How Fed's Crypto Denial Fits Into Broad Regulatory Movement

By **Moorari Shah, A.J. Dhaliwal and Matt Benz** (March 6, 2023)

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The crypto-asset sector has been in the crosshairs of federal banking regulators for several years. Rarely does a week go by without a statement or speech laying out the expectations or road maps for planned crypto-asset regulation.

Still, regulators have been playing a game of catch-up as the total market capitalization of crypto-assets grew to exceed $2.5 trillion by fall of 2021.[1] And while the regulators purported to forecast their priorities for crypto-assets, they took little concrete action to implement any planned regulations.

Shortly after, regulators were largely left scrambling without a concrete plan of action after the recent string of high-profile crypto bankruptcies began to domino in the summer of 2022.

A tumultuous 2022 for crypto has reignited concerns regarding the safety and soundness of crypto-assets across the regulatory landscape. The recent flurry of regulatory activity across agencies and jurisdictions appears more coordinated and determined to rein in the crypto-assets sector to prevent risks from migrating to other parts of the financial system.

What the fruits of this regulatory focus will look like, and what the downstream impacts will be, remains to be seen. Nevertheless, the words of regulators in recent months provide insight into what such a regulatory framework may look like, and the increase in regulatory actions forecasts what the corresponding impacts may be on banking organizations.

In particular, the Federal Reserve Board of Governors' recent denial of a crypto firm's application to become a member of the Federal Reserve System offers a distilled view into how regulators are likely to approach the intersection of banking and crypto-assets in the coming months.

Words

Prudential Banking Regulators

As early as November 2021, the Fed, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency issued joint statements about developing a crypto-asset road map and plans to provide greater clarity on whether certain crypto-asset banking activities, such as facilitating customer purchases and sales of crypto-assets, were legally permissible.[2]

The OCC also issued Interpretive Letter No. 1179 requiring national banks and savings institutions to notify the OCC of intent to engage in certain crypto activities and receive a letter of nonobjection in return from the agency.

On Jan. 3, the Fed, FDIC and OCC issued a joint statement expressing significant safety and soundness concerns associated with crypto-assets and advising caution due to the various risks that such assets pose to banking organizations that engage in cryptocurrency-related services.[3]

Among the key risks, the regulators flagged legal uncertainties related to custody practices, redemptions, and ownership rights, and contagion and concentration risks within the crypto-asset sector resulting from interconnections among certain crypto-asset participants. The regulators expressed a commitment to ensuring that risks associated with the crypto-asset sector do not migrate to the banking system.

Most recently, on Feb. 23, the Fed, FDIC and OCC issued another joint statement highlighting several significant liquidity risks that crypto-assets and participants in the crypto-asset sector pose to banking organizations due to the unpredictable scale and timing of crypto deposit inflows and outflows.[4]

Specifically, the regulators noted various risks associated with deposits that constitute stablecoin-related reserves and deposits placed by a crypto company that are for the benefit of the crypto company's customers. The stability of such deposits, the regulators explained, hinges on volatile customer behavior and crypto-asset market dynamics rather than the banking organization's direct counterparty.

More broadly, the regulators cautioned banking organizations against concentrating deposit funding bases in crypto-assets or related entities that share similar risk profiles. The regulators advised banking organizations to establish and maintain effective risk management and controls commensurate with the level of liquidity risks posed by deposits of this nature.

White House

The executive branch has been similarly vocal regarding the need to regulate crypto-assets.

In March 2022, President Joe Biden issued Executive Order 14067 that called on federal agencies to examine the risks and benefits of cryptocurrencies.[5] This directive focused on six particular areas of investigation: consumer and investor protection, financial stability, illicit activity, U.S. competitiveness on a global stage, financial inclusion, and responsible innovation.

In September 2022, President Biden followed up by issuing a framework for governance of the digital asset ecosystem, which advocated for a whole-of-government approach to regulating the industry.[6]

More recently, on Jan. 27, the Biden administration presented a road map for mitigating cryptocurrency risks to ensure that cryptocurrencies do not undermine financial stability, investors are protected and bad actors are held accountable.[7] On the same day, the Fed issued a policy statement to promote a level playing field for all banks with a federal supervisor, regardless of deposit insurance status.

The statement makes clear that uninsured and insured banks supervised by the board will be subject to the same limitations on activities, including novel banking activities, such as crypto-asset-related activities.

Actions

FRB

On Jan. 27, the Fed announced that it unanimously voted to deny a Wyoming-based crypto firm's application to become a member of the Federal Reserve System.[8] This denial ended Custodia Bank's effort to obtain a master account, which allows companies to move money through the Federal Reserve System without using a federally insured bank.

