



BankDirector.

Custody of Digital Assets

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Custody of Digital Assets

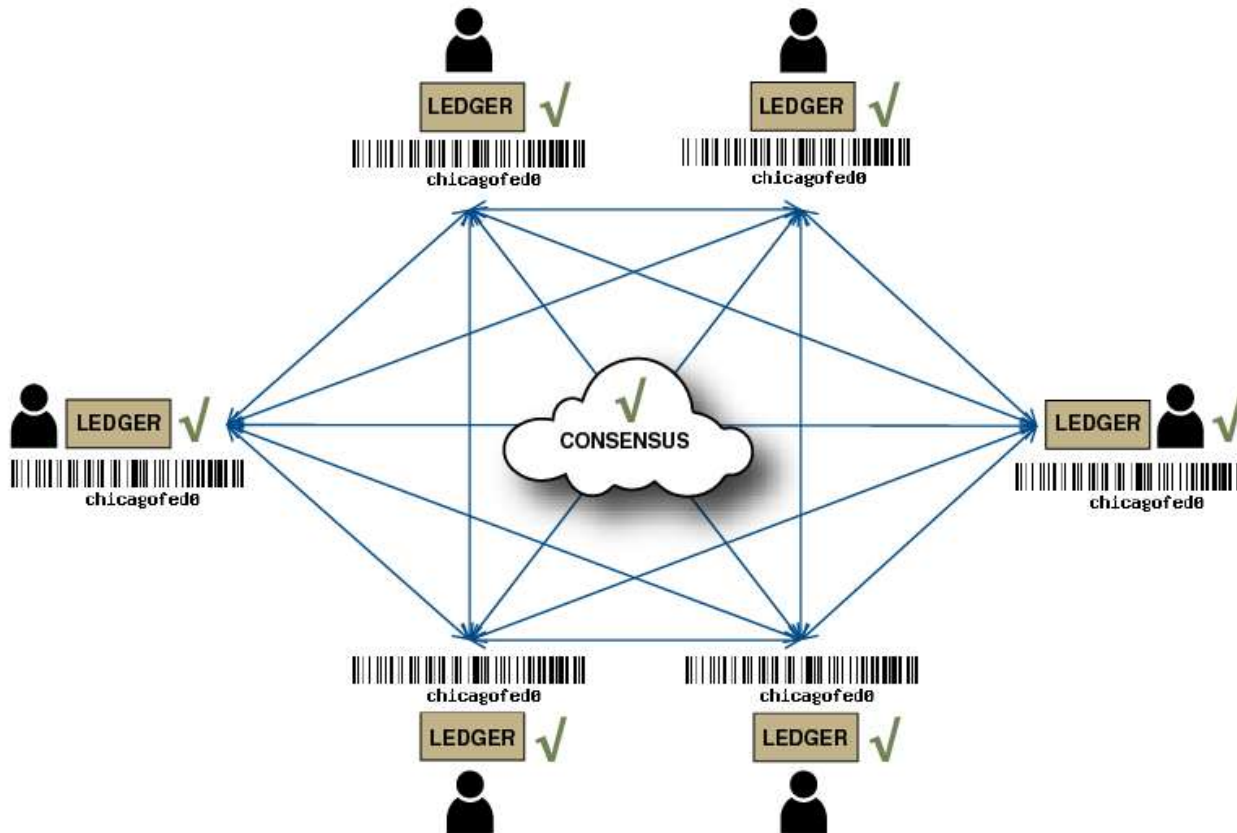
- **Introduction** - brief overview of distributed ledger technology
- **Drawing the Lines** - Blockchain Technology, Digital Currencies, Digital Assets, and Wallets
- **An Invitation for Banks** - OCC Regulation of Custody of Digital Assets – 2020 Interpretive Letter
- **A Caution to Banks** - SEC Response to the 2020 Letter
- **Clarifying Obligations** - OCC 2021 Interpretive Letter
- **A Two Layer System** - State Regulation of Digital Assets – New York BitLicense
- **Conclusion**

