

Expect Greater Regulatory Scrutiny Of Crypto-Asset Activities

By **Kathryn Ryan, Gordon Miller and Max Bonici** (September 14, 2022)

In mid-August, the Federal Reserve issued guidance on crypto-asset and related activities, joining the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation in alerting their supervised entities that they must provide written notice before engaging in this space.

Institutions already engaging in these activities must also file notice. The separate issuances from all three federal prudential banking agencies make clear that supervised entities engaged in crypto-asset and related activities will be subject to heightened supervisory scrutiny.

They also signal a meaningful change in supervisory posture and scrutiny about the ability of supervised entities to identify and mitigate the risks in this rapidly evolving area.

The OCC and FDIC were relatively accommodating when Congress and the current administration were not actively engaged on this issue and the market for crypto-assets was less volatile. However, as Congress appears to be nearing some determinations regarding cyber-asset oversight, and volatility, fraud and related losses mount, all three federal banking agencies have backpedaled.

Revisiting previous determinations of permissibility and curtailing the powers of supervised entities is a rare step for these agencies, when not directed to do so by the courts or Congress.

The Fed's guidance, at a high level, harmonizes the agencies' approaches by generally requiring that supervised entities provide some form of written notice to their supervisory points of contact that describes the activities and how the supervised entity will control for various risks, including safety and soundness, financial stability, and consumer protection, among others.

The guidance nevertheless is not a comprehensive, regulatory framework. Instead, the approach leaves ultimate discretion to supervisors across three different agencies, which does not appear to accord entirely with the agencies' recent rules on guidance to improve transparency.

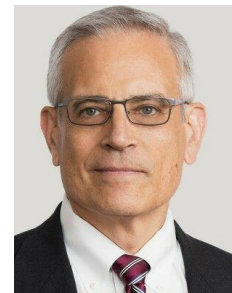
As a result, supervised entities, their service providers — including information technology and information security providers — should expect heightened scrutiny of their crypto-asset and related activities.

Regulatory protections like predetermined time frames are not available, and determinations made by the federal banking agencies will generally develop anecdotally and constitute confidential supervisory information, limiting public awareness of the frameworks as they develop.

OCC Approach



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The OCC started the tightening trend late in 2021 when it clarified that crypto-asset and related activities previously determined to be legally permissible for national banks would now require the OCC's written approval — written notification of the OCC's nonobjection — before a supervised entity could engage in those activities.

The activities that the OCC determined to be permissible entailed providing crypto-asset custody services, holding dollar deposits as reserves backing stablecoins, acting as nodes on a distributed ledger to verify customer payments, and engaging in stablecoin activities to facilitate payment transactions on a distributed ledger.

Recently, some in Congress have pressured the OCC to rescind altogether the original interpretive letters finding these activities to be permissible bank activities.

The requirement to seek written prior approval to engage in an activity that has already been determined to be a banking power is unusual. Once the OCC determines that an activity is within the business of banking, no notice is required at all, or a bank generally must provide prior notice, or even after-the-fact notice in some cases, to engage in it.

For instance, prior to joining a payment system, a national bank must provide prior notice if it would be exposed to open-ended liability, but only after-the-fact notice otherwise.

For other activities that lack a determination, prior written approval is typically sought. The following also generally require the OCC's prior approval:

- Structural questions concerning establishing subsidiaries or financial subsidiaries;
- Significant powers, such as fiduciary powers;
- Changes to a bank's business or financials, such as location of branches or capital distributions.

Requiring OCC supervised entities to obtain prior written approval to engage in a predetermined permissible activity indicates an unusually high level of caution.

The OCC's interpretations directly affect national banks, federal savings associations, and federal branches of non-U.S. banks. But because some state wild card statutes allow state banks to exercise the same powers as national banks, the OCC's interpretations of legal permissibility have a wider reach in some jurisdictions.

Federal Reserve and FDIC Approach

The Federal Reserve is not a chartering agency like the OCC, but it regulates and supervises bank holding companies, state member banks and affiliates not subject to other federal functional regulators like the U.S. Securities and Exchange Commission or the Commodity Futures Trading Commission.

The FDIC principally regulates and supervises state nonmember banks. While the FDIC does not establish state bank powers, a state bank may not engage in an activity that is not permissible for a national bank unless the FDIC determines that such activity would not pose a significant risk to the deposit insurance fund under Section 24 of the Federal Deposit Insurance Act.

The Fed and the FDIC have defined certain crypto-asset and related activities but stopped short of addressing their legal permissibility. For both agencies, a crypto-asset is any digital asset implemented using cryptographic techniques.

Federal Reserve's Examples

FDIC's Examples

Crypto-asset safekeeping

Acting as a crypto-asset custodian

Traditional custody services

Ancillary custody services

Facilitation of customer purchases and sales of crypto-assets

Acting as market makers or exchange or redemption agents

Loans collateralized by crypto-assets

Related activities such as finder activities and lending

Issuance, distribution of stablecoins

Issuing crypto and other digital assets

Maintaining stablecoin reserves

Participating in blockchain- and distributed ledger-based settlement or payment systems, including performing node functions

Both agencies explained in their respective guidance that more activities may be covered as the industry and technology evolve. While illustrative, it is not clear under the Fed's guidance what facilitation of a customer purchase or sale of crypto-assets means. Similarly, related activities under the FDIC's guidance appear to be quite broad.

The FDIC generally does not determine the legal permissibility of state banking activities. Instead, it typically reviews bank activities under safety and soundness standards, as well as through financial stability and consumer protection lenses, among others.

But the Fed does determine the permissibility of certain activities for bank holding companies and nonbank affiliates that are not under a different federal regulator.

Under the Fed's guidance, supervised entities must demonstrate in their notifications that the activities are legally permissible and determine whether any filings are required under applicable federal or state laws. Key authorities subject to the Fed's interpretations include:

- Section 4 of the Bank Holding Company Act and Regulation Y, which provide the permissible activities, including financial and related activities for bank holding companies and their nonbank subsidiaries;
- Section 10(c) of the Home Owners' Loan Act and Regulation LL, which similarly provide the permissible activities for savings and loan holding companies; and
- The Federal Reserve Act and Regulation H, which prohibit a state member bank from changing the general character of its business or scope of corporate powers without the permission of the Fed.

Although the Fed did not make a specific determination in the guidance, supervised entities may consult with Fed supervisors as to whether an activity is permissible.

Unlike the OCC's approach, the Fed does not require that a supervised entity seek its written nonobjection, but it did follow the OCC and FDIC's approach by requiring that a supervised entity provide prior notice before engaging in a crypto-asset or related activity.

Requiring prior notice to engage in a permissible activity, as under the OCC regulations, is also unusual for the Fed.

For instance, prior notice is not required for various exempt nonbanking activities and acquisitions under Regulation Y — instead, after-the-fact notice and certifications are generally allowed.

And while financial holding company status is needed to engage in a broader range of financial and related activities, qualified institutions are only required to provide post-transaction notice for those activities.

Under the guidance, Regulation Y's notification procedures are effectively overridden by this prior notice requirement if the activity involves crypto-asset or related activities.

The Takeaway

Entities subject to federal banking supervision are subject to new review and standards for evolving crypto-asset and related activities. These new review standards override regulatory procedures that apply outside of the crypto-asset context.

As Congress and the current administration develop a policy framework for crypto-assets, this approach may change. For now, federally supervised entities should expect a process that effectively amounts to preclearance for crypto-asset and related activities.

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