While not federally insured, the crypto firm holds a state charter and operates as a special purpose depository institution offering a variety of financial services for both U.S. dollars and digital assets, including banking services, custody services and escrow services.

The crypto firm markets its services as tailored to business customers who transact with digital assets and are seeking enhanced regulatory clarity with minimized transactional risk, bridging the gap between traditional finance and crypto.

Despite the crypto firm's marketed emphasis on maintaining regulatory compliance, the Fed ultimately determined that the firm's application was inconsistent with the legal prerequisites for obtaining a master account.

In providing its reasoning, the Fed noted that the firm's novel business model and proposed focus on crypto-assets presented significant safety and soundness risks, including its proposal to issue crypto-assets on open, public and decentralized networks.

The Fed also stated that the crypto firm's risk management framework was insufficient to address concerns regarding the heightened risks associated with its proposed crypto activities.

Shortly after the Fed's denial, the Federal Reserve Bank of Kansas City also denied Custodia Bank's pending application for a master account. And on Feb. 23, the Fed doubled down, announcing that it again rejected the crypto firm's request for reconsideration of the application denial.[9]

The crypto firm has since filed a lawsuit against the Fed Board and the Kansas City Fed in the U.S. District Court for the District of Wyoming challenging its application denial, and the case remains pending.

FDIC

After issuing an advisory in 2022 about certain misrepresentations about FDIC deposit insurance made by some crypto companies,[10] on Feb. 15, the FDIC sent letters to four entities demanding that they stop making false or misleading representations about FDIC deposit insurance.[11]

Letters were sent to cryptocurrency exchange CEX.IO Corp., nonbank financial services provider Zera Financial, and two websites, Captainaltcoin.com and Banklesstimes.com, demanding that they cease and desist from making allegedly false and misleading statements about FDIC deposit insurance and take immediate corrective action to address these statements.

OCC

In addition, the OCC continues to receive interest from crypto companies seeking national trust bank charters, similar to the ones issued during the prior administration. Based on recent actions, it would appear that an application's likelihood of success is tenuous at best.

SEC

Other federal agencies have similarly taken concrete action to regulate companies operating in the crypto-asset space.

On Feb. 9, the U.S. Securities and Exchange Commission filed a complaint[12] against Payward Ventures Inc. a cryptocurrency exchange doing business as Kraken, for failing to register the offer and sale of their crypto-asset service staking-as-a-service program.

On Feb. 15, the SEC announced that it voted to propose a new rule[13] that would bring sweeping changes to federal regulations that would expand custody rules to include assets like crypto and require companies to gain or maintain registration in order to hold those customer assets.

If enacted, the rule would also expand the definition of "asset class" under the Investment Advisers Act of 1940 to include crypto-assets that are not traditionally categorized as funds or securities.

Congress

Recent congressional actions are in line with the broader government movement on crypto. In June 2022, Sens. Cynthia Lummis, R-Wyo., and Kristen Gilibrand, D-N.Y., introduced a bill to Congress that seeks to extend a comprehensive set of regulations across the crypto-asset sector.

The bill would set new federal law for stablecoins and taxes on small-scale crypto transactions, and provide clear jurisdiction to federal regulators to establish further rules aimed at ensuring the safety and soundness of crypto-assets. The bill, titled the Responsible Financial Innovation Act, will likely be split into several pieces as it winds its way through congressional committees throughout the next year.

On Feb. 14, the Senate Banking Committee held a hearing titled "Crypto Crash: Why Financial System Safeguards are Needed for Digital Assets," focused on digital asset regulation. The hearing focused on the impact of FTX Trading Ltd.'s collapse on the crypto market, how regulators have approached the industry and what Congress can do to provide regulatory clarity.

While the committee and the witnesses offered differing viewpoints concerning the digital asset market, all participants were focused on consumer protection as a singular theme.

States

State regulatory authorities have also ramped up enforcement actions targeting crypto companies. On Jan. 26, the California Department of Financial Protection and Innovation announced its participation in a $22.5 million multistate settlement with Nexo Inc., a Cayman Islands digital asset firm, to resolve a securities enforcement action in connection with the platform's earn interest product. [14]

On Jan. 23, the New York Department of Financial Services released updated guidance aimed at protecting consumers in the event of virtual currency insolvency.[15] The updated guidance set forth several new requirements for companies operating as custodians of crypto-assets, including segregating customer funds, mandatory sub-custody agreements where third parties are involved and enhanced disclosure requirements.

Takeaways

In short, federal and state agencies appear primed to continue their march on crypto-assets and inch closer every day to implementing the comprehensive regulatory framework that authorities have long been advocating for.