- Regulators in the United States have attempted to craft a clean solution to the complex problem of the custody of digital assets.
- As investors have become increasingly interested in digital assets, U.S. regulators have faced the challenge of attempting to protect customer funds and securities using laws written in the 1930s, 1940s, and 1970s.
- Unfortunately, these laws were not designed to regulate custody of digital assets.
- This presentation provides an overview of digital assets and the technology used to hold digital assets, including Bitcoin followed by a focus on the current state of the regulation of custody of digital assets by the Office of the Comptroller of the Currency (“OCC”), the Securities and Exchange Commission (“SEC”), and the New York Department of Financial Services (“NYDFS”).
- In this presentation we use the term “**digital asset**” which refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology. Digital assets cover a wide range of assets including virtual currencies, coins, and tokens.
- Importantly, a digital asset may meet the definition of a “security” under the federal securities laws.
- For the purposes of this presentation, a digital asset that is a security is referred to as a “digital asset security.”


- Blockchain technology (also known as distributed ledger technology) is a distributed list of all transactions across a peer-to-peer network.
- Blockchain technology is at the core of Bitcoin and other digital currencies. It has the potential to disrupt a wide variety of business processes.
- A blockchain is meant to be an authoritative record because every user agrees on it. In some blockchain initiatives there are no central, regulated institutions playing any role in the process.
- Blockchain technology is a database structure that can only be updated by appending a new set (or block) of valid transactions to the log of previous transactions.
- As noted by Goldman Sachs in a note to clients:

In its most basic form, the **blockchain records ownership of bitcoin and transactions involving the crypto currency across a wide network of computers, as opposed to a centralized ledger.** Transactions are signed off by the parties involved using the software, checked by the network or the “crowd,” then added to the blockchain – a long string of code that records all activity. Encryption in the software ensures these “blocks” cannot be tampered with or altered. And the de- centralized nature means the “crowd” police the whole system. **The software cuts out the need for a “trusted middleman” to sit in between parties in a transaction, such as a bank or clearinghouse.** This makes transactions quicker, cheaper, and easier when compared to the current systems banks use.

Blockchain Technology (Part I)

