The Crypto Exchange — S02 Ep04, Crypto Year in Review 2022: State-Level Regulatory Developments in the Digital Asset Market
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Ethan Ostroff:

Welcome to another episode of the *Crypto Exchange*, a Troutman Pepper podcast focusing on the world of digital assets and payments. I'm your host, Ethan Ostroff and a partner at Troutman Pepper, and I'm happy that you have joined us for our episode today. We will be discussing state-level regulatory activity relating to interest-bearing cryptocurrency deposit products, which were the subject of many enforcement actions during 2022.

As a reminder to our subscribers, today's episode is part three of our four-part series. During last week's episode, which featured Rene McNulty and Carlin McCrory, along with myself, we covered other recent activity by the FDIC, the OCC, and the Federal Reserve. Before we dive into today's episode, I'd like to remind our subscribers to visit and subscribe to our blog, consumerfinancialserviceslawmonitor.com. And while you're at it, please head over to troutman.com/podcasts.html and take a listen to other podcasts that are currently being offered by our colleagues, each of whom are subject matter experts in their respective practices.

These podcasts are insightful, entertaining, and are dedicated to interesting areas of the law. Each of our podcasts are also available for download on popular streaming platforms like Spotify, Apple Podcasts, and more. Today, I'm pleased to be joined by my colleagues, Keith Barnett and Addison Morgan.

Guys, thanks so much for joining me today. Jumping right in, 2022 was a tumultuous year for the digital asset market. And some of the more notable events included the rise and catastrophic fall of an algorithmic Stablecoin, as well as the implosion of a major digital asset exchange. Both of these events seem to contribute to the wave of crypto lending firm insolvencies that occurred during the latter half of 2022. Many of these firms offered interest-bearing cryptocurrency deposit products to the customers at some point in time, and the state regulators seem to have the product in their crosshairs. So, to help our listeners understand what's going on in the space and the current lay of the land, Keith, how does an interest-bearing cryptocurrency deposit product function?

Keith Barnett:

I think the product can be analogized to a traditional bank deposit. But instead of being denominated in US dollars, the deposit is denominated in some type of digital asset. So here, a consumer transfers his or her digital assets to a digital asset wallet assigned by the crypto lending firm. And the digital asset wallet that contains the consumer's digital assets is maintained by the crypto lending firm on its platform.

In exchange for the deposits, the crypto lending firm will provide rewards to its depositors in the form of a yield. And the crypto lending firm can then generate that yield to pay rewards to its depositors by deploying deposits in various revenue-generating activities. Lending to institutional investors, lending to retail investors, providing liquidity on decentralized finance platforms, and investing in other digital asset products are examples of these other activities. Some of these firms actually offered annual interest rates as high as 12%.

Ethan Ostroff:

Right. So, when you think about the mechanics of an interest-bearing cryptocurrency deposit project, it makes sense that you might analogize it to a bank deposit. But Addison, in that context, state regulators don't seem to have that same perception of this product as being the same as a deposit, in a traditional sense, right?

Addison Morgan:

You're right, Ethan. They did not. Within each enforcement action that has been filed against crypto lending firms that have offered this product, the regulators have alleged that the product itself constitutes the unregistered sale of securities in the form of investment contracts. Securities offerings are subject to robust disclosure requirements that are geared towards surprising investors of material information related to the risk associated with a particular investment. So many of the regulators allege that the firms who've offered these products failed to adequately disclose to consumers the risk of depositing their digital assets on these firms' platforms.

Ethan Ostroff:

Right. So, in addition to this issue about failing to register with the appropriate state regulator prior to offering this type of product, it seems that state regulators are concerned about potential consumer harm that could arise through offerings of this product. While it seems that digital assets and blockchain technology are becoming more interwoven into society's existing systems day by day, certain aspects of these technologies remain incredibly complex. So, this learning curve factor coupled with the inadequate risk disclosures could have inhibited a consumer's ability to conduct due diligence on these products. Is that how we should be thinking about this, Keith?