As evidenced by the Fed's recent membership denial, even crypto firms that bend over backward to comply with existing regulations have an uphill battle to win regulatory approval. Based on the Fed's denial, and the other recent words and actions of regulators, it is apparent that several areas of the crypto-asset sector are likely to draw particularized scrutiny in the near term.

Banking Activities

The Fed, OCC and FDIC have publicly represented their joint belief that issuing or holding as principal crypto-assets that are issued, stored or transferred on an open, public and/or decentralized network or similar system is highly likely to be inconsistent with safe and sound banking practices.

For example, as the Fed detailed in the recent membership denial, the inherent anonymity associated with blockchain-based assets renders traditional risk management frameworks unable to adequately detect money laundering and terrorism activities. The Fed denial indicates that even state-chartered depository institutions have an elevated burden of proof where their business models involve crypto-assets.

What was once skepticism regarding the logistics of integrating digital assets into the national banking system has hardened into a firm presumption that the two are, at present, incompatible. The perception that digital assets broadly pose safety and soundness risks will likely serve as the predicate for further regulation aimed at cordoning digital assets off from the national banking system.

Banking organizations engaged with digital assets should expect to face headwinds in seeking national recognition.

Stablecoins

Regulators continue to urge caution and express concern with respect to stablecoins, virtual currencies that are backed by assets like gold or fiat currency. Algorithmic stablecoins, coins that use software to balance supply and demand to ensure stability, similarly remain a target of regulators.

To highlight this concern, the Fed explained that its recent membership denial was based, in part, on the crypto firm's potential issuance of stablecoins.

In line with agency recommendations, lawmakers are accordingly pursuing a regulatory scheme that would subject stablecoin wallet providers to federal oversight and risk management standards while also requiring compliance with activity restrictions that limit affiliation with commercial entities and limits on use of users' transaction data.

Stablecoin issuers and wallet providers should be aware that regulation of the rapidly developing field is likely to be subject to regulation by multiple federal agencies. And traditional banking organizations that are considering expansions into stablecoin markets should be aware of the potential for regulatory blowback.

Interest-Bearing Crypto Accounts

Despite the present lack of legislation or formal rules governing interest-bearing crypto accounts and crypto lending, the recent commitment of resources by federal and state agencies toward regulating and prosecuting lenders operating in the digital asset and cryptocurrency space demonstrates a heightened regulatory focus on mitigating the perceived risks that crypto lending poses to consumers.

Presumably in an attempt distance itself from the shadow over interest-bearing crypto accounts, the firm that was recently denied Fed membership emphasized in its application that it is a nonlending institution. While this was not enough to save Custodia Bank's application, its clear efforts to distinguish itself from crypto lenders is telling with regard to the perception of interest-bearing crypto accounts in the regulatory community.

It is apparent that institutions offering interest-bearing crypto products are under the microscope, and regulators will pursue enforcement actions before engaging in a formal rulemaking process to clarify the legal framework that governs these financial products. Companies offering financial services relating to crypto-assets should be on notice that regulatory scrutiny will be at its sharpest when it comes to lending activities.

It is critical that banks and other financial institutions remain aware of and quickly implement any and all best practices issued by authorities with respect to crypto-assets or else risk ending up in the eye of the regulatory storm encircling the crypto-asset sector.

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[1] https://coinmarketcap.com/charts/.

[2] https://www.occ.gov/news-issuances/news-releases/2021/nr-ia-2021-120a.pdf.

[3] https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230103a1.pdf.

[4] https://www.fdic.gov/news/financial-institution-letters/2023/fil23008a.pdf.

[5] https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/.

[6] https://www.whitehouse.gov/briefing-room/statements-releases/2022/09/16/fact-

sheet-white-house-releases-first-ever-comprehensive-framework-for-responsible-development-of-digital-assets/.

[7] https://www.whitehouse.gov/nec/briefing-room/2023/01/27/the-administrations-roadmap-to-mitigate-cryptocurrencies-risks/.

[8] https://www.federalreserve.gov/newsevents/pressreleases/orders20230127a.htm.

[9] https://www.federalreserve.gov/newsevents/pressreleases/orders20230223a.htm.

[10] https://www.fdic.gov/news/financial-institution-letters/2022/fil22035b.pdf.

[11] https://www.fdic.gov/news/press-releases/2023/pr23009.html.

[12] https://www.sec.gov/litigation/complaints/2023/comp-pr2023-25.pdf.

[13] https://www.sec.gov/rules/proposed/2023/ia-6240.pdf.

[14] https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/01/Admin.-Action-Nexo-Capital-Inc.-Settlement-Agreement.pdf?emrc=63e53a62dd0d4.

[15] https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures.