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The Rise of Cryptocurrency for Banks

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On July 22, 2020, the Office of the Comptroller of the Currency (the OCC) confirmed in Interpretive Letter #1170 the authority of a national bank to provide cryptocurrency custody services. Since that time, the OCC has issued other crypto-friendly guidance, expanding the scope of permissible national bank activities with cryptocurrencies. In January 2021 in Interpretive Letter #1174, the OCC confirmed that a national bank may use new technologies, including independent node verification networks (INVNs) and related stablecoins, to carry out bank-permissible functions, such as payment activities. On April 23, the OCC granted preliminary conditional approval of a limited purpose national trust bank charter for a bank that will provide services only associated with digital assets. The OCC's decisions may lay the groundwork for greater bank engagement in cryptocurrency activities, which have been subject to regulatory uncertainty.

As the OCC is the chartering authority for national banks, this guidance is currently only applicable to those institutions. However, the OCC, Federal Reserve, and Federal Deposit Insurance Commission (FDIC) have indicated recently that they may work together on a more coordinated regulatory approach to cryptocurrency as it becomes an area of increasing public interest. Significantly more uncertainty remains with respect to state-chartered banks' engagement in cryptocurrency activities, and state-chartered banks will need to work closely with their state banking regulators as the market for these activities further grows and develops.

In this article, we discuss the parameters of OCC Interpretive Letters #1170 and #1174, and the OCC's April 23 conditional approval. We also examine what may come next for federal and state-chartered banks with respect to their involvement in the cryptocurrency market.

Custody Services

Just as physical custodians hold property, such as securities, on behalf of customers who for example may be other financial institutions, institutional investors, and investment funds, cryptocurrency custodians hold cryptographic access keys to units of cryptocurrency. Since cryptocurrencies do not exist in any physical form, a particular unit of cryptocurrency is assigned to a party using a set of unique cryptographic keys. To access or transfer cryptocurrency, a party must have access to these keys. Additionally, if a third party obtains these keys, then they can take (steal) the cryptocurrency. Consequently, losing or holding keys in an unsecure manner can result in significant losses of value to the owner of the cryptocurrency. A great deal of industry effort has been spent on safekeeping for cryptocurrency.

Custodians hold cryptographic access keys in a "wallet" that protects the keys from discovery by a third party. Keys can be stored in "hot" wallets or "cold" wallets. "Hot" wallets are connected to the internet, while "cold" wallets are physical devices, such as paper or hardware wallets stored in a physical vault. Hot wallets allow for

transactions, while cold wallets freeze the cryptocurrency in place rather than allowing for transactions, and are generally thought to provide better protection from “theft.”

Before Interpretive Letter #1170 confirming that national banks may custody cryptocurrency, significant regulatory uncertainty existed around the permissible activities of banks with respect to cryptocurrencies. This uncertainty resulted in most cryptocurrency custody business being conducted by crypto-focused companies and not by banks. Many potential institutional players in the cryptocurrency markets had concerns regarding such providers and seemed to prefer bank custodians.

In addition, the lack of bank custodians for cryptocurrency prevented many investment funds from engaging in the cryptocurrency market. Many investment funds are required by regulation to use a qualified custodian to hold their property, and that custodian is usually a bank, broker-dealer, or futures commission merchant. Investment funds have largely been unable to find such qualified custodians for the custody of cryptocurrency. By confirming national banks’ authority to custody cryptocurrency, the OCC helped open the door for investment funds to potentially invest in cryptocurrency.

This OCC guidance is similar in impact to recent U.S. Securities and Exchange Commission (SEC) guidance for broker-dealers. In December 2020, the SEC provided regulatory relief permitting broker-dealers to custody digital asset securities, which are digital assets meeting the definition of “securities” under the federal securities laws, in certain circumstances. The SEC also announced that while the current guidance is temporary, it intends to develop a formal framework for custody of digital asset securities.

The FDIC also recently signaled interest in custodianship of digital assets by insured depository institutions. On May 17, the FDIC issued a request for information and comment regarding insured depository institutions’ current and potential digital asset activities, including custodial activities. This request may signal an attempt to align the regulatory treatment of digital assets and offer greater certainty to financial entities. The FDIC has requested comments by July 16.

Taken together, the OCC, SEC, and FDIC actions seem intended to create a level playing field for various types of regulated custodians.

Permissible Payment Activities

In Interpretive Letter #1174, the OCC concluded that national banks may use new technologies, including INVNs and related stablecoins, to perform functions that are permissible for banks, most notably payment activities.

An INVN is a shared electronic database that enables copies of the same information to be stored on multiple computers. A common example of an INVN is a distributed ledger, where cryptocurrency transactions are recorded.

