy toward digital assets themselves[1] or the ecosystem of businesses surrounding digital assets, poorly constructed policies and procedures are a risk to any effective compliance program. Although regulated institutions are encouraged to "take a risk-based approach in assessing individual customer relationships, rather than declining to provide banking services to entire categories of customers without regard to the risks presented,"[2] many continue to take the simplistic "just say 'no'" or risky "do not ask, do not tell" approach toward this industry. As a result, these institutions (a) have a limited understanding of digital assets and DARBs; (b) have not clearly defined "digital asset-related business"; and (c) therefore have nonexistent, unclear or incomplete policies and procedures, which can lead to inconsistent interpretation and implementation.

Leveraging prior work experience—which defines terminologies and taxonomies in the cannabis industry[3] and recent discussions with top-tier FIs—this article shares a comprehensive and cohesive framework for defining DARBs and classifies them into three relevant risk-based tiers. FIs, regulators and policymakers will benefit from this framework when developing, revising or updating their digital asset-related policies and procedures.

Why is this relevant?

In March 2022, U.S. President Joseph Biden issued his "Executive Order on Ensuring Responsible Development of Digital Assets," which stated, "Advances in digital and distributed ledger technology for financial services have led to dramatic growth in markets for digital assets, with profound implications for the protection of consumers, investors, and businesses, including data privacy and security; financial stability and systemic risk; crime; national security; the ability to exercise human rights; financial inclusion and equity; and energy demand and climate change. In November 2021, non-state issued digital assets reached a combined market capitalization of $3 trillion, up from approximately $14 billion in early November 2016."[4]

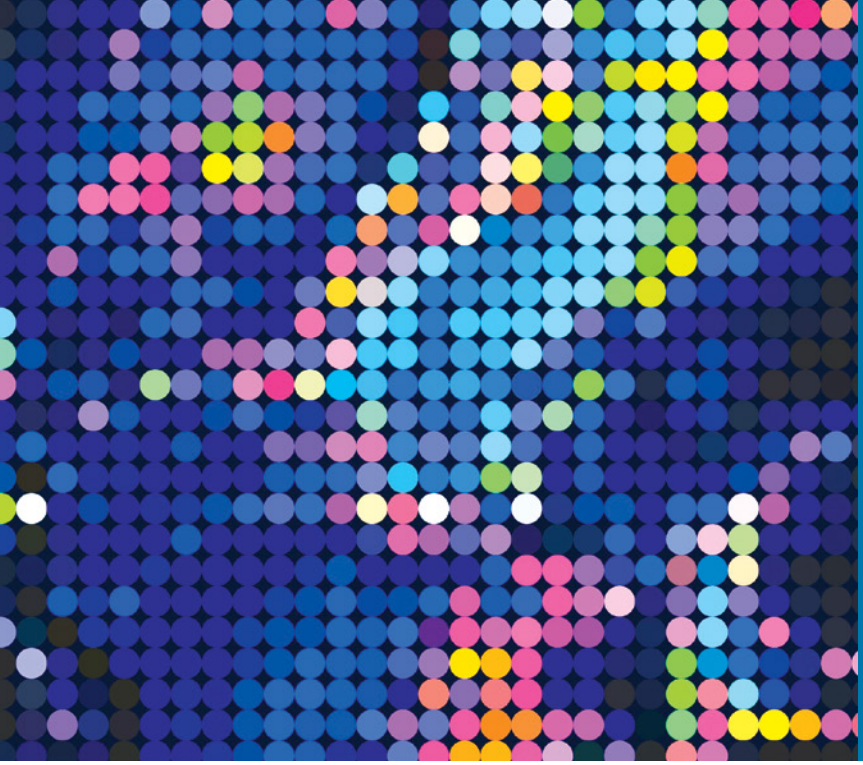
More recently, in January 2023, the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (OCC) issued the "Joint Statement on Crypto-Asset Risks to Banking Organizations," which stated, "The events of the past year have been marked by significant volatility and the exposure of vulnerabilities in the crypto-asset sector…" and goes on to list a number of key risks to banking organizations.[5]

