PAXOS

4 Areas to Consider When Adding Crypto to Your Application

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An increasing number of mainstream financial services companies see adding crypto to their platforms as a strategic business opportunity, due in large part to enormous consumer demand. People are eager to buy, sell, transfer and make payments in crypto—evidenced by the million people who signed up for Robinhood's waitlist when it launched its crypto offering.[1] There's also interest in more niche crypto services, such as lending for interest or earning interest on owned crypto assets.

Mobilizing to meet that demand can help your company build consistent new revenue streams at a low cost, expand top-of-funnel market reach beyond your core segments and increase share-of-wallet with your existing customers. But to power crypto capabilities securely and cost-effectively, you need a clear strategy for regulation and tech to support crypto features.

The end goal is for your users to transact seamlessly with crypto, but a lot needs to happen behind the scenes to make that happen. These are the four main areas to carefully think through:

1. Licensing
2. Compliance
3. Custody
4. Liquidity

User Experience

Offer crypto capabilities to your users

Licensing

Meet the right money transmission regulations to ensure customer funds are handled appropriately

Compliance

Meet the right regulatory & compliance standards to buy & sell crypto

Custody

Store your users' assets and cryptographic keys in secure solutions

Liquidity

Use a network of liquidity providers to ensure your users get the best price when purchasing crypto

1 Cheng, E. "More than 1 million people sign up for early access to Robinhood's new crypto trading service." CNBC. cnb.cx/3pP5Cgz

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Licensing

In the US, crypto services are governed by federal and state money transmission laws and regulations, with the state laws generally focused on consumer protection to ensure that customer funds are handled appropriately.

Companies that provide crypto services must generally obtain state licensure, which can happen in three ways:

Money Transmitter Licenses (MTLs): MTLs regulate money movement but not the custody of funds. They have to be obtained on a state-by-state basis, which is onerous, but since their compliance requirements are far less stringent than the alternatives', some companies prefer this route.

BitLicense: The New York State Department of Finance created this unique license in 2015 to regulate businesses that provide crypto services but don't otherwise want or need MTLs or Trust company charters. A BitLicense is easier to obtain than a Trust charter, with less stringent requirements.

Trust Charter: New York State allows companies to engage in virtual currency activity via a limited purpose Trust charter, which is recognized in every US state and encompasses (but isn't limited to) cryptocurrency. Trust charters are the highest standard for regulatory licensing, offering the safest, most comprehensive coverage for not only buying and selling, but also storing (or custodying) crypto. Trust companies are qualified custodians of client funds and have escrow and custodial trust services. They're also regulated by the New York State Department of Finance.

The nuances of a licensing strategy have a direct impact on user experience. For example, Robinhood users in Nevada, West Virginia and Hawaii can't trade crypto because the company doesn't have money transmitter licenses in those states. Partnering with a Trust company is the preferred approach for many organizations because it helps them avoid the patchwork of state-by-state MTL requirements.

	Trust Company	Money Transmitter License (MTL)	BitLicense
Operate a digital asset exchange	**Yes**	**No** Exchange is state by state licensure	**Yes**
Recognized in every US state	**Yes** Plus ability to set up international branches	**Depends** MTL is state by state licensure	**No**
Qualified custodian of client funds (fiat and digital asset)	**Yes**	**No** MTL only allows for movement of client funds	**No**
Escrow and custodial trust services	**Yes**	**No**	**No**

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Compliance

In addition to having the right licensing in place to transact in crypto, there are ongoing compliance requirements to meet as well. Specifically, you will need to consider federal laws and regulations like the Bank Secrecy Act, which are designed to prevent money laundering, terrorism funding and other illicit activity. These laws require banks and money services businesses (including those dealing in crypto) to file certain reports, such as Suspicious Activity Reports or “SARs,” and maintain robust anti-money laundering compliance programs.

Here are the two main compliance standards:

- **Know Your Customer (KYC)** data collection for user onboarding
- **Ongoing Transaction Monitoring** to detect money laundering and high-risk activity, such as OFAC-sanctioned addresses, darknet markets, fraud and anomalous transactions

KYC controls require that you collect and maintain certain information about customers, such as names and addresses, to identify potential bad actors and keep them from abusing the financial system. Specifically, information collected during onboarding can be used to verify the account holder’s identity and confirm that the account’s funding source is legitimate.