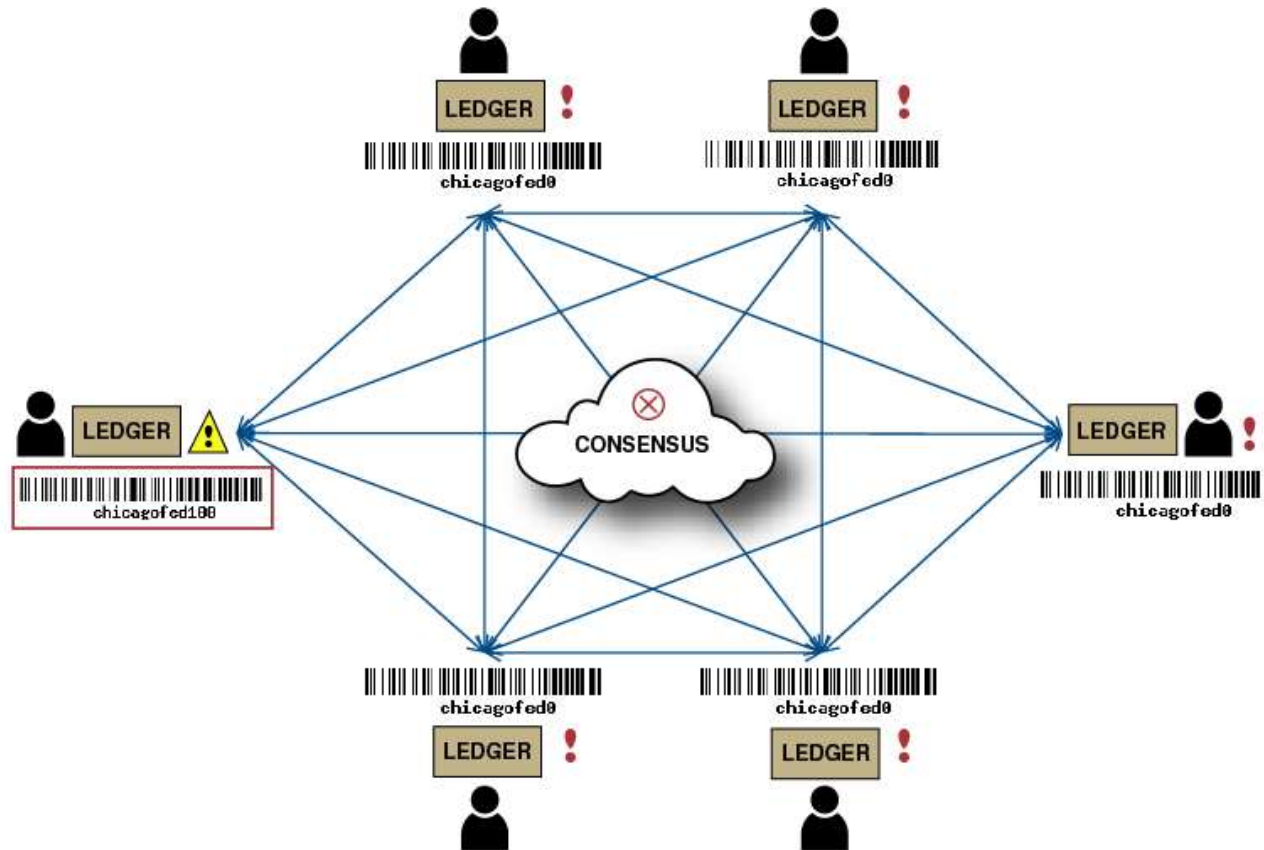


Operator: Each node operator is able to update his/her record in the ledger, communicate that information to the network, and reconcile his/her ledger with the other nodes in the network.

 This represents the current state of the ledger.
chicagofed0

- Each user of the network agrees on the “official” or “authoritative” ledger of transactions.
- Each entry in the ledger is given a cryptographic code that is compared against other operators in the network.
- When all the operators/nodes agree on the ledger, consensus is reached, and the official record is created. (“chicagofed0”).

Blockchain Technology (Part II)



- Prior to the transaction, the network had consensus on the ledger: (“chicagofed0”)
- When a new transaction is submitted to the network, the operators/nodes notice a change. (New Ledger: chicagofed100).
- At this point, the network must “reconcile” the change and reach consensus on the new, official ledger.

⊗ When a node operator updates his/her records and digitally signs the ledger, it will invoke a reconciliation/consensus fail alert.

⚠ Represents a change in the state of the ledger. In this example, the state of the ledger changes from chicagofed0 to chicagofed100.

! When the states of the ledgers do not match, there is an alert that notifies node operators about the change.

- When a new transaction is added to the ledger, the network must have a way to “validate” and confirm the legitimacy of the change to the official ledger.
- There are any number of solutions to this challenge:
 - A central “authority” approves changes.
 - A decentralized system where each operator approves a change.
 - Bitcoin does this through “proof of work”—operators present the solution to a mathematical puzzle derived from the block’s header—requiring vast computing power. These “miners” are given rewards for their “proof of work.”
 - If any one operator/node submits a falsified record, it is immediately discovered by the other operators/nodes. Thus, to commit fraud, a bad actor would have to corrupt the entire operator/node network.
 - A record cannot be deleted or altered. The network only allows the consensus to “add” to the record. All records are viewed by all operators/nodes.
 - Once a block is added to the chain, a new “block hash” or cryptographic key is created that will “solve” the mathematical puzzle. The “owner” then receives this key, along with the previous key.
- When a new transaction is added to the ledger, it is encoded and becomes a permanent transaction record for that particular block.

