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# Banking Crypto

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# CRYPTO: HOT NEW TREND OR MORE?



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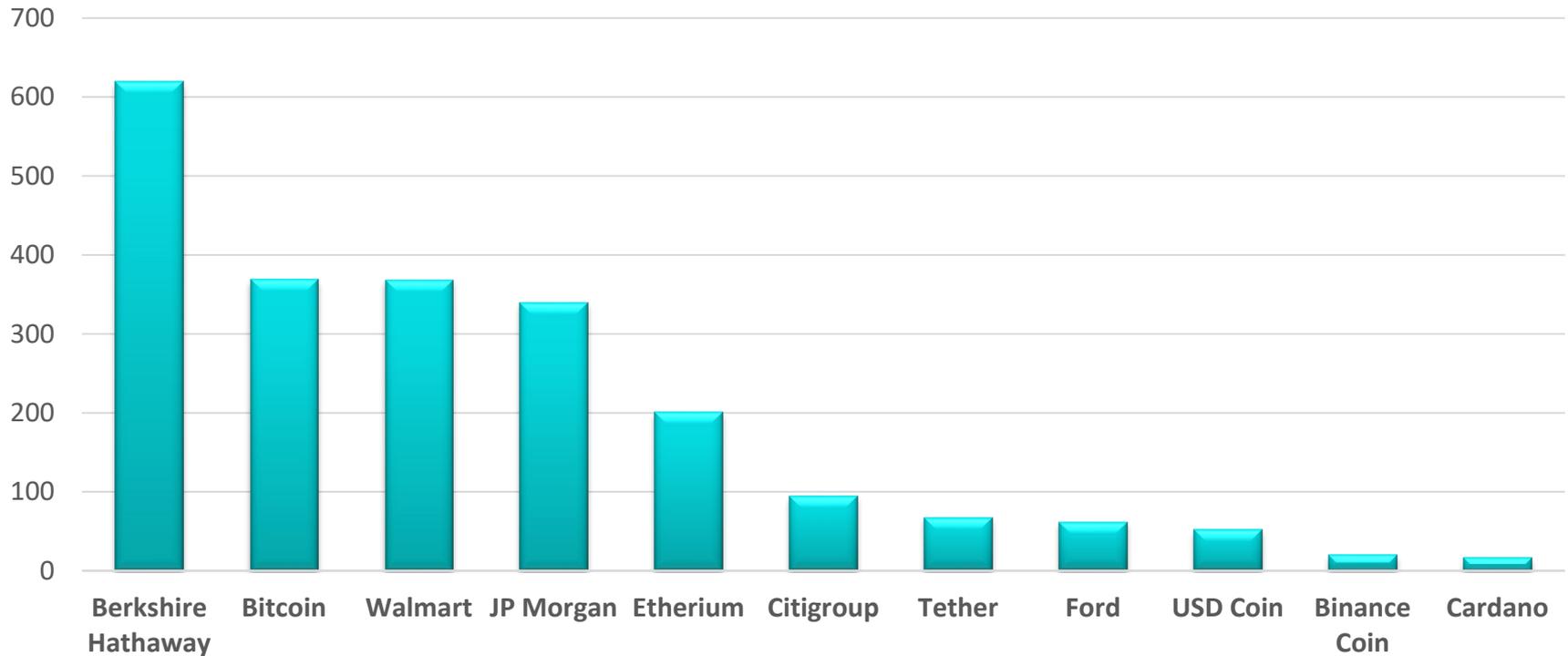
# Introduction

- Cryptocurrency and NFTs have been the subject of considerable investment attention in recent years.
  - As of March 2022, total market cap of crypto markets was over \$2 trillion.
  - Dropped since then, but still substantial at \$1.25 trillion as of June 9, 2022.
- Even retailers and well-known existing brands are exploring how to use these technologies to their advantage.
- It is likely that every area of law will grapple with how to address crypto at some point; the process has already begun in many areas.



