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Locke Lord QuickStudy: OCC Issues Chief Counsel Interpretative Letter ?Authorizing Federally Chartered Banks and Thrifts To ?Participate in Independent Node Verification Networks ?and Use Stablecoins for Payment Activities

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The Office of the Comptroller of the Currency (OCC) published a Chief Counsel's Interpretative, Letter IR 1174 January 2021, ("the Letter") ?confirming the authority of national banks' and federal savings associations' to participate in independent ?node verification networks (INVN) another term for distributed ledger blockchain technology, and use stablecoin cryptocurrency to conduct payment activities and other bank permissible functions.?

Citing the Chief Counsel's letter Acting Comptroller Brooks stated: "Our letter removes any legal ?uncertainty about the authority of banks to connect to blockchains as validator nodes and thereby ?transact stablecoin payments on behalf of customers who are increasingly demanding the speed, ?efficiency, interoperability, and low cost associated with these products."?

The Letter concludes a national bank or federal savings association may validate, store, and record ?payments transactions by serving as a node on an INVN. Likewise, a bank may use INVNs and related ?stablecoins to carry out other permissible payment activities. ?

In a press release ("the Release") accompanying the letter the OCC extolled the benefits of block chain technology to ?the banking system stating that "[e]ngaging in INVN within the federal banking system may enhance ?the efficiency, effectiveness, and stability of payments activities and achieve the benefits of real-time ?payments already enjoyed in other countries." It continued to characterize use of these new ?technologies as "more resilient than other payment networks" and a more verifiable system than many ?used by banks today.

Nonetheless, the OCC cautioned banks of potential risks when conducting INVN-related activities, ?including operational risks, compliance risk, and fraud. The OCC expressed confidence that banks ?have sufficient experience with managing technology risks inherent in these new activities derived ?from similar electronic activities expressly permitted for banks," including providing electronic custody ?services, acting as a digital certification authority, and providing data processing services." Stating the ?obvious the Release cites potential money laundering activities and terrorist financing risks cautioning ?banks to develop compliance programs for the reporting and recordkeeping requirements of the Bank ?Secrecy Act and the particular risks of cryptocurrency

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transactions. What the Release does not ?address is what those programs should entail and one suspects that community banks will find ?significant costs in seeking outside expertise in a developing field. Moreover the risks in the use of ?stablecoins as a medium of exchange are yet to be fully appreciated as no two stablecoins are alike. ?The letter begs the question as to what constitutes a stablecoin. Depending on the fiat currency which ?the stablecoin is exchangeable for on a 1:1 basis raises, there are various issues regarding currency and reserve ?risk. The OCC described the various structural elements of cryptocurrency in IL 1170. In addition, ?the OCC recently addressed the permissibility of a national bank holding reserves for stablecoins ?that are backed by fiat currency on at least a 1:1 basis in situations where there is a hosted wallet. ?See OCC Interpretive Letter 1172 (Sept. 21, 2020) (IL 1172). Further guidance can be found in the ?"President's Working Group on Financial Markets Releases Statement on Key Regulatory & ?Supervisory Issues Relevant to Certain Stablecoins".?

The Chief Counsel's letter contains a historical analysis of the history of banking before the Roman Empire in support of the ?proposition that banking is fundamentally a function of acting as an intermediary. It notes the ?evolution of this function as a necessary adaption to changing technology and business practices. It ?cites examples of adaption of new technologies to carry out bank-permissible activities, including ?payment activities and those related to electronic funds transfer systems, real-time settlement ?systems and stored value systems as part of their permissible payments-related activities. The ?rationale behind the Interpretive Letter can be best summed up with the statement "that national ?bank powers "must be construed so as to permit new ways of conducting the very old business of ?banking." The Letter is more a policy brief on the necessity of the evolution of national bank powers ?to meet changing business practices caused by changes in technology. Indeed, it represents yet another milestone in a succession of OCC ?interpretations of expanded national bank powers over its long history. The Letter reasons that ?payment activities fundamentally involve transmitting instructions to transfer a specified sum from ?one account on a ledger to another account on the same or a different ledger. Payment systems to be ?effective must use a trusted, centralized entity for validation. The Letter views serving as nodes on ?INVNs, while technologically advanced, is merely another method of validating transfers.?