Keith Barnett:

Yeah, I think that's right. Digital assets and blockchain technology have received a lot of attention as of late, but they're both still relatively esoteric and new phenomena. From a policy standpoint, I think many of the enforcement actions related to this issue have been founded upon the fact that crypto lending firms have failed to inform investors about the complexities of the business models that were powering these products.

Ethan Ostroff:

Addison, how would you explain that current state of affairs and how the state regulators are operating right now, with this background?

Addison Morgan:

Throughout 2022, the California Department of Financial Protection and Innovation was very active in bringing enforcement actions against crypto lending firms that have offered this type of product and the cease and desist order issued against a now-defunct cryptocurrency exchange. The DFPI alleged that a consumer's ability to receive interest payments from this exchange's deposit product was dependent on the success of the exchange's business and not any activity of the depositor, him or herself. So, like many crypto lending firms, one aspect of this exchange's business model consisted of lending deposits to institutional investors in exchange for interest payments.

I think this allegation is important because it illuminates a theme that I believe will be at the forefront of the regulatory themes this year, and that is assisting consumers and retail investors to effectively manage counterparty risks through some comprehensive disclosure regime. If an entity takes your assets and lends them to a borrower, you would want to have information about the borrower. But if you are unaware of this arrangement altogether, then it becomes much more difficult to manage your exposure in that situation.

Ethan Ostroff:

Helpful insights there, Addison. It makes sense, but I guess what I'm thinking about is what happens, Keith, if a borrower of deposits becomes unable to repay its loan to the crypto lending firm providing the deposit product? In other words, default seems like it would have the potential to destroy the crypto lending firm's ability to provide yield to its depositors, and possibly leave the firm without adequate assets to meet the withdrawal requests borrowers. Did any of the regulatory orders discuss this particular issue over the past year?

Keith Barnett:

Yeah, that has happened. You hit the nail on the head. And its cease and desist order against one crypto lending firm that's actually currently in the midst of bankruptcy proceedings, the California Department of Financial Protection and Innovation alleged that firm failed to disclose material aspects of its business related to the risks that the firm would be unable to meet withdrawal demands in the event of the liquidity due to institutional lending activities. And we actually discussed this during one of our podcasts last year.

Some of you may recall that the California Department of Financial Protection and Innovation further alleged that the firm failed to disclose the identities and creditworthiness of entities. This firm provided digital asset loans, a portion of which the firm funded through digital assets that it received from depositors. And due to a downturn in the market and liquidity issues, a few crypto lending firms decided to pause withdrawals of deposits from its platform, as you just alluded to. The withdrawal pauses have been scrutinized by state regulators, and I think the investor uproars that have followed as a result of these pauses simply emphasize the regulatory sentiment that robust consumer disclosures are necessary to sustain a product of this nature.

It's an unfortunate situation, but across the board, the decision to pause crypto deposit withdrawals was to ensure that these firms had enough liquid capital to restructure their existing debt obligations in the decentralized finance base. Ironically enough, some of the yield these crypto lending firms were able to provide to their depositors derived from their lending and borrowing activities in a decentralized finance protocols.

Ethan Ostroff:

We know, based upon recent activity in different bankruptcy cases involving crypto firms, that the contractual agreements that establish these products vests all the rights of ownership control over the digital assets that are being held in the deposit account to the crypto lending firm. Circling back to the traditional bank deposit analogy we talked about earlier, bank deposits are protected by deposit insurance offered through the FDIC. And we talked a little bit about recent activities by the FDIC in our prior year in review podcasts. This insurance product protects bank deposits in the unlikely event of a bankruptcy. The FDIC has made it very clear that deposit insurance does not apply to digital assets, so I'm wondering whether this lack of insurance protection was discussed as a potential misleading omission in any of the regulatory actions we saw last year?

Keith Barnett:

Yeah. That's a great question, Ethan. And as we addressed in some of our podcasts last year, that was the crux of the problem. In fact, the FDIC issued several statements to anyone who will listen. They did it online stating that these crypto exchanges do not have FDIC insurance because these funds, the fiat currency and the cryptocurrency, they're not being held at a bank, at an FDIC insured bank, and that these exchanges are not such. Even though these exchanges may have had money transmitter licenses or other types of licenses, that is not the same as having FDIC insurance. And in a notice of hearing that it issued to a crypto exchange, the Texas State Securities Board took issue with certain consumer-facing statements made by a crypto exchange relating to a trust and transparency, which apparently derived from this exchange of status as a Canadian public company that was traded on the Toronto Stock Exchange and this company's alleged full compliance with applicable domestic and international laws.

According to the Texas State Securities Board, both of these statements were materially misleading because among other things, the deposit product that this exchange had offered was neither protected by SIPC, otherwise known as the Securities Investor Protection Corporation, nor was the deposit insured by the FDIC, so you have a double whammy here. You have a company that is not registered with the SEC and therefore does not have the SIPC insurance, but it's also not a bank, so you don't have FDIC insurance. In this particular case, the Texas State Securities Board's decision to pinpoint the fact that FDIC insurance does not apply to these deposit products further underscores the current regulatory perspective of this market.

Ethan Ostroff:

To wrap up this episode, I sort of wanted to give you both an opportunity to talk a little bit about what you see coming out in the pipeline with respect to the future of interest-bearing crypto deposits. Maybe Addison, your thoughts first.

Addison Morgan:

In the short term, I think that the state regulators have made it pretty clear that they intend to remove this product from the market due to many of the things we discussed earlier, particularly, the shortcomings related to risk disclosures. But in the long term, I think that the product may regain some of the traction that it garnered during the outset of 2022 – if certain guardrails are instituted.

Although the assets are different, the crypto deposit product, as a business model, is very similar to the bank deposit business model. However, there are numerous consumer-facing guardrails like FDIC deposit insurance and bank reserve requirements that have been integrated into the bank deposit business model. And these guardrails are very effective at insulating consumers from the unintended risk associated with a traditional bank's lending practices, which are funded in some shape or form by consumer deposits.

The FDIC has made it clear that it is unlikely deposit insurance will be applied to digital assets, so I think this, as well as just the opaqueness of the reserves held by these crypto lending firms, has led to an industry push to require these firms to publish their proof of reserves, as well as the proof of their liabilities on the blockchain. Making a firm's accounting publicly available on chain would enable an investor to make an informed decision as to which crypto lending firm he or she would like to engage.

If a crypto lending firm's liabilities exceed its reserves, then the consumer now can deduce that this particular crypto lending firm may be on the verge of insolvency. I do not believe that crypto lending firms will actually implement this practice on their own accord, so it will likely have to be mandated through some sort of congressional statute or regulatory rulemaking.

Ethan Ostroff:

Addison, those are some very interesting points and reflections. I do wonder when we talk about the sophistication of consumers, particularly the consumers that the state regulators are focused on protecting, if they're sophisticated enough, even if all of this information was available on chain for them to understand it and use it in making these types of decisions, I guess we'll have to wait and see how that plays out. Keith, any thoughts you'd like to leave with our listeners?

Keith Barnett:

Nothing more than what's already been said. It's going to be interesting to see what the regulators do in 2023, given the backdrop that they had from 2022. I think we're going to see a lot more attempted legislation and a lot more statements from politicians on how more regulations are needed.

Ethan Ostroff:

Right. It's going to be really interesting to follow what goes on the Hill with the shift in the balance of power in the House, the new House Financial Services Subcommittee that's focused on digital assets and how that all plays out.

I want to thank you both for joining us today and sharing your insights with our subscribers. To our subscribers, as always, thank you for listening. Don't forget to visit us at our blog, consumerfinancialserviceslawmonitor.com and hit that subscribe button, so you can get all of our daily updates about what's going on in the world of consumer finance. And stay tuned for the fourth installment of our series of podcasts recapping 2022 in the digital asset space. Thank you all for listening.