

What Shifting Crypto Policy Means For Banks, Market Players

By **Jeremy McLaughlin, Rebecca Laird and Daniel Nuñez Cohen** (December 9, 2021)

On Nov. 23, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corp. and the Federal Reserve Board issued a Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps[1] announcing the results and next steps of their much anticipated crypto asset policy sprint.

Simultaneously, the OCC issued Interpretive Letter 1179,[2] which provides important clarification of prior OCC guidance regarding permissible crypto asset activities for national banks and imposes new requirements to conduct such activities.

The joint statement and interpretive letter raise many questions and are filled with important considerations that will affect how the legacy and emerging crypto asset native banking sector will take shape.

We provide three key takeaways from the joint statement and three key takeaways from the interpretive letter for banks and crypto asset market participants.

Among these takeaways is that banks will face meaningful regulatory scrutiny when providing core crypto asset services, such as a bank's ability to comply with the unsettled and uncertain scope of federal securities and commodities laws with respect to crypto assets.

Key Takeaways From the Joint Statement

1. The federal banking regulators intend to provide regulatory clarity regarding several critical crypto asset services throughout 2022.

According to the joint statement, the federal banking regulators "plan to provide greater clarity on whether certain activities related to crypto assets conducted by banking organizations are legally permissible, and expectations for safety and soundness" throughout 2022.

In particular, the federal banking regulators will address several key services, including:

- Custody — settlement, execution, tax services, record-keeping, reporting and safekeeping;
- Ancillary custody services — staking, facilitating crypto asset lending, network governance;



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- Facilitating customer purchases and sales of crypto;
- Crypto-collateralized loans;
- Issuance and distribution of stablecoins; and
- Activities that result in holding crypto assets on balance sheet.

As discussed further below in this article, the OCC has already issued some guidance on a few of these topics, particularly stablecoins.

However, such guidance is limited to national banks, and the federal banking regulators have yet to issue joint guidance.[3]

Any such joint guidance will likely supersede prior OCC guidance and provide critical guidance on how FDIC-insured state banks and bank holding companies address their compliance and risk management capabilities in the crypto asset space.

We anticipate guidance regarding stablecoins to be at or very near the top of the priority list in light of the federal banking regulators' work on the President's Working Group on Financial Markets' stablecoin report[4] and the significant attention stablecoins are receiving on Capitol Hill.[5]

The inclusion of ancillary custody services — specifically staking, network governance and facilitating crypto asset lending — is particularly notable for two reasons. First, these services are fundamental to the rapidly growing decentralized finance, or DeFi, space, and second, these areas may implicate federal securities and derivatives laws.

The federal banking regulators did not, however, provide any concrete deadlines on issuing guidance and, as discussed below, are likely to issue a joint request for information, or RFI, which will very likely garner significant feedback and prolong the process.

It is possible that the federal banking regulators will not address all of these topics in 2022, but it is likely they will make significant progress on shaping the regulatory framework for the foreseeable future.

These advancements are certainly a welcome development for those crypto asset market participants suffering under the weight of regulatory uncertainty.

Although it will be important for the federal banking regulators to ensure they solicit and meaningfully consider feedback from all stakeholders, we think it equally important that the industry continue to receive greater regulatory clarity.

2. The Basel Committee's updated consultation on the prudential treatment of crypto asset exposures may coincide with updated guidance from the federal banking regulators regarding capital requirements.

In July, the Basel Committee on Banking Supervision issued a consultation regarding the prudential treatment of crypto asset exposures.[6]

In response to numerous comments explaining that the proposed capital requirements were too onerous, the Basel Committee announced that it would issue updated guidance in mid-2022. The Basel Committee made the announcement two weeks before the federal banking regulators issued the joint statement.

The joint statement's penultimate paragraph states:

The agencies also will evaluate the application of bank capital and liquidity standards to cryptoassets for activities involving U.S. banking organizations and will continue to engage with the Basel Committee on Banking Supervision on its consultative process in this area.

It appears the federal banking regulators are seeking to line up their guidance, or at least preliminary guidance, on "[a]ctivities that result in holding crypto-assets on balance sheet" with the Basel Committee's updated consultation.

This could portend a relatively preliminary look at capital requirements for banks engaging in crypto asset services that affect their balance sheet.