The letter similarly supports the use of stablecoins to support payment activities as a necessary ?evolution of bank powers. Stablecoins subsume all the issues inherent in INVNs. However, stablecoins present more global issues that are yet to be resolved. Authorization of widespread adoption of INVN technology begs the question of whether treating stablecoins as currency ?is a necessary and appropriate bank power. The President's Working Group Statement on Stablecoins ?identified an eye opening host of macro issues that stablecoins present involving financial stability, financial ?integrity, user protection, market integrity, operational resilience, well-functioning payments ?and trading markets, macroeconomic and monetary stability, and enhanced cross-border ?cooperation. In view of these concerns, the OCC Letter necessarily involved some degree of collaboration between the Treasury Department, the Federal Reserve Board and the OCC not to mention the key committees of Congress

The use of stablecoins by national banks to effect payments is one step away from authorizing the creation of stablecoins by individual banks. Already, a major Japanese banking institution, Mizuho, has created its own yen pegged stablecoin and J P Morgan has issued its own stablecoin. Interestingly, in a footnote to the Letter which cites a number of these examples the OCC disclaims any opinion as to their authority.

The National Bank Act passed during the Lincoln Administration, authorized the creation of national banks. Ironically, these banks were permitted to deposit government bonds with the U.S. Treasury to provide security to

back bank notes issued by the individual banks, a new uniform national currency that could be redeemed for gold or silver. It was this function which gave the regulator its name “Comptroller of the Currency” This was the original stablecoin of the realm and was legal tender. For a variety of reasons, some directly related to the problems in the dual banking system, the authority to issue bank notes was taken from the banks by the Federal Reserve Act of 1913 and conferred on the Federal Reserve Banks which to this day issue Federal Reserve Notes as legal tender which has become the medium of exchange for most all major forms of global commerce. One wonders if the OCC interpretative Letter stopped short of affirming the authority of National Banks to issue stablecoins because of the language of the Federal Reserve Act that gives the power to create currency exclusively to the Federal Reserve Banks. It would appear that conferral of authority on National banks to issue stablecoins would bring national banking history full circle.

It is important to note that the Letter is a legal opinion and does not have the force and effect of law as would a validly issued regulation. The absence of a pronouncement having the force and effect of law may give users some pause. Undoubtedly, disputes between parties may call into question the validity of transactions involving payments effected with stablecoin by banks. The considerable body of law that has been created to resolve payment disputes may not have caught up with digital payments effected through stablecoins or blockchain technology. Moreover, while every indication is that the OCC is leaning to authorizing stablecoin issuance, it has not done so even though the largest US bank has commenced issuance. However the Federal Reserve Board with MIT is working on ”Project Hamilton” with the goal of creating a central bank digital currency. Presumably, when the open source code for this currency is published, it will preempt the creation of bank issued digital currency. While the OCC has not reached a definitive position on stablecoin issuance by banks, unregulated non-banks can and do issue all manner of cryptocurrency. Banks contemplating involvement with stablecoin would be well advised to anticipate intense supervisory scrutiny.

Blockchain technology or participation in INVN presents different issues. Facebook’s entry into the digital currency space with Libra, triggered concerns worldwide over use of user data, privacy and the ability to manipulate financial information especially because it planned to base its currency on a basket of global currencies. Moreover, for all its touted security it is not foolproof. There have already been a number of incidents which call into question whether it has more vulnerability than supposed. Indeed the Fed’s Project Hamilton is exploring the use of competing technologies. The danger of reliance on INVN is the mistaken belief that it is an ironclad verification system. Any system is subject to breach, particularly those upon which there is a lack of vigilance because of overconfidence in its integrity. Cyber intrusions particularly those involving classified defense data are becoming more common. If the prize is great enough there is no reason to suspect that state actors and common cyber criminals won’t be sufficiently incented to find new technologies to defeat distributed ledger technology. Already, there are concerns over the jurisdictional access to the hosting states. Thus, banks would be well advised to be prepared to assess the technological risks in using and transacting in this technology. However, they should also avoid the mistaken assumption that INVN technology needs to be foolproof. It only needs to be more reliable than the competing methods. That calculus is not only a function of the risk of a breach but the comparative risk of the magnitude of the breach as opposed to individual transactional breaches.

We are only at the threshold of the transformation of centuries old verification systems to identify and verify ownership. Doubtlessly, we will learn much as block chain technology and its competing technology become more widespread. One is reminded of the recent experience with mortgage title transfers during the last financial crisis and the resistance of the courts to recognize title transfer agreements among mortgage holders that weren’t

properly recorded in locale deed registries. While technology change is rapid the judicial and governmental systems are slow to react. The OCC has reacted in a timely fashion, whether its sister agencies and the Congress agree remains to be seen.

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