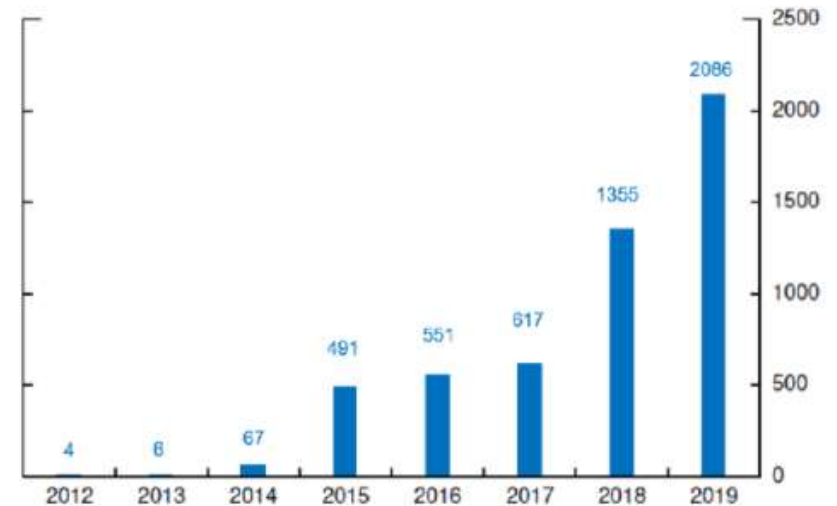


U.S. SECURITIES AND
EXCHANGE COMMISSION

- The SEC has defined digital assets as “an asset that is issued and transferred using distributed ledger or blockchain technology.”
- Digital assets include, but are not limited to digital (virtual) currencies, coins, and tokens.
- A digital asset may in certain instances be deemed a security under the federal securities laws.
- While not defined in the securities laws, the SEC often refers to digital assets that are securities as a “digital asset securities.”

- Digital currencies are monetary units of exchange stored or represented in a digital or other electronic format that operate like currency in some environments, but that do not have legal tender status in any jurisdiction.
- The term digital currency refers to electronic money that operates like a currency in some environments but does not have all the attributes of “real” (i.e., “fiat”) currency issued by a governmental agency.
 - Digital currencies can be created by an individual, corporation, or organization, or can arise from use and acceptance by people as currency.
 - Traditional currencies are generally either backed by the faith and credit of the national governments that recognize the currency (the fiat system) or by real assets or hard commodities, such as gold, silver, or minerals (the commodity system).
 - Digital currencies can be backed by the system and market setting a value (Bitcoin) or through various “tethers” to fiat currency.
 - Tether coins promise that the coin is backed by some amount of fiat currency or a physical assets (such as a real estate tether coin).

Figure 6 Number of Cryptocurrencies 2012-2019



*Source: Federal Reserve Update (Dec. 18, 2019)

Total Market Capitalization



*Source: CoinMarketCap



FinCEN GUIDANCE

FIN-2019-G001

Issued: May 9, 2019

Subject: Application of FinCEN's Regulations to Certain Business Models
Involving Convertible Virtual Currencies

- FinCEN Requirements (a quick primer):
 - **Exchanges** (whether digital currency-to-digital currency or fiat-to-digital currency) must register with FinCEN and comply with money transmitter requirements.
 - **Digital currency ATM providers** must comply with BSA/AML and FinCEN requirements for money transmitters.
 - **Mixers or digital currency anonymizers** are money transmitters and are subject to FinCEN registration and requirements.
 - **Digital currency payment processors** do not have exemptions for merchant payment processing is regulated as money transmission.

- Digital assets are stored by associating them with addresses called “wallets” which can be stored on web servers, local hardware like personal computers, jump drives and mobile devices, or on paper print-outs.
- A digital asset wallet takes the form of a cryptographic public key, which is a string of numbers and letters. Each public key has a matching “private key,” known only to the user.
- Control of the private keys is what assures one of control of the digital assets at any address, so collections of private keys must be protected by passwords or other means of securing them.
- The question of the custody of digital assets that are securities presents substantial problems for firms registered with the SEC as an investment adviser or a broker-dealer.

