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Federal Embrace Of Crypto Regs Won't Lower State Hurdles

By **Joseph Castelluccio, Justin Herring and Don Irwin** (December 5, 2024, 2:04 PM EST)


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The outcome of the U.S. elections last month, presenting the prospect of a crypto-friendly president and Congress, have unleashed a torrent of enthusiasm that has been building throughout the cryptocurrency sector this year. While there is still a long and winding road to clear, thoughtful and comprehensive crypto regulation in the U.S., there are good reasons to expect more regulatory clarity and more selective enforcement at the federal level.

However, while crypto regulatory reform at the federal level has been the focus of most of the crypto sector's attention, most financial services activity in the U.S. is also regulated at the state level. As a result, U.S. state laws and regulators will continue to play an important role in many digital asset products and markets in the U.S., including the use of cryptocurrencies, tokenization and use of traditional financial assets — such as stablecoins and other real-world crypto-assets — as well as the broader use of distributed ledger and blockchain technology to support financial transactions.

Even if new federal laws are passed to create clearer regulatory frameworks — and crypto antagonists are removed from key federal agency positions — state-level legal and regulatory hurdles to bringing digital asset products and services to the market will remain.

In this article, we discuss the role that state law and regulators will continue to play in digital asset products and markets.

State regulators will continue to have jurisdiction.

In recent years, calls for crypto regulatory clarity have been aimed primarily at the federal regulators that oversee securities, commodities and banking activity. The results of the U.S. elections make it more likely that updates to federal crypto laws and new leadership at federal regulatory agencies will finally deliver sought-after clarity, as well as a less-skeptical view of crypto activities overall.

Even if that occurs, many crypto ventures and businesses developing digital asset products and services must still navigate the state rules that apply to all financial services businesses, such as money transmitters, and crypto-specific rules, like New York's BitLicense regime and California's Digital Financial Assets Law.[1]

For example, financial services companies such as banks, insurance companies, and payments providers that seek to bring digital asset products and services to the market will need to satisfy these state regulators. And when a business engages in digital asset or crypto activity that falls under existing definitions of financial services activities, it will also be regulated under the laws that apply to that activity.

For example, many companies that require a BitLicense in New York also have either a money-services license or a trust license. Those licenses carry a number of obligations that should be considered the baseline requirements for businesses dealing in digital asset products and services in New York; the core requirements for dealing in digital asset products and services are derived from general financial services laws.

Beyond this baseline, in New York, the BitLicense is also required by the New York State Department of Financial Services for businesses conducting virtual currency activities in the state. However, "virtual currency activities" is broadly defined and is intended to be applied to an extensive array of activities in the state. The BitLicense adds heightened general and crypto-specific requirements, and existing supervision or registration with a federal authority generally will not exempt a company from the requirement to obtain a BitLicense if it is conducting virtual currency activities.

State regulators, such as those in New York and California, oversee some of the most significant financial markets and financial institutions in the world, and they will continue to have a strong interest in regulating crypto. Despite what happens at the federal level, the interests and outlooks of those regulators may not always align. For example, blue-state regulators may react to Republican control of the White House and Congress by stepping up their own rulemaking and oversight in areas where they have jurisdiction.

State law issues remain unresolved.

Important state law issues that affect the digital asset sector — such as laws related to property ownership and legal liabilities — will not be addressed by changes to federal laws.

For example, "not your keys, not your crypto" continues to be an accurate yet unsatisfying description of property laws as they generally apply to digital asset ownership in the U.S. The phrase is often used to highlight risks associated with centralized custody of digital assets, and the lack of recourse that "owners" of those assets may have if access or control of the assets are lost, should the custodian of the assets get hacked or become insolvent. This legal uncertainty will not be affected by any changes to the federal regulatory framework.

In addition, the legal status of decentralized autonomous organizations, or DAOs, in the U.S. remains unclear — and the subject of litigation. Despite DAO-specific laws being passed in states such as Wyoming and Delaware, most DAOs have declined to create formal legal entities under these laws to seek the formal legal protections that these laws may provide.

While many DAOs choose instead to form legal wrapper entities offshore, many do not, choosing to operate without any generally recognized legal entity structure. As a result, DAO members — or token holders who participated in governance — can potentially be exposed to broad liability for the DAO's actions. For example, courts have found DAOs to be general partnerships under state law, with each member in the DAO deemed to be a general partner of the DAO and therefore fully liable for its actions.

However, the work to modernize state law to address some of this uncertainty has begun apart from, and unrelated to, federal regulatory regimes.

For example, the 2022 amendments to the Uniform Commercial Code added Article 12 to address both blockchain and distributed ledger technologies more broadly. The Article 12 amendments are designed to provide consistent legal treatment for digital assets and blockchain records by, for instance, establishing definitions and rules around control of electronic records — i.e., cryptographic keys — and transfer of interests. So far, Article 12 has been enacted by 25 states, with bills introduced in five further state legislatures as of November.[2]

Key Takeaways

The evolution of state laws on digital assets — both cryptocurrencies and tokenization, as well as other uses of blockchain technology — will continue on a parallel, but unrelated, track from federal regulatory updates in this area. As a result, the interaction between state law and any new federal laws and regulations should remain a focus of companies building products and services in this space.

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[1] California's Digital Financial Assets Law, originally scheduled to go into effect in 2025, is now scheduled to become effective July 1, 2026.

[2] The New York City Bar Association published a committee report, reissued in July 2024, in support of New York State adopting the Article 12 amendments.