

Digital Currency Innovation Lab Report

December 2022

By Hawaii Division of Financial Institutions

Executive Summary

The report highlights (1) the purpose and history of the Digital Currency Innovation Lab; (2) the process and data from the participating companies; and (3) recommend solutions for the digital currency industry.

The Digital Currency Innovation Lab (“DCIL”) was a two-year research project created by the Commissioner of Financial Institutions, Division of Financial Institutions (“HDFI”) using the authority found in Hawaii Revised Statutes Chapters 412 and 489D. The commissioner forged a partnership with the Hawaii Technology Development Corporation (“HTDC”) to launch the DCIL in 2020.

The DCIL invited digital currency companies who would ordinarily be required to get licensed as a money transmitter in order to conduct transaction activity. The DCIL had two cohorts of participants who shared information and reviewed various drafts of legislation.

At the end of the first year of the DCIL, the HDFI and HTDC offered a digital currency licensure scheme to the legislature as the HDFI concluded the digital currency transactions did not fit into the money transmitter law envisioned by HRS 489D. The legislation would have allowed HDFI to license, supervise, examine, and investigate digital currency companies in order to provide consumer protection. The legislation did not pass out of the legislature.

Although the legislature did not provide funding to continue the DCIL, the HDFI and HTDC extended the DCIL for two years due to the number of Hawaii consumers who had accounts with the participating companies in the DCIL.

At the end of the 2020 DCIL, the HDFI continues to conclude some consumers do not understand the volatility of this industry or that consumers can lose all of their funds if companies declare bankruptcy. The HDFI stated in testimony that digital currency is not money transmission as envisioned by HRS 489D. Nationwide, states continue to use the money transmitter laws to license or exempt digital currency company activity. The HDFI believes consumers would benefit from education about digital currency transactions and from clear disclosures about potential losses.

Background

What is the Digital Currency Innovation Lab?

The Digital Currency Innovation Lab (“DCIL”) was created by the Division of Financial Institutions, Department of Commerce and Consumer Affairs as a research project authorized by Hawaii Revised Statutes (“HRS”) Chapters 412 and 489D. These statutes allowed the Commissioner of Financial Institutions to conduct research into products and services which may affect financial services. There was no clear pathway and no state or federal study to help determine the nature of these transactions and whether there was consumer harm.

In particular HRS, Chapter 489D, allowed for licensure of companies conducting money transmissions. Money transmission is defined as

"Money transmission" means to engage in the business of:

(1) Selling or issuing payment instruments; or

(2) Receiving money or monetary value for transmission to a location within or outside the United States by any and all means, including wire, facsimile, or electronic transfer.

. . . (emphasis added)¹

"Monetary value" means a medium of exchange, whether or not redeemable in money. (emphasis added)²

Nationwide, states used the money transmitter laws to license, supervise, or exempt from licensure, digital currency companies. In 2014, HDFI issued a warning to Hawaii consumers about the use of Bitcoin, stating that these transactions were covered by Hawaii’s money transmitter law. Like other states, Hawaii’s law allowed for the licensure of digital currency companies in order to conduct transmission activities as monetary value. Digital currency companies were unable to continue to meet the licensing requirements due to the volatile valuation of digital currency, lack of bonding instruments and the inability to create trust accounts for customer funds.

The HDFI introduced bills to the legislature since 2015 in order to either exempt digital currency activity from the money transmitter law or allow for the licensure of digital currency companies with amendments to the money transmitter law. The laws did not

¹ HRS, 489D-4

² HRS, 489D-4

pass out of the legislature. Further, there was interest by digital currency companies and consumers to have the laws changed allowing for digital currency transactions.

By 2019, there was growing pressure from the industry and consumers about the lack of ability to legally transmit digital currency. The Commissioner decided to conduct a research project to determine (1) whether the money transmitter law was appropriate to license digital currency companies; (2) whether there were any consumer protection issues or concerns; and (3) whether digital currency companies should be licensed and what the license requirements should be to protect consumers.

The Commissioner found the Hawaii Technology Development Corporation (“HTDC”) as a partner who embraced innovation and economic development. This Digital Currency Innovation Lab (“DCIL”) provides the implementation of the research project by HHDFI and HTDC. The DCIL is the first of its kind in the nation, created specifically by the agency. HHDFI notes other states have other sandbox programs, but not specifically studying digital currency companies and created by the legislature.

The synergy between regulatory compliance and economic development would made this partnership successful. HTDC became the face of the research project interacting directly with the companies and consumers by providing information on their website, providing educational webinars, and assisting in arranging roundtable discussions with industry and consumers, as well as other stakeholders.