A stablecoin is a type of cryptocurrency that is designed to have a more stable value because its value is pegged to external reference. In its letter, the OCC particularly focused its discussion on stablecoins that are backed by a fiat currency.[1] These fiat-backed stablecoins can typically be exchanged for one unit of the underlying fiat currency, and therefore, can serve as a way to store, transfer, transmit and exchange the value of the fiat

currency.

Banks may be well positioned to facilitate payments using INVNs and stablecoins since a core function of banks is to act as financial intermediaries and to facilitate the flow of money and credit in the economy. Banks possess the expertise to facilitate the exchange of payments, and settle transactions, between parties. This letter may open the door for national banks to use distributed ledger technologies in the way they currently use traditional financial networks, such as SWIFT, the Automated Clearing House, and FedWire. Using INVNs to transmit stablecoins and other cryptocurrencies may facilitate payments and support financial transactions in a potentially cheaper, faster, and more efficient manner than centralized payment systems.

Special Purpose National Bank Charter

The OCC further signaled its increasing acceptance of cryptocurrency when it granted preliminary conditional approval of the application to charter Paxos National Trust (Paxos) as a limited purpose national trust bank in April. Paxos intends to provide only services associated with digital assets, including custody services; payment, exchange and other agent services; and trading services.

The OCC's decision indicates a move towards greater integration of cryptocurrency businesses into the financial regulatory framework. The possibility of being granted a federal charter will likely streamline the businesses of cryptocurrency entities that can obtain them. These entities will not have to manage different states' licensing requirements for cryptocurrency businesses, which often implicate money transmission regulations. Instead, they will be able to operate more seamlessly on a nationwide basis.

Next Steps for Federal and State-Chartered Banks

The OCC's decisions in the past year indicate an increasing openness to allowing national banks to engage in cryptocurrency businesses. In all cases, however, the OCC has said that a national bank should consult with its OCC supervisors prior to engaging in cryptocurrency custody and payment activities. While the OCC, Federal Reserve, and FDIC have recently expressed plans to work together more closely to align on cryptocurrency regulation, the direction such regulation will take is uncertain. In his testimony before the Committee on Financial Services in May, the newly appointed Acting Comptroller of the Currency, Michael Hsu, stated that he has requested a review of the "interpretive letters and guidance regarding cryptocurrencies and digital assets," as well as the updates to the "framework for chartering national banks and trust companies."

Additionally, although the OCC's letters and the recent request for information by the FDIC indicate that there is momentum building towards allowing banks to engage in cryptocurrency activities, there is still no regulatory guidance for banks regarding significant aspects of the cryptocurrency market. Notably, there is no regulatory guidance regarding how a bank may make cryptocurrency investments as principal or whether a bank may make loans based on cryptocurrency collateral. There are also no guidelines regarding how a bank might partner with a fintech company to offer cryptocurrency products and services.

Significantly more uncertainty exists with respect to state-chartered banks' engagement in cryptocurrency activities. While the OCC's guidance may pave the way for state-chartered banks to become more involved in cryptocurrency activities, we expect that there will be meaningful engagement and coordination among the various

state banking regulators on this issue. State-chartered banks will need to work with their state banking regulators as the market for banks' cryptocurrency activities develops and expands.

While banks appear poised to operate in an expanding and ever-more-in-demand cryptocurrency market, banks that decide to engage in cryptocurrency activities, including custody and payment activities, need to understand the risks and other regulatory regimes associated with these activities. For national banks, the OCC has said that banks engaging in permissible cryptocurrency activities should "conduct a legal analysis to ensure the activities will be conducted consistent with all applicable laws," including anti-money laundering, Bank Secrecy Act, and consumer protection laws and regulations. The OCC also highlighted that certain cryptocurrencies may be considered "securities" for purposes of the federal securities laws, and therefore may be subject to the OCC's regulations on recordkeeping and confirmation requirements for securities transactions and the SEC's federal securities laws.

Banks should also expect to invest significant resources to improve their technology and security capabilities and systems before engaging in cryptocurrency activities. As the OCC noted in its guidance, a national bank must have sufficient technological expertise to ensure that it can manage new technologies in a safe and sound manner. In the context of custodying cryptocurrencies, the OCC said that national banks should have effective information security infrastructure and controls in place to mitigate hacking, theft, and fraud. The OCC also emphasized that different cryptocurrencies may have different technical characteristics, which require risk management procedures specific to that particular currency.

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[1] Fiat currency is paper money and coins that serves as legal tender by decree, or fiat, of the government. Fiat currency is inconvertible, meaning that it is not convertible into nor backed by any commodity, such as gold or silver.

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