3. The federal banking regulators are likely to issue a joint request for information.

In addition to updating guidance on key crypto asset services, the federal banking regulators indicated, but did not promise, that they would issue a request for information on those services.

Per the joint statement, "the agencies have identified a number of areas where additional public clarity is warranted," referring to the activities discussed in our first key takeaway.

Any such RFI would be the federal banking regulators' first jointly issued RFI on crypto assets. The FDIC issued its own RFI in May.[7] The OCC also issued its own advanced notice of proposed rulemaking in June 2020 under former acting Comptroller of the Currency Brian Brooks, but this is unlikely to move forward in the same vein, if at all.[8]

A joint RFI will likely cover very similar — and some of the exact same — issues as the prior solicitations.

For instance, the FDIC's RFI sought comments on secondary lending, direct balance sheet activities, custody and stablecoins. Many more market participants and stakeholders are likely to comment on a jointly issued RFI in 2022, however, than commented on the OCC's advanced notice of proposed rulemaking or the FDIC's request for information.

Since May, countless additional advocacy organizations have formed or deepened their engagement, and the political stakes are significantly higher. Accordingly, we anticipate a very wide range of comments that will require a substantial amount of time for the federal banking regulators to consider.

Key Takeaways From Interpretive Letter 1179

The OCC issued Interpretive Letter 1179 nearly simultaneously with the joint statement.

The interpretive letter updates prior OCC guidance on crypto asset services that national banks may provide. The interpretive letter raises several important considerations for national banks and sheds some light on the potential positions the OCC will take in designing joint guidance.

1. National banks' existing crypto asset services will be subject to heightened scrutiny, and prospective services to preclearance.

Interpretive Letter 1179 clarifies that the activities permitted by Interpretive Letters 1170,[9] 1172[10] and 1174[11] are still authorized, but subject to stricter scrutiny and preclearance for prospective services.

The interpretive letter states that any national bank that wishes to start providing such services must notify its supervisory office, in writing, of its intention to engage in any of these activities, and refrain from engaging in them until it receives written notification of the supervisory office's nonobjection.

After receipt of the notification, the OCC will evaluate the bank's risk management systems, controls and measurement systems to determine whether the bank can provide the proposed activities in a safe and sound manner.

If the notification provides, "to the satisfaction of its supervisory office, that [the bank] has controls in place to conduct the activity in a safe and sound manner," the supervisory office will issue a written notice of nonobjection.

National banks seeking a letter of nonobjection should demonstrate that their risk management systems can address operational risks, such as hacks, fraud, theft and vendor management; liquidity risks; strategic risk; and other regulatory compliance concerns — mainly illicit finance and anti-money laundering issues, but also consumer protection laws.

National banks that already provide such services are not required to issue a new notice to the relevant supervisory office, nor halt providing such services. Rather, the OCC will continue to evaluate such services as part of the examination process, which very likely will include the same considerations of the bank's risk management practices.

Interpretive Letter 1179 thus imposes a significantly higher burden on national banks to offer these services than before, but does not provide any clarity as to how the OCC will evaluate the bank's risk management capabilities via examination or as part of the nonobjection process.

It also portends much more scrutiny of such offerings during examinations, but again does not provide clarity as to how examiners will assess a bank's risk management policies and procedures.

Given that prior OCC letters provided important comfort for national banks desirous of engaging with the crypto asset industry, it is concerning that the interpretive letter raises the risk profile of offering such services, and will likely result in uncertainty among national banks, at least in the short to medium term as the OCC develops more clear standards.

2. The OCC will require national banks to opine on the uncertain and unsettled regulatory framework for crypto assets before offering permissible crypto asset services.

As part of the newly required pre-service notification process, the OCC requires a national bank to essentially opine on the application of the unsettled and unclear federal financial framework for crypto assets.

Per the interpretive letter, a bank

should demonstrate, in writing, an understanding of any compliance obligations related to the specific activities the bank intends to conduct, including, but not limited to, any applicable requirements under the federal securities laws, the Bank Secrecy Act, anti-money laundering, the Commodity Exchange Act, and consumer protection laws. For example, a bank should understand that there may be different legal and compliance obligations for stablecoin activities, depending on how the particular stablecoin is structured.

