Published on *The National Law Review* https://natlawreview.com

Digital Asset Customer Protections Signed into Texas Law

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Texas Governor Abbott has signed landmark legislation to ensure that digital asset service providers with Texas customers maintain adequate reserves and do not commingle customer funds with corporate assets. Texas Representative Giovani Capriglione and Texas Senator Tan Parker sponsored companion bills that passed the Texas House (HB1666) and the Texas Senate (SB770) with bipartisan support. Governor Abbott signed the legislation on Friday, June 9. The new law, Chapter 160 of the Texas Finance Code, becomes effective on September 1, 2023.[1]

Under the new law, many digital asset service providers with Texas customers must segregate and separately account for customer funds, as well as maintain adequate reserves. Among other things, those platforms cannot:

1. commingle customer funds with funds belonging to the digital asset service provider, except in limited instances,

2. use customer funds of one customer to secure or guarantee the transactions of another customer, or

3. maintain customer funds in a way that a customer cannot fully withdraw its funds.

The new law also requires greater transparency for digital asset customers at least quarterly, as well as an annual "proof-of-reserves" attestation to the Texas Department of Banking within 90 days of the end of the fiscal year and when applying for a new money transmission license in Texas. Additionally, an independent auditor must attest that the report is accurate.

Gavin Fearey, a member of Winstead's Investment Management & Private Funds Industry Group, served on a working group assembled by Texas Blockchain Council, a non-profit industry association working to make Texas a leader in digital assets, to provide input and feedback on the legislation. Mr. Fearey commented:

"Segregating and separately accounting for customer funds are foundational principles in custody and trading of many types of assets in the financial industry. Recent events, such as FTX, remind us how important these principles are, particularly when—for regulatory reasons, investor protection, or otherwise—there is not self-custody of bitcoin and other digital assets. It's been a pleasure to serve

with Lee Bratcher, my colleague Nick Curley and the team on TBC's working group providing input and feedback on HB 1666."

Mr. Fearey has advised investors and businesses in the digital asset space since 2017. He has been a contributor on regulatory policy for the safekeeping of digital assets for:

- the Wall Street Blockchain Alliance's ("***WSBA***") letter to the SEC's Division of Investment Management discussing the custody rule with respect to digital assets in 2022 (available here);
- the WSBA's "Crypto Industry Principles," a publication articulating standards for responsible digital asset and cryptocurrency market participants in 2023 (available here);
- the WSBA's comment to the SEC on the proposed safeguarding rule in 2023 (available here); and
- the letter to SEC staff in the Division of Investment Management on engaging on fund innovation and cryptocurrency-related holdings in 2018 (available here).

Custodians and other digital asset service providers with money transmission licenses in Texas should examine whether their activities are within the scope of the new law and, if so, take the necessary steps to comply with the law's requirements by September 1, 2023. In addition, investment funds and other digital asset customers should examine their custody arrangements with digital asset service providers to ensure compliance with the new law. Below are *Frequently Asked Questions* on the new law.

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[1] The text of the new law appears in the enrolled bill, a copy of which is available here.

Exhibit A

Frequently Asked Questions on new Chapter 160 of the Texas Finance Code
Segregating and Separately Accounting for Customer Funds / Proof-of-Reserves

Chapter 160 of the Texas Finance Code (resulting from companion bills HB1666 and SB770) requires many digital asset service providers operating in Texas to segregate and separately account for customer funds. These companion bills passed in the Texas House and Senate. The enrolled bill was signed into law by Governor Greg Abbott on Friday, June 9, 2023. The law is effective September 1, 2023.

What does the law prohibit? The new law generally requires many digital asset service providers operating in Texas to segregate and separately account for customer funds from the provider's own funds (whether operating capital, proprietary accounts, digital assets, or other property). Specifically, these digital asset service providers are prohibited from (1) commingling customer funds with funds belonging to the digital asset service provider except for limited situations, (2) using the customer funds of one customer to secure or guarantee the transactions of another customer, and (3) maintaining customer funds in a way that a customer cannot fully withdraw its funds.

Where can a customer's digital assets be kept? The law requires digital asset service providers to keep most digital assets that are customer funds in either (1) a separate account for obligations to

each digital asset customer or (2) an omnibus account that only contains digital assets of customers and in which the assets of one customer are not strictly segregated from the assets of another customer. To prevent overlap, this particular requirement does not apply to sovereign currency or other customer funds subject to the requirements of *Chapter 151* or, presumably, its new successor *Chapter 152* (*i.e.*, those within the definition of money or monetary value, which includes certain stablecoins).

What accounting transparency does the law require? The legislation requires the digital asset service provider to create a plan to allow (1) each digital asset customer to view at least a quarterly accounting of any outstanding liabilities owed to the customer and the customer's digital assets held in custody by the digital asset service provider and (2) an auditor to view a pseudonymized version of this information at any time.

What annual reports and attestations are required? Digital asset service providers must file an auditor?attested "proof-of-reserves" report with the Texas Department of Banking within 90 days after the end of the fiscal year and when applying for a new money transmission license. The report must include: (1) the provider's attestation of outstanding liabilities to digital asset customers; (2) evidence of customer assets held by the provider; (3) a copy of the provider's plan to provide accounting transparency to customers at least quarterly; and (4) an attestation by an auditor that the information in the report was true and accurate. The auditor must be an independent certified public accountant licensed in the United States and apply attestation standards adopted by the American Institute of Certified Public Accountants.

To whom does the bill apply? Digital asset service providers subject to the new Texas legislation are (1) electronic platforms which facilitate the trading of digital assets and maintain custody of customer digital assets that (2) are doing business in the state of Texas, (3) hold a money transmission license in Texas and (4) either serve more than 500 digital asset customers in the state or have at least $10 million in customer funds. The law does not apply to banks or entities excluded by rule or by the banking commissioner's order based on a finding that they are not required to hold a money transmission license or not subject to the requirements of the law.

Who administers the new law? The Department of Banking administers the new law. The Finance Commission has rulemaking authority for the new law. The commissioner may examine a digital asset service provider in the same manner as any entity holding a money transmission license under *Chapter 151* (or, presumably, its new successor *Chapter 152*).

What are other exceptions under the new law? The Texas legislation allows certain exceptions to these requirements. Among other things, the commissioner can waive a requirement or permit substituted information if the commissioner determines the waiver or substituted information is consistent with the purpose of the new law and in the best interest of the public. In addition, the digital asset service provider can include its own funds, assets or property with customer funds for the purpose of facilitating trade and operational needs to provide services, but those amounts are considered customer funds and the provider can only withdraw or assert a claim on that amount to the extent it exceeds the amount deposited for or by customers. Further, public companies (*i.e.*, those subject to the Sarbanes-Oxley Act) can meet certain reporting requirements by submitting audits performed in accordance with Sarbanes-Oxley.

What are the remedies or penalties under the new law? Failure to comply with the new law could result in, among other things, the Department of Banking (1) suspending or revoking a money transmission license, or (2) imposing any penalty under *Chapter 151* (or, presumably, its new

successor *Chapter 152*).

When is the new law effective? The new law takes effect on September 1, 2023.

National Law Review, Volume XIII, Number 166