# Size of the Cryptocurrency Industry

## Market Cap (\$ billion)



**Top 6 cryptocurrencies have combined ~\$725 billion market cap. Bitcoin would rank #15 in the world among publicly traded companies.**

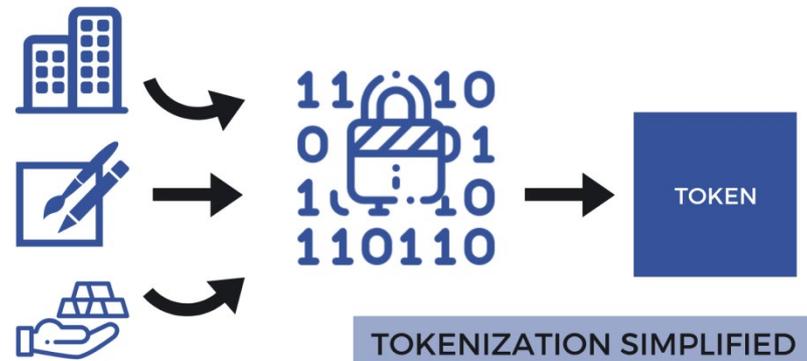
# What is Cryptocurrency?

- AKA “Digital Currency” and “Virtual Currency”
- IRS/CFTC definition:
  - A digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value
- Bitcoin is one example of a virtual currency
  - Thousands of different cryptocurrencies
- A “stablecoin” is a cryptocurrency for which the price is pegged to a real-world asset like gold, the dollar or euro



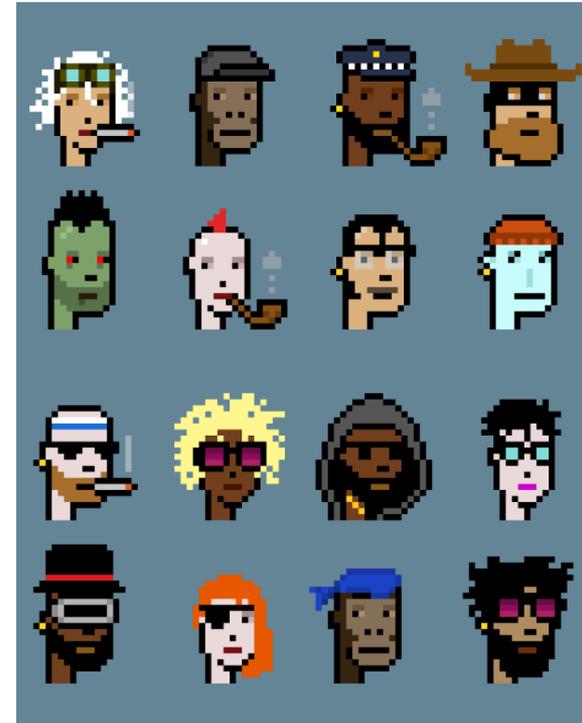
# What is a Digital Token?

- **Tokenization is the process of creating a digital representation, or “token,” of the rights to an asset.**
- Tokenized assets can exist and be traded on a blockchain.
- You get all the benefits of blockchain (immutability, transparency, immediacy, trust, fractional ownership).
- But, tokenizing a physical asset is imperfect. For example, what happens if the physical asset is destroyed but the digital token is immutable?
- **There are many types of tokens:  
Utility Tokens; Security Tokens;  
Currency Tokens; Asset Tokens...**



# NFTs = Non-Fungible Tokens

- **An NFT is a non-fungible digital asset.**
  - “Non-fungible” because each NFT has a unique digital footprint embedded in its code that is immutable and irreplicable as recorded on a blockchain.
  - NFTs can represent a 1 of 1 “original,” such as a unique work of art. NFTs can also represent one of a fixed number of copies in a limited series.
- **In contrast, traditional digital files are fungible.**
  - Like streaming music or sharing digital images by email.
  - You can copy and paste that digital image an infinite number of times and broadly distribute.
- **An NFT serves as unique verification of ownership, like a digital certificate, that could be used to establish ownership of anything after it is created (minted) on one of any number of blockchains.**
  - An NFT is the digital version of a certificate of authenticity, embodied on a blockchain.
  - An NFT is digitally stamped so, although the image can be copied and pasted, the digital file that is transferred can be traced and authenticated to the source.