As such, national and international government agencies have been offering descriptions and definitions of digital asset-related businesses and have drafted regulations and guidelines to mitigate risk to FIs, investors and consumers. The Federal Reserve has stated that given the "heightened and novel risks" posed by digital assets, it is "closely monitoring banking organizations' participation" in digital asset-related activities.[6] In April 2022, the OCC issued a consent order against "the first crypto-native bank,"[7] noting the importance of anti-money laundering (AML)/Bank Secrecy Act elements in "novel digital asset activities."[8] The OCC noted that prior to engaging in any digital asset-related activities—knowingly or unknowingly—FIs "must ensure such activity is legally permissible" and "have in place adequate systems, risk management, and controls to conduct such activities in a safe and sound manner and consistent with all applicable laws…."[9]

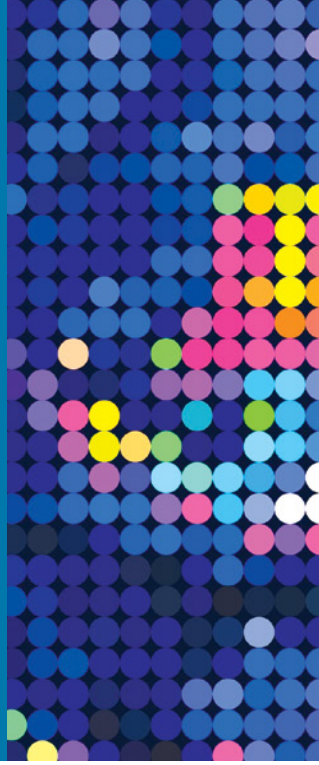
However, in order to effectively meet these guidelines, FIs need to clearly define DARBs and then develop risk-based policies and procedures specific to DARBs, including effective methods for consistently identifying, categorizing by risk-rating and treating accordingly.

A three-tiered risk approach

The following framework can be used to consistently define, identify and classify DARBs into three risk-based tiers, which effectively describe the degree to which a business "touches" digital assets and/or interacts with other DARBs. This multi-tiered approach can help FIs—including those that believe they have minimal exposure to the industry—to determine which businesses operating in the digital asset ecosystem they may be willing to offer products and services to and, equally important, to what extent they may need to update policies, procedures and due diligence methods to identify, measure and mitigate digital asset-related risk.



Most countries and states are still contemplating how to regulate DARBs, including which types/tiers of DARBs should be regulated and by whom



Tier 1A DARBs

Tier 1A DARBs are considered the riskiest because they directly "touch" digital assets and, as such, are the most likely to be licensed, regulated and supervised for AML and counter-terrorist financing purposes. Tier 1A also includes intermediaries "whose activities may increase risks to financial stability." Domestically, the U.S. Securities and Exchange Commission (SEC) describes these intermediaries as those who are "involved with digital asset investment, trading, and safekeeping,"[10] while internationally, the Financial Action Task Force (FATF) refers to them as virtual asset service providers (VASPs)[11] and Markets in Crypto-Assets (MiCA) refers to them as crypto-asset service providers (CASPs).[12] Tier 1A DARBs include, but are not limited to:

- Issuers
- Miners
- Exchanges and trading platforms[13]
- Order-taking and execution
- Custody and administration
- Wallets and ATMs

Tier 1B DARBs

A Tier 1B DARB is a business that either (a) invests directly in digital assets and/or (b) wholly owns, manages and/or controls one or more Tier 1A DARBs. This Tier 1B concept generally aligns with the SEC, which highlights digital asset exchange-traded funds, and CipherTrace, which highlights digital asset hedge funds.[14] Segmenting between Tier 1A "operators" and Tier 1B "owner/investors" is helpful and warranted, even though they are in the same risk tier.