This requirement may be quite challenging, as the federal financial regulatory regime for the vast majority of crypto assets is unsettled and uncertain. Hardly any of the largest crypto assets by market cap have been registered as or determined to be — or not to be — a security by the U.S. Securities and Exchange Commission or a court of law.[12]

Yet SEC Chair Gary Gensler has asserted that most crypto assets are securities,[13] and the SEC has initiated numerous investigations. Not all SEC commissioners agree, however, as Commissioner Hester Peirce has argued that the securities laws do not clearly apply to many crypto assets.[14]

Similarly, Commodity Futures Trading Commission acting Chairman Rostin Behnam has stated that approximately 60% of current crypto assets are commodities,[15] and the CFTC has taken numerous enforcement actions against crypto asset exchanges for violations of the Commodity Exchange Act.[16]

SEC General Counsel Dan Berkovitz, who was formerly a CFTC commissioner, has even stated that any derivative trading on a DeFi platform is illegal because such platforms are not registered with the CFTC,[17] while Commissioner Dawn Stump has stated on several occasions that the CFTC needs to provide more clarity for crypto asset markets.[18]

Even the stablecoin report provides numerous recommendations for legislation to clarify the application of banking laws to stablecoins.

Moreover, numerous new crypto assets are created every day, each with varying characteristics, and some of which may eventually obtain significant market capitalizations.

It is an interesting quandary, to say the least, to require national banks to demonstrate their understanding of any compliance obligation related to a specific activity — whether any given crypto asset is a security, commodity, derivative, or other type of good or product — when federal regulators have yet to do so comprehensively.

3. Despite defending its authority to do so, the OCC is unlikely to grant national trust company charters to new crypto asset company applicants.

Interpretive Letter 1179 also defends the OCC's authority to provide a national trust company charter to an entity that operates in a fiduciary capacity under state law.

Per the letter, the OCC explains that it may look to state law to determine whether an activity is that of a "trust company and activities related thereto," but an applicant's activities will not automatically be deemed trust activities or fiduciary activities within the meaning of federal law solely by virtue of state law.

The effect of the letter is to defend the OCC's authority to charter or approve the conversion of a company to a national trust bank on the basis that the applicant's operations are limited to those of a trust company under state law.

To date, several crypto asset companies have received such a charter on a conditional basis, which has generated criticism from various market participants and trade associations.[19]

Despite defending its authority to do so, while Michael Hsu remains acting comptroller — or is confirmed as the permanent comptroller — the OCC is unlikely to grant any additional national trust bank charters to crypto asset companies that provide custody services.

That is because Hsu has indicated that the OCC will require such companies to obtain full service bank charters — entities that can lend, accept deposits and facilitate payments.[20]

Given the rocky nomination of professor Saule Omarova, who recently bowed out of the running to be the permanent comptroller of the currency, it is likely that Hsu will maintain his position for the foreseeable future, if not permanently.

Conclusion

The joint statement raises more questions than answers, which is unfortunate for an industry already paralyzed at times by regulatory uncertainty.

Yet the joint statement sets up 2022 as an important year for shaping the development of crypto asset services in the legacy and emerging crypto asset native banking industry.

The interpretive letter raises new and challenging hurdles for national banks that wish to provide legally permissible crypto asset services.

It is quite likely that the key regulators — Fed Chair Jerome Powell, FDIC Chairman Jelena McWilliams and the OCC's Hsu — will remain in place through 2022, if not much longer, particularly at the FDIC and the Fed, so market participants should not wait for a changing of the guard.

Rather, banking institutions should engage with any RFI issued by the federal banking regulators as well as the Basel Committee's updated consultation to get ahead of foreseeable or unattended consequences.

Moreover, banking institutions should engage with policymakers directly as Congress

increases its attention to the industry and formulates policy positions.

In the meantime, the banking industry will face meaningful regulatory challenges to providing core crypto asset services, including the need to address its ability to comply with the unsettled and uncertain scope of federal securities and derivatives laws with respect to crypto assets.

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[1] FIL-75-2021 (Nov. 23, 2021), <https://www.fdic.gov/news/press-releases/2021/pr21096a.pdf>.

[2] Interpretive Letter 1179 (Nov. 23, 2021), <https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf>.