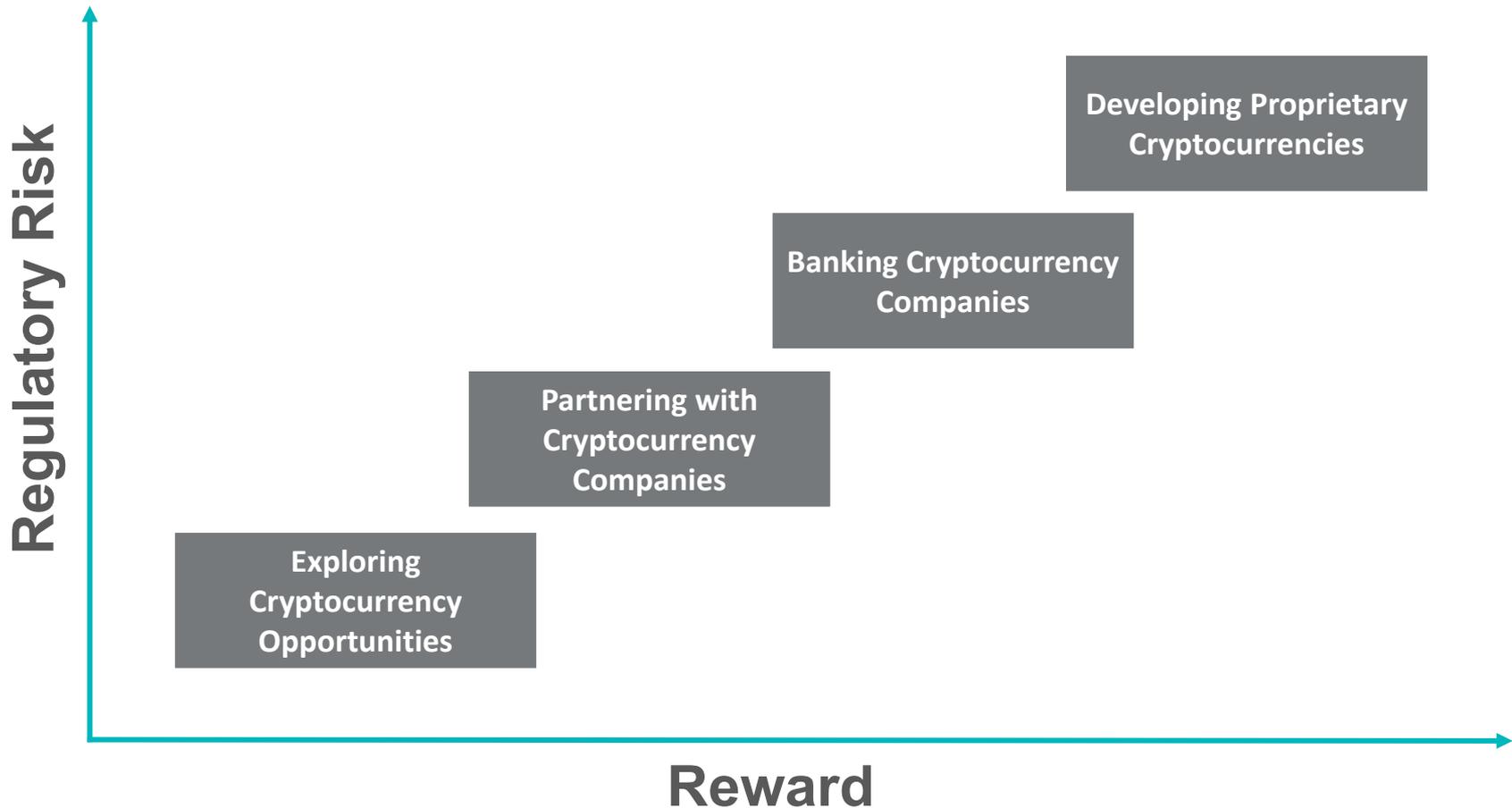


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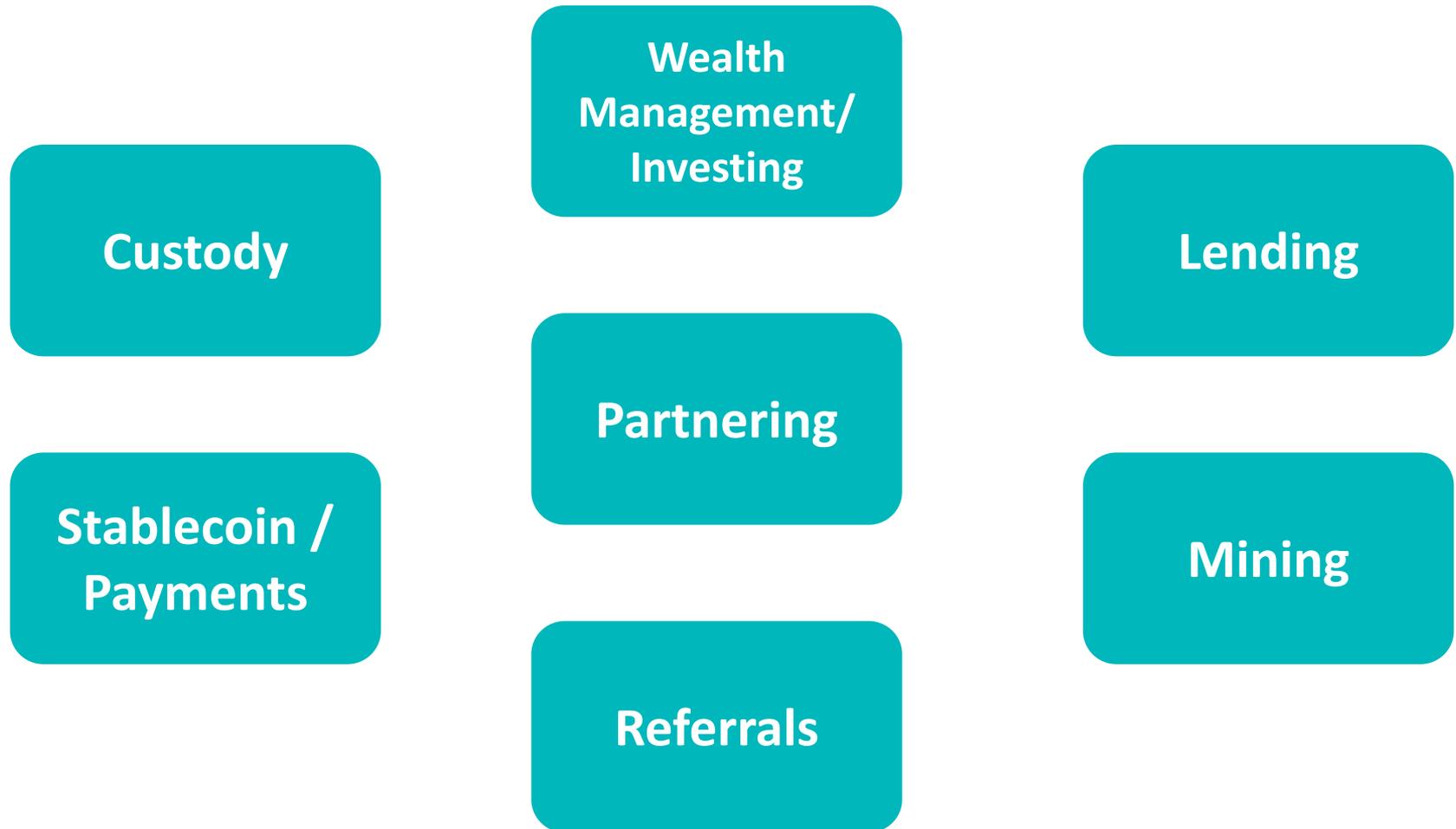
# Cryptocurrency Activity

# Cryptocurrency Activity in the Bank Industry

Wide range of activity by banks in the cryptocurrency space.



# Cryptocurrency Activity in the Bank Industry



# Cryptocurrency Activity in the Bank Industry

“ I’m not a Bitcoin supporter. I don’t care about Bitcoin, and I have no interest in it. On the other hand, clients are interested, and I don’t tell clients what to do.”