After your customers are onboarded, you must continuously monitor activity and transactions for signs of money laundering, terrorism funding or other financial crimes. If you don’t have the capabilities to do this in-house, you need to engage a partner to help.

Unlike cash, which is nearly impossible to trace, there are tools leveraging blockchain technology to track the use—and users—of crypto. For example, Paxos uses a tool called Chainalysis to identify wallet addresses associated with bad actors and track movement of crypto to those wallets, even if it passes through other locations first.

Custody

When you enable crypto trading on your platform, you need to understand who is holding the crypto assets and ensure that customer assets are stored (or "custodied") as securely as possible. You also need to consider how users' keys—the mechanism for accessing crypto assets—will be stored, in "cold" or "hot" wallets.

Cold wallets are used to custody crypto offline in a physically secure location that can't be accessed through the internet. Withdrawals are slower, since they're processed manually in batch loads. Conversely, hot wallets are online, and transactions are executed automatically through secure Multi-Party Computation (MPC) algorithms. Because hot wallets are online, they are considered more vulnerable to hacks and theft than cold storage methods, and as a result, often have their value capped.

If crypto is held in a cold wallet, only select personnel with physical access can process it while following stringent procedures, whereas hot wallets allow for immediate withdrawals. For example, if someone buys $100 of BTC on a retail exchange and wants to withdraw it, it's likely to be processed immediately via a hot wallet. If the amount is $1 million of BTC, it's likely to be processed a few hours later in a cold transaction. Most exchanges use a mix of cold and hot wallet processes.

Cold Wallets

Fully offline (air-gapped)
Physically secure location
Slow; periodic batch procedures
Used for:
Minting and burning
Large customer withdrawals

Hot Wallets

Online processing through Multi-Party Computation (MPC)
Capped value in wallet
Real-time processing
Used for:
Customer withdrawals

When looking for a company to custody your customers' crypto assets, the safest and most secure option is a regulated Trust company. A regulated Trust company such as Paxos (which uses a combination of cold and hot wallets) provides the highest standard for custody for three reasons. First, Trusts are qualified custodians and as such are legally obligated to safely hold cash, crypto, securities and commodities on behalf of customers. Second, customer assets custodied by Trust companies are bankruptcy remote, meaning they're held independently of the company's operations and protected from bankruptcy proceedings. Finally, since assets are held in FDIC-insured bank accounts or US government-guaranteed instruments, their value is guaranteed.

A regulated Trust Company is the gold standard for custody

QUALIFIED CUSTODIAN	BANKRUPTCY REMOTE	INSURED OR GUARANTEED
Approved to custody assets like cash, crypto, securities and commodities	Client assets are fully bankruptcy remote	Held in FDIC-insured bank accounts or in US government-guaranteed instruments

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Liquidity

The last key consideration when adding crypto to your platform or app is liquidity. Companies wanting to add crypto to their apps will require access to a marketplace where people can buy and sell crypto assets. Since getting the best price is the most important aspect of customer experience for many crypto users, access to liquid markets is crucial.

To vet partners through this lens, you should consider six parameters:

- **Liquidity Providers:** An exchange partner should have a lineup of providers (i.e., institutions and large companies) depositing assets into the exchange to help build ample liquidity and small spreads. This guarantees a good experience for end users.
- **Site Reliability and Uptime:** Crypto is compelling because it's 24/7, so any exchange needs to have always-on capabilities and a strong history of few outages and close to 100% uptime.
- **Institutional Grade:** Does the exchange have enterprise-grade software that can support onboarding a large number of new end users?
- **Counterparty Risk:** To eliminate the risk of a counterparty defaulting on a trade, trades should be pre-funded and settled immediately.
- **Redundancy:** A failover plan should be in place for when the platform has an issue.
- **Regulatory Status:** Does the exchange support users in all 50 states (what about international markets?) Since crypto is treated differently in different states, you'll need to choose an exchange with all the relevant licenses to support your customer base.

Conclusion

Adding crypto to your applications lets your customers access a growing cryptocurrency market worth more than $1 trillion, which in turn can help you build new revenue streams, acquire new customers and deepen relationships with existing customers. This is no easy matter, however, and there are many considerations that will impact the success of your endeavor. To get crypto right for your business, it's essential to find a partner with the right licenses to support your customer base and a strong compliance program, as well as qualified custodian status to store crypto assets and deep liquidity to provide the best prices and a seamless user experience.

Interested in adding crypto to your application? Get in touch now to learn more about your options.