Tier 2 and Tier 3 DARBs

There are thousands of "indirect" or "ancillary" businesses that interact with Tier 1 DARBs but that do not "touch" digital assets and are not expected to be licensed/regulated. Generally, this class of DARBs is excluded from the concepts of FATF's VASP and MiCA's CASP, even though they still pose a high risk of possibly "aiding and abetting" any illicit digital asset activities that they support at their Tier 1 DARB clientele. For this reason, our framework contemplates and defines these as Tier 2 and Tier 3 DARBs.

Tier 2 DARBs are newer, smaller companies generally created specifically to participate in the digital asset economy focused on selling products and services to Tier 1s and generating "substantial" revenue (e.g., greater than 50%) from Tier 1s. A Tier 2 DARB would appear to align with what CipherTrace calls a "Digital Asset Entity," which includes "gambling sites, incubators, and other entities which use [digital assets] but are not classed as financial institutions."[15] Examples of Tier 2 DARBs include, but are not limited to:

- Hardware manufacturers
- Software providers
- Fintechs
- Blockchain developers
- Pre-acquisition special purpose acquisition companies (SPACs)
- Professional services
- Energy providers

Tier 3 DARBs

Tier 3 DARBs are considered the least risky tier and not a "digital asset-related business" in the strictest sense. Like Tier 2s, Tier 3 DARBs are known to have Tier 1 DARBs as customers. However, unlike Tier 2s, Tier 3s are older, larger companies that historically operated outside of the digital asset economy that are not focused on selling products and services to Tier 1s and generate "unsubstantial" revenue (e.g., less than 50%) from Tier 1s. Fundamentally, Tier 3s differentiate from Tier 2s by age, focus and revenue concentration.

Wiggle room

This framework is meant to be flexible and allow for wiggle room so that each FI can adjust it as needed to "take a risk-based approach in assessing individual customer relationships." A few examples might include the following:

- **Increase risk tier:** Although professional services firms known to serve Tier 1 DARBs might be categorized as Tier 3 by default (the lowest risk and "limited risk"), if a large, mature firm develops a focus on digital assets and generates substantial revenue to come from the industry, it could reasonably be categorized as Tier 2.
- **Decrease risk tier:** Although digital asset custody businesses are categorized as Tier 1 by default (the highest risk and possibly "off-limits"), if a large, mature custodian bank begins to provide some digital asset custody services, one expects only incidental revenue from the new line of business; it could reasonably be categorized as Tier 2 or even Tier 3.
- **Add a new risk tier:** In lieu of using this simple three-tiered framework, in which Tier 2 and Tier 3 are differentiated by a single revenue-concentration limit, your institution might consider additional tiers/buckets to account for a sliding scale of revenue to allow for more granularity.

A note about regulation and licensing

Most countries and states are still contemplating how to regulate DARBs, including which types/tiers of DARBs should be regulated and by whom. As such, there are not any clear frameworks for licensing and regulating Tier 1 DARBs, even though Tier 1 DARBs clearly exist and operate. For this reason, whether a particular business is yet duly "licensed" by a national or state regulator is not directly relevant when determining if that business is a DARB.

Conclusion

The goal of this article is not to influence an FI's decision of whether to participate in digital asset-related businesses as an asset class but rather to share a framework for developing comprehensive policies and procedures to consistently and effectively make risk-based decisions regarding DARBs. AT

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[1] CRB Monitor utilizes the term "digital asset" to align with the Biden Administration's, the SEC's and the Congressional Research Service's (CRS) usage. Per the SEC, "The term 'digital asset'... refers to an asset that is issued and transferred using distributed ledger or blockchain technology, including, but not limited to, so-called 'virtual currencies,' 'coins,' and 'tokens.'" Per the CRS, "'Digital assets' are assets issued and transferred using distributed ledger or blockchain technology. They are often referred to as crypto assets, cryptocurrency, or digital tokens, among other terminology." For further information, see "Digital Assets and SEC Regulation," *Congressional Research Service*, June 23, 2021, https://crsreports.congress.gov/product/pdf/R/R46208; "Framework for 'Investment Contract' Analysis of Digital Assets," *U.S. Securities and Exchange Commission*, April 3, 2019, https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets

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