- Jamie Dimon, J.P. Morgan CEO



## J.P.Morgan



In 2020, the bank created Onyx, an Ethereum-based platform to provide client solutions, which has since grown into a revenue center <sup>(1)</sup>

In February 2021, JPM Coin was launched on the Onyx network; the proprietary stable coin allows financial institutions to use blockchain rails and smart contracts to transfer value and settle wholesale transactions on a payment-vs-delivery or payment-vs-payment basis



In April 2021, JP Morgan announced that it would be offering a Bitcoin Fund for the first time, with custody services offered by NYDIG, exemplifying the growing trend of traditional players partnering with crypto-native service providers <sup>(2)</sup>



In late 2019, State Street and Gemini announced the launch of a digital asset pilot and in June 2020 went on to launch a new division dedicated to digital finance and the crypto economy



In April of 2021, State Street announced that it had been appointed administrator of a Bitcoin-backed exchange traded on the Frankfurt Exchange



Partnering with crypto-native data and administrative software provider Lukka, State Street announced in July 2021 the provision of digital and crypto fund administration capabilities for private fund clients



Fidelity Investments created a crypto-specific subsidiary – Fidelity Digital Assets – in 2018 to provide institutional-grade solutions in what was a retail-centric space



Focused on custody, trade execution and digital asset client support, Fidelity Digital Assets is the first step for Fidelity to create a comprehensive crypto offering



Bridging digital and traditional asset classes is an explicit long-term goal of the organization. One example is the June 2021 announcement of new clearing and settlement services in collaboration with TP ICAP’s new digital asset platform

Source: Company websites

(1) Finextra, “JPMorgan builds blockchain payments system for Siemens”

(2) Coindesk, “JPMorgan to Let Clients Invest in Bitcoin Fund for First Time”

# Cryptocurrency Activity in the Bank Industry

Many large financial services companies have continued to expand their crypto-related investments over the last several years as new technologies and use cases have emerged.

## SELECTED TOP FINANCIAL SERVICES INVESTORS IN CRYPTO-RELATED COMPANIES <sup>(1)</sup>

Company	Number of Investments	Selected Investments		
	13	<ul style="list-style-type: none"> <li>Eaglebrook Advisors</li> <li>Digital Asset Services</li> <li>Solidus Labs</li> <li>Coin Metrics</li> <li>Casa</li> </ul>	<ul style="list-style-type: none"> <li>Figment Networks</li> <li>Wintermute Trading</li> <li>FalconX</li> <li>BlockFi</li> <li>OpenNode</li> </ul>	<ul style="list-style-type: none"> <li>Talos Trading</li> <li>Stacked Financial</li> <li>Circle Internet Financial</li> </ul>
	6	<ul style="list-style-type: none"> <li>Unbound Tech</li> <li>HQLAx</li> <li>Coin Metrics</li> </ul>	<ul style="list-style-type: none"> <li>Blockdaemon</li> <li>One River</li> <li>Anchorage</li> </ul>	
	5	<ul style="list-style-type: none"> <li>Unbound Tech</li> <li>HQLAx</li> <li>Contour</li> </ul>	<ul style="list-style-type: none"> <li>Amberdata</li> <li>TRM</li> </ul>	
	4	<ul style="list-style-type: none"> <li>Candex</li> <li>HQLAx</li> <li>Consensys</li> <li>Blockdaemon</li> </ul>		
	4	<ul style="list-style-type: none"> <li>Linklogis</li> <li>Metaco</li> <li>Copa Fin</li> <li>Contour</li> </ul>		
	3	<ul style="list-style-type: none"> <li>Contour</li> <li>Axon</li> <li>we.trade</li> </ul>		

Source: FT Partners' Proprietary Transaction Database

(1) Unique company investments over trailing two-year period (01/01/21 – 02/16/22)

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# Regulatory Framework

On March 9, 2022, President Joe Biden signed an executive order delineating federal priorities in evaluating and regulating digital assets, and instructing a range of federal agencies to gather facts on digital assets markets and technology in pursuit of constructing a regulatory regime that balances opportunity and risk in digital assets.

Overview

- The executive order strikes a balanced approach to future regulation and legal framework of digital assets
- At its core, crypto business models and activities that replicate those in other asset classes should be regulated correspondingly
- The executive order calls for:
  - The exploration of a US CBDC
  - The protection of US consumers, investors and businesses
  - The protection of US and Global Financial Stability, and the mitigation of systemic risk
  - The mitigation of illicit finance and national security risks posed by the illicit use of digital assets
  - The promotion of US leadership in technology and economic competitiveness to reinforce US leadership in the global financial system
  - The promotion of equitable access to safe and affordable financial services
  - The support of technological advances, and ensuring responsible development and use of digital assets

The White House's Executive Order on Digital Assets Reporting Schedule <sup>(1)</sup>