[3] Many states have enacted parity statutes that authorize state-chartered banks to offer the same services as national banks. Thus, future joint guidance could potentially expand or limit crypto services that state-chartered banks may offer.

[4] Report on Stablecoins (Nov. 1, 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf. For analysis, see "The Future of Stable (Bank) Coins?: President's Working Group on Financial Markets Urges Legislation Limiting Stablecoins to Insured Banks", <https://www.fintechlawblog.com/2021/11/the-future-of-stable-bank-coins-presidents-working-group-on-financial-markets-urges-legislation-limiting-stablecoins-to-insured-banks/>.

[5] For example: "Brown Presses Stablecoin Companies on Risks" (Nov. 23, 2021), <https://www.brown.senate.gov/newsroom/press/release/brown-stablecoin-companies>; "Toomey Statement on Biden Administration's Stablecoin Report (Nov. 1, 2021), <https://www.banking.senate.gov/newsroom/minority/toomey-statement-on-biden-administrations-stablecoin-report>.

[6] Prudential Treatment of Cryptoasset Exposures, Consultative Document, The Basel Committee on Banking Supervision (June 2021), <https://www.bis.org/bcbs/publ/d519.pdf>. For analysis, see "Digital Tokens and the Banking System: Basel Committee Proposed Risk-weighted Asset Framework for Cryptoassets" (July 12, 2021), <https://www.klgates.com/Digital-Tokens-and-the-Banking-System-Basel-Committee-Proposes-Risk-Weighted-Assets-Framework-for-Cryptoassets-7-12-2021>.

[7] RIN 3064-ZA25 (May 17, 2021), <https://www.fdic.gov/news/press-releases/2021/pr21046.html>.

[8] OCC Bulletin 2020-59 (June 4, 2020), <https://www.occ.treas.gov/news-issuances/bulletins/2020/bulletin-2020-59.html>.

[9] Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers.

[10] Authority to Hold [Certain Types of] Stablecoin's Reserves.

[11] Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities.

[12] In a letter to Cipher Technologies Management LP, the SEC's Division of Investment Management took the position that bitcoin, the largest crypto-asset by market cap, is not a security.

See <https://www.sec.gov/Archives/edgar/data/1776589/999999999719007180/filename1.pdf>. Former SEC Division of Corporation Finance Director William Hinman stated in a speech expressing his own views that Ether is not a security.

See <https://www.sec.gov/news/speech/speech-hinman-061418>. In contrast, the SEC is currently litigating whether XRP is a security.

[13] Chairman Gensler made such comments during his live testimony before the House Financial Services Committee on October 5, 2021, and on various other occasions.

[14] "Lawless in Austin," (Oct. 8, 2021), <https://www.sec.gov/news/speech/peirce-2021-10-08>.

[15] Acting Chairman Behnam made these comments during his nomination hearing before the Senate Committee on Agriculture, Nutrition, and Forestry on October 27, 2021.

Moreover, the CFTC has also held for many years that bitcoin is a commodity.

See https://www.cftc.gov/LearnAndProtect/AdvisoriesAndArticles/fraudadv_funds_trading_in_bitcoin_futures.html. See too have some courts (see, i.e., <https://www.cftc.gov/sites/default/files/idc/groups/public/@lrenforcementactions/documents/legalpleading/enfcoindroporder030618.pdf>).

[16] For instance, via enforcement action, the CFTC has asserted that Tether is a commodity.

See <https://www.cftc.gov/PressRoom/SpeechesTestimony/stumpstatement101521>.

[17] "Climate Change and Decentralized Finance: New Challenges for the CFTC" (June 8, 2021), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opaberkovitz7>.

[18] For instance, "Family Feud, Jeopardy, and Let's Make a Deal," (Nov. 3, 2021), <https://www.cftc.gov/PressRoom/SpeechesTestimony/opastump10>.

[19] See the January 8, 2021 letter from various depository trade associations to the OCC regarding the charters of Paxos and BitPay, <https://www.aba.com/-/media/documents/comment-letter/joint-trades-letter-to-occ-re-trust-charter-application-01082021.pdf?rev=e90dc92690ed46568e5940888c49d9a8>.

[20] "Statement of Michael J. Hsu, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate (Aug. 3, 2021), <https://www.occ.gov/news-issuances/congressional-testimony/2021/ct-occ-2021-79-written.pdf>.