During the two-year period of participation, the participating companies committed to providing key metrics specified by HDFI. The data collected will be instrumental in developing determining whether local legislation around digital currency while laying the groundwork for the next phase of this pilot program is needed for consumer protection.

Who is HDFI?

Through licensing, supervision, and examinations, HDFI ensures the safety and soundness of state-chartered and state-licensed financial institutions, and ensures regulatory compliance by state-licensed chartered banks, credit unions and trust companies as well as state-licensed escrow depositories, money transmitters, mortgage servicers, mortgage loan originators and mortgage loan originator companies and installment lenders.

Use the CRF

Safety and soundness include maintaining public confidence in the banking financial institution system, identifying undue risks and weak risk management practices,

identifying the cause and severity of problems at individual banks and emerging risks in the broader financial-services industries.

2) Regulatory compliance includes assessing the quality of a bank's compliance management system, reviewing compliance with relevant consumer protection laws and regulations, reviewing the compliance posture, and reviewing the way customer complaints are handled by of newly chartered and licensed institutions.

Who is HTDC?

HTDC's purpose is to:

- 1) Facilitate the growth and development of commercial technologies in Hawaii;
- 2) Develop projects, collect, and analyze information on the state of commercial technology activity in Hawaii (including financial technologies);
- 3) Promote Hawaii as a site for commercial technology activities (including financial technology activities) and provide advice on policies and planning for technology-based economic development;
- 4) Create an environment to support technological economic development by supporting all aspects of technology-based economic development; and
- 5) Develop programs that support start-up and existing technology companies in Hawaii and coordinate efforts with other public agencies involved in stimulating technology-based economic development in Hawaii.

The role of the agencies.

The partnership between HDFI and HTDC offered an opportunity to work together to study digital currency transaction activity in the DCIL. HDFI would track, collect data, and generally oversee activity conducted by the participants in the DCIL and the digital currency transaction activity would be available to consumers for a limited time period. If the companies agreed to the terms set by HDFI, the Commissioner would take no action on any money transmission activity using digital currency provided that the participants are compliant with the DCIL guidelines and limitations, and the Commissioner would allow the digital currency transactions which could otherwise be considered unlicensed activity under HRS Chapter 489D.

HTDC was the face of the research program. HTDC provided information on its website about digital currency, arranged webinars for consumers and industry, assisted in roundtable discussions with consumers and industry and other stakeholders, and provided the communication channel with participants, applicants, and consumers.

Application process

Cohort 1

The two-year DCIL initiative began accepting applications (See Appendix 1) in March 2020 and received submissions from 19 companies. Following a comprehensive review, 12 participants who fulfilled the conditions to provide their services in the state were selected to join the program. These companies include: Apex Crypto, bitFlyer USA, BlockFi Trading, CEX.IO, Cloud Nalu, Coinme, ErisX, Flexa Network, Gemini Trust Company, Novi Financial, River Financial and Robinhood Crypto. The cohort included start-ups, a local company, and established companies.

Cohort 2

In June 2021, four new U.S.- based digital currency companies were admitted into the DCIL. The second cohort was limited to companies who were already established, unlike Cohort 1. The second cohort included: BitStop, Provenance Technologies, SoFi and Uphold.

Guardrails for digital currency activity

Certain guardrails regarding digital currency activity exist for companies to participate in the DCIL. These included the following:

- 1) A company remains “subject to all criminal and consumer protection laws,” including the Consumer Protection Act which prohibits deceptive and certain other practices.
- 2) Federal laws may apply irrespective of whether a participant is in the Sandbox.
- 3) State business license and tax laws may apply.
- 4) Sandbox participants must agree to cooperate with HHDFI in determining the necessary level of supervision and examination of the participant, as well as the appropriate licensing for the company once the trial period is completed.

5) Sandbox participants ultimately are responsible for compliance with all applicable federal and state laws and should consult with counsel as necessary to ensure compliance.

In addition, companies were required to provide written disclosures (“The virtual currency or digital currency invested or used for purchase may not retain its value and may lose value, including loss of the principal.”)

Companies were also required to provide the following descriptions:

- 1) Describe the innovative product or service
- 2) Describe how consumers will benefit and how the product is different from already available products.
- 3) Describe risks to consumers who purchase or use the product or service, and how an injured consumer will be made whole.
- 4) Describe procedures for ending the program when the sandbox time period concludes as it affects consumers who participated in the sandbox VC transactions.

Ongoing Supervision

In addition, ongoing supervision efforts included providing a report every quarter to HDFI regarding the following key metrics:

- 1) Total number of Hawaii customers
- 2) Number of accounts opened for Hawaii customers during the period
- 3) Number of stored value accounts opened for Hawaii customers during the period
- 4) Number of accounts of Hawaii customers closed during the period
- 5) Number of transactions processed for Hawaii customers during the period
- 6) Total dollar value of transactions processed for Hawaii customers during the period
- 7) Type(s) of digital currency transacted for Hawaii customers
- 8) Did the participant experience any system outages or data breaches during the period?
- 9) Number of complaints received during the period

10) Any issued or pending regulatory enforcement actions? If yes, provide an explanation.

DCIL Website and Quarterly statistics

The statistics were posted on HTDC's website. HTDC was the face of the DCIL and was able to create a website for consumers and participants to get information.

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There are a total of 10 cryptocurrency-based companies in the DCIL, ranging from exchanges to brokerages, payment platforms and ATM networks.

For the full list, click [HERE](#).



To re-watch past DCIL Webinars, visit [HERE](#).



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Short Recap of the DCIL Program
[Presented at the DCIL 2.0 Meet-Up]

[View Online](#)

March 2020 – August 2021

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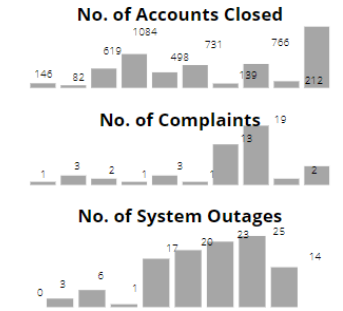
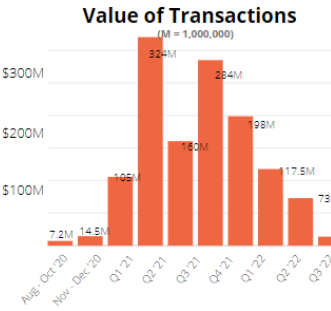
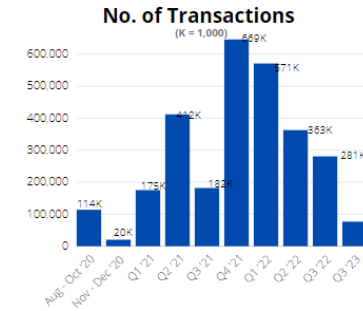
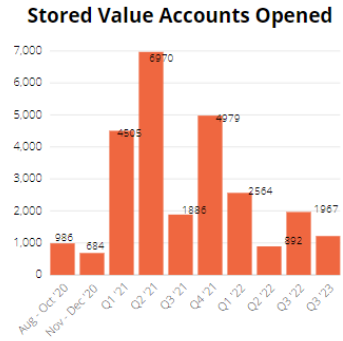
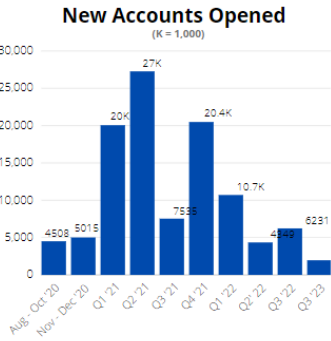
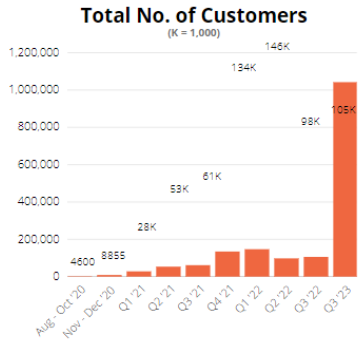


Stay tuned for upcoming community engagement opportunities!



A Snapshot of Digital Currency Activity
[Customers in Hawaii]

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For any press or media queries, please contact us at fintech@htdc.org

- March 17, 2020 – Hawaii launches first sandbox for digital currency
- August 19, 2020 – Hawaii digital currency sandbox announces first cohort of participants
- January 25, 2021 – Hawaii’s digital currency sandbox seeking to expand the playing field
- May 12, 2021 – Bypassing the bitcoin blockade (Hawaii Business Magazine)
- May 24, 2021 – Interview with Commissioner Iris Ikeda (Radio Show “Play it Safe at 6”)
- June 18, 2021 – Hawaii’s digital currency lab announces second cohort of participants
- July 21, 2021 – Bytemarks Cafe: The Digital Currency Sandbox and Cryptocurrency
- October 20, 2021 – Hawaii’s DCIL Announces “NFT For Good” Initiative
- November 1, 2021 – Capitol Connection: ‘NFT For Good’ to Benefit Local Artists, Community
- November 3, 2021 – KITV4: Local mural artists to sell their colorful creations as NFTs
- November 17, 2021 – Bytemarks Cafe: Artwork & NFTs (Hawaii Public Radio | Start at 7:37)
- November 22, 2021 – Hawaii’s top bank regulator looks to pave the way for crypto acceptance in the Islands (Spectrum News)
- June 2, 2022 – State of Hawaii’s Digital Currency Innovation Lab extended to June 30, 2024
- July 11, 2022 – 11 Companies Continue in State of Hawaii’s Digital Currency Innovation Lab




Check out our [list of FAQs!](#)

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Findings and Observations

HDFI findings and observations arise from several sources, primarily including: 1) The HDFI Roundtable with DCIL participants, 2) Trends identified over several quarters of reporting data and metrics submitted by the DCIL participants, as well as 3) Ongoing supervision / Communications with DCIL participants during the course of the DCIL program

Roundtable with DCIL Participants on June 22, 2021

The main purpose of the June forum hosted by the HDFI Commissioner was to solicit participant input regarding regulating digital currency services and activities. The discussion revolved around regulatory structure / scheme, consumer protection, and distinctions between the different types of digital currency activities.

The following overall key themes and perspectives from the industry emerged:

1) DCIL participants viewed regulatory oversight as a positive and particularly needed in the areas of exchange and custody- companies broadly intend to comply with set rules and regulations

2) Money transmitter laws are not good a fit for this industry when considering the diversity of all types of digital currency activity. In terms of regulation, there is a need to determine what type of activity the company is conducting. Trying to apply traditional finance rules is not possible, and regulations need to be built so as not to force a company into a particular technology given that technology changes and an alternative that is better may be available in the future.

3) Ongoing education about the nature of the digital currency business for both consumers and regulators should be a priority.

4) Cooperative multi-state examinations would be preferred to lessen the burden on companies

5) Preference for tiered renewal fees to enable start-ups to operate as opposed to a flat fee which could be considered cost prohibitive

Reporting trends

Trends of significant amount of activity continue to be reported in the DCIL as reflected by the account and transactional data across the participants. At one of the peak quarterly periods, more than \$324 million in transactions were recorded over the three-month time frame, with over 27,000 customer accounts opened in Hawaii. Also notable is the increasing diversity in the types of digital currencies being transacted (currently over 60 different types of digital currencies reported by DCIL participants). In the latest

September 2021 report, the total number of Hawaii customers being accounted for amounts to over 60,000.

Ongoing Supervision / Communications with DCIL participants during the course of the DCIL program – Changes in senior management

Ongoing supervision of the DCIL participants reflected a recurring theme of frequent changes in senior management / executives and key personnel within the companies. This has highlighted the presence of heightened volatility and turnover experienced in the digital currency industry vis a vis other financial sectors, and presents a challenge in terms of ongoing supervision and communication. Changes in ownership were also observed amongst the DCIL participants as well.

Recommendations

Currently, the Division of Financial Institutions and the Hawaii Technology Development Corporation (HTDC) are conducting a two-year "sandbox" program to study digital currency transactions (Digital Currency Innovation Lab or DCIL) to close December 31, 2022. The HDFI intends to either supervise this evolving industry or determine that the money transmitter law is not applicable for this activity.

This study allows companies to conduct digital currency transactions without obtaining a money transmitter license while the Division of Financial Institutions evaluates the need for more permanent and comprehensive oversight. Prior to the study, HDFI determined that the digital currency activity fit into the definition of money transmission and that the money transmission law applied to any company.

The data, findings and observations gathered through the DCIL program confirmed that digital currency transactions are not optimally regulated through existing money transmitter laws and that a new regulatory framework is appropriate. A licensing program for regulation and oversight of digital currency companies to replace the DCIL is recommended, specifically proposed under the Special Purpose Digital Currency Licensing Act, to be added as a new chapter to the Hawaii Revised Statutes. Such regulatory oversight would require the need for specialized staff with the technical expertise to regulate digital currency companies.

Going forward, HDFI will support the legislative initiative to license the digital currency companies to conduct activity. The legislative initiative will provide similar requirements as is present in the DCIL sandbox, regulating the companies to confirm the companies have the experience and skill set to operate the company and have adequate capital and liquidity to operate the company. Testimony will clearly state this digital currency activity is not money transmission as we have determined in the DCIL.

Other alternatives to licensure include allowing for unregulated activity, specifically exempting the activity from money transmission laws or allowing for unlicensed activity. Other states have taken any one of these alternative pathways to address digital currency activity. To date, there is not a majority of states taking a particular pathway or guidance for digital currency companies.