Days from Order	30	60	90	120	150	180	210	540
Initiative	Deliverable							
US CBDC	Report on Implications of CBDC on economic growth and stability, financial inclusion, financial crime							
	Assess whether legislation is necessary to issue CBDC							
	Provide a legislative proposal based on the Treasury report above and input from the Federal Reserve							
Consumer, Investor & Business Protection	Report on the implications of digital assets for US consumers, investors, businesses and for equitable economic growth							
	Report on technical evaluation of the technological infrastructure, capacity, and expertise to implement CBDCs							
	Report on environmental / energy impact of digital assets and blockchain technology more generally						Update energy / environmental report to address any knowledge gaps	
	Report on the role of law enforcement agencies in detecting, investigating, and prosecuting criminal activity in digital assets							
Stability, Systemic Risk, & Market Integrity	Report outlining financial stability risks and regulatory gaps on various digital assets, providing recommendations to address risks							
Illicit Finance & Associated National Security Risks*	Develop Coordinated action plan based on report							
	Notify relevant agencies on any rulemaking related to digital asset illicit finance risks							
	Generate additional annexes to Treasury report							
International Cooperation & US Competitiveness	Establish framework for interagency international engagement on global principles for digital assets				Submit report on priority actions taken under the framework and its effectiveness			
	Establish a framework for enhancing US economic competitiveness in, and leveraging of, digital asset technology							
	Report on strengthening international law enforcement cooperation on digital assets							

\* The timeline for these reports begins following the Treasury's submission of the National Strategy for Combating Terrorist and Other Illicit Financing Report to Congress

Legend:

Secretary of the Treasury  
Secretary of Commerce

Attorney General  
Director of OST and / or US CTO

Various Department Heads

Sources: The White House Briefing Room  
(1) Cipolaro, G., Kochav, E. "NYDIG Research Weekly Newsletter". March 10, 2022.

## Federal Reserve

- **Access to FRB master account – Who may have an FRB account?**
  - Federal Reserve Guidelines (May 11, 2021, 86 Fed. Reg. 25,865; March 8, 2022, 87 Fed. Reg. 12,957; August 15, 2022, forthcoming)
  - Custodia Bank sues Federal Reserve for a master account (June 2022)
- **CBDC** – A direct liability of the Federal Reserve that is widely available to the general public (January 2022 report)
- **SR 22-6** – Bank holding companies and state member banks should consult with the Federal Reserve before engaging in crypto-asset-related activities

## OCC

- **Interpretive Letters**
  - 1170 (July 2020) (banks may provide cryptocurrency custody services);
  - 1172 (October 2020) (banks may hold dollar deposits serving as reserves backing stablecoins in certain circumstances);
  - 1174 (January 2021) ((1) banks may act as nodes on an independent node verification network (i.e., distributed ledger) to verify customer payments and (2) banks may engage in certain stablecoin activities to facilitate payment transactions on a distributed ledger.); and
  - 1179 (November 2021) (affirms IL 1170, IL 1172, and IL 1174, but provision of services must be safe and sound and supervisory notice required)
- **Trust only charters to cryptocurrency companies**
  - Anchorage (Opened January 2021, Consent Order April 2022)
  - Protego (Conditional Conversion Approval February 2021)
  - Paxos (Conditional Approval April 2021)

## FDIC

- 12 USC 1831a – insured bank cannot engage in an activity that is not permissible for a national bank
- May 2021 request for information (RFI) focused on how banks are investing in and deploying digital assets/cryptocurrencies
  - FDIC Chairman Jelena McWilliams noted that the goal of the RFI is to shed more light on “what banks are doing, what banks are considering doing and what, if anything, the FDIC should be doing in this space.”
- April 2022: FIL 16-2022
  - Upon receipt, the FDIC will review the notification and information received, request additional information as needed, and consider the safety and soundness, financial stability, and consumer protection considerations of the proposed activity.
- August 2022 – Cease and Desist Letters to five companies for making misleading or false statements about deposit insurance

## Treasury/FinCEN

- Interpretive Guidance & NPR
- Secretary Yellen's calls for "comprehensive and coordinated" approach to regulation

### Other Considerations:

- SEC
- CFTC
- IRS
- DOL

***Bitcoin stands out***

# State Regulatory Framework

- States leading the way in providing clarity for how banks can offer cryptocurrency products and services
- Different approaches: Piecemeal vs. Wholesale
- Don't forget about guidance
- May see a wave of new state-level laws in the coming years, e.g., Nebraska, Virginia in 2022
- Unified action? (Conference of State Bank Supervisors)

**Permissive**

**Restrictive**

Wyoming

California

Arkansas

New York

## Three-Prong Analysis:

- 1. Is there something that expressly gives my bank the authority to conduct this specific activity? Or is there something that expressly prohibits it?**
  - OCC interpretive letters; state laws
  
- 2. Is there something I can analogize this to? Is this simply an extension of a traditional banking activity?**
  - Just custodying a new asset class
  - Just lending against a new asset class
  - Just using a new form of technology (stablecoin) to facilitate payments
  
- 3. Is this an implied power? Or, can my state bank rely on national bank parity?**

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# Risk Management

# Risk Management Framework

Banks remain responsible for proper risk management for all products or services provided, regardless of involvement of a third-party service provider.

## US (Federal Deposit Insurance Corporation) FDIC:

"An institution's board of directors and senior management are ultimately **responsible for managing activities conducted through third-party** relationships, and identifying and controlling the risks arising from such relationships"

*FIL 44-2008*

## US Consumer Financial Protection Bureau (CFPB):

"[We] expect institutions to oversee business relationships with service providers with the **same level of scrutiny as any other line of business** in which it is engaged."

*CFPB 2012-03*

## US DODD-FRANK ACT:

"A service provider is "any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service"; a covered person is "any person that engages in offering or providing a consumer financial product or service; and any affiliate of a person described [as such] if such affiliate acts as a service provider to such person"

*Dodd-Frank Act (Section 1002(26))*

## US Office of the Controller of the Currency (OCC)

" [A] third-party relationship is any business arrangement between a bank and another entity, by contract or otherwise". A bank's **use of a third party** "**does not diminish the responsibility** of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws".

*OCC 2013-29*

- *To address the problems of synthetic banking in payments and of fragmented supervision of crypto, and to create an environment where responsible innovation can flourish, we need to “level up” banking and finance. I am using “level up” in both senses of the term—that is, to increase something in order to remove a disparity, and to progress to the next level. We need to remove the disparity between the rights and obligations of banks and the rights and obligations of synthetic banking providers by holding SBPs to banking standards. **At the same time, we need banks, fintechs, and crypto firms to step up and make the business of handling other people’s money an ultra-high trust endeavor, where the needs of all customers are met in a reliable and consistently safe, sound, and fair way.***
- *At the OCC, we have begun to increase our focus on the banks that provide services to large fintechs and facilitate synthetic banking outside of the bank regulatory perimeter.*

# 9 Pillars of Third-Party Risk CMS

1. Risk Assessment

2. Diligence

3. Board Tolerances and Oversight

4. Contracts

5. Policies and Procedures

6. Compliance

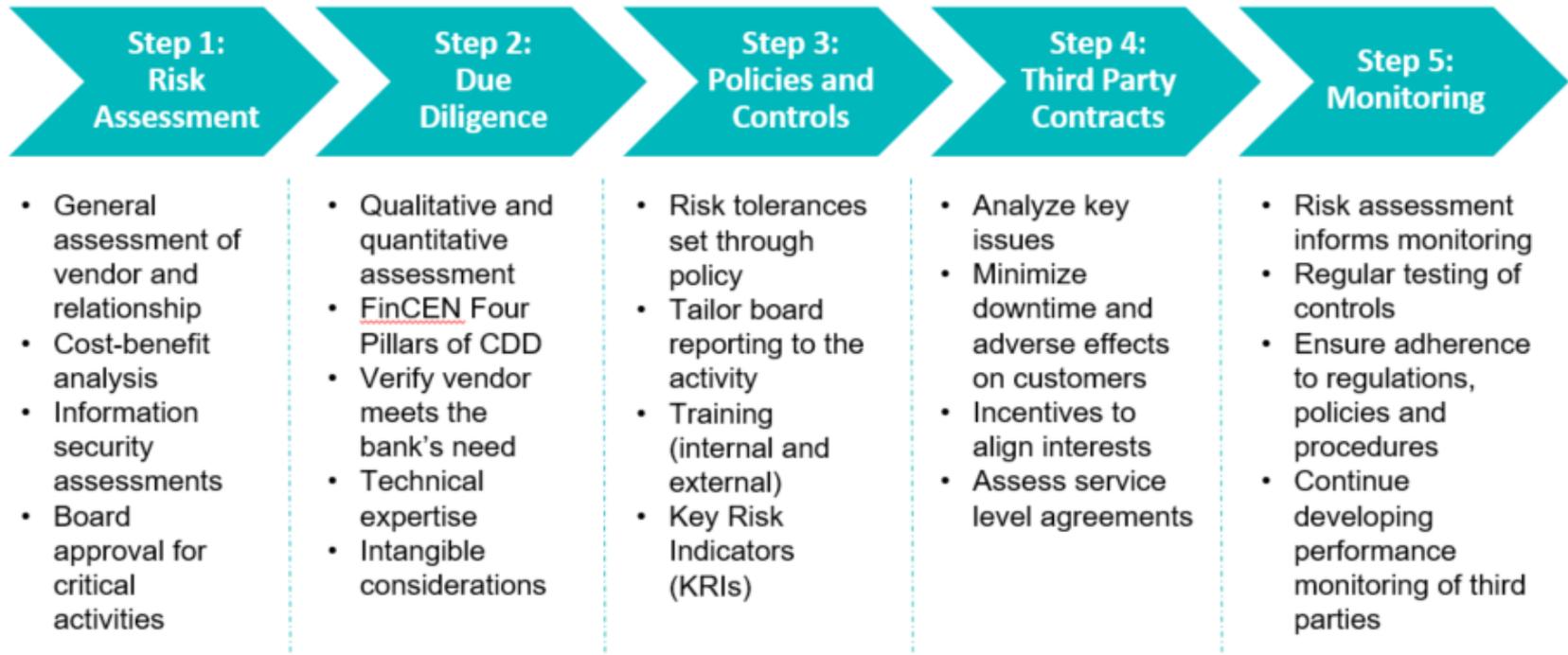
7. Training

8. Customer Complaint Management

9. Testing/Monitoring

# Risk Management Stages

Banks should follow a structured framework for third-party risk management.



## RISK ASSESSMENT OF:

- Strategic
  - How does the activity fit with the strategic plan?
  - Consider the likely returns and impact of compliance controls on the income stream
- Credit
- Operational
  - Technology, BSA/AML
- Compliance
- Transactional
- Legal
- Reputation
- Fraud
- Third-party risk

# Conducting Due Diligence on Financial Technology Companies August 2021

- Business experience and qualification
- Financial condition
- Legal and regulatory compliance
- Risk management and controls
- Information security
- Operational resilience

### Board Level KRIs

- Monthly volume and charge-offs
- Complaints
- Monthly SAR filings
- Number of SLA misses

**KRIs should be monitored as averages with large deviations being flagged and investigated.**

### Bank Level KRIs

- Weekly volume
- Weekly charge-offs
- New account exceptions
- Customer complaints
- Weekly SAR filings
- Complaints (CFPB Complaint Database)
- Number of SLA misses

## Step 4: Third Party Contracts

“Financial institutions should engage experienced counsel to ensure that its interests are protected and potential contingencies are considered, such as the potential effect of regulatory changes on the vendor’s obligations and performance.” *Federal Reserve Bank of Philadelphia, Consumer Compliance Outlook (First Quarter 2011)*

- Third party contract. Issues to be addressed include:
  - Scope of outsourced services
  - Critical terms
  - Written procedures
  - Service levels
  - Payment schedules
  - Incentives to align interests of the service provider and financial institution
  - Customer protections

- Third party monitoring
  - Performance monitoring controls include:
    - Auditing compliance with consumer protection laws and regulations
    - Periodic monitoring, including on-site quality assurance reviews
    - Regularly reviewing metrics for the third party's performance relative to service level agreements
    - Reviewing customer complaints for services or products handled by the third party (conducting anonymous testing)
    - Compliance with contract terms
    - Third party's training to its employees
    - Periodic performance review

### Assess Risk Management Framework

- Review and revise policies and procedures
- Develop risk assessment standards
- Evaluate third-party complaint management systems
- Due diligence framework and documentation
- Monitor/test
- MIS/board reporting

**Remember:**  
***Document,***  
***document,***  
***document!!***

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Questions?

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