Banks Facilitating Digital Currency Transactions



- *Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses* (April 26, 2005).
- Banks must conduct due diligence on their customers, including registered/unregistered money services businesses:
 - Follow the bank's CIP;
 - Confirm FinCEN registration and if it is required;
 - Confirm compliance with state and local licensing requirements;
 - Confirm agent status, if applicable;
 - Conduct a basic BSA/AML risk assessment and identify follow-up due diligence.
- Both the OCC and FDIC have pursued actions against banks that facilitated illegal money transmission through unregistered money services businesses ("MSBs").
- To date, most enforcement actions regarding digital currency has been focused on the exchanges, providers, or anonymizers—not the banks. However, in February 2020, the OCC took action against **M.Y. Safra Bank, FSB** for facilitating transactions for cryptocurrency-related unregistered MSBs. The bank had been processing transactions for digital currency exchangers, digital currency ATM operators, crypto arbitrage trading accounts, blockchain developers and incubators, and fiat currency MSBs.

Requirements for Banks

Adequate Customer Due
Diligence

Review of the Digital Asset for
Legal Compliance

Compliance with Anti-Money
Laundering Obligations for
Cryptocurrencies

Compliance with SEC
Requirements for Recordkeeping
and Confirmations

Overall Compliance of the Digital
Asset for Compliance with Legal
Requirements

Adequate Knowledge of the
Assets and Ability to Properly
Manage the Asset

OCC Regulation of Custody of Digital Assets



- On July 22, 2020 (the “2020 Letter”), the OCC published an interpretive letter recognizing that a national bank may provide custody services for cryptocurrencies, including providing storage for the cryptographic keys associated with these assets.
- The 2020 Letter discussed the custody services provided by banks and concluded banks may provide “cryptocurrency custody services, including holding the unique cryptographic keys that permit the control and transfer of the customer’s cryptocurrency, is a modern form of these traditional bank activities.”
- The 2020 Letter recognized past OCC interpretive letters that authorize national banks to provide similar services such as escrow encryption keys used in connection with digital certificates, and secure web-based document storage, retrieval and collaboration of documents and files containing personal information or valuable confidential trade or business information.
- The 2020 Letter notes providing custody for cryptocurrencies will require a bank to provide custody for cryptographic keys. The OCC reiterated that national banks have the authority to provide custody for this type of digital assets.
- The OCC also affirmed the agency’s belief in its own expansive power to “authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform.”

- Services Identified by the OCC the 2020 Letter:
 - Crypto-to-crypto exchanges
 - Crypto-to-fiat exchanges
 - Transaction settlement
 - Trade execution
 - Recordkeeping, valuation, and tax services
 - Custodian for the digital assets
 - Custodian for the cryptographic keys in digital or physical forms

- Services could be performed in a fiduciary or non-fiduciary context (the former subject to the trust or custody requirements of national banks).

- All of these services would fall within the “powers” granted to national banks and federal savings banks.

OCC Letter on Custody of Digital Assets

- National banks have declined to provide custody services for cryptocurrencies and other digital assets because of the lack of clarity on the permissibility of custody of digital assets.
- While some state-chartered trust companies have provided these services, the majority of state banks have also declined to do so because of the lack of regulatory clarity.
- The OCC guidance may expand the number of banks that are willing to provide custodial services for digital assets which will enable more institutions and individuals to invest in digital assets.
- The 2020 Letter may also enable registered investment advisers, which are required to maintain custody of their assets at banks under the Investment Company Act, to hold cryptocurrencies.
- The 2020 Letter may also enable registered investment advisers with retail customers, whose assets are commonly held in brokerage accounts, to advise on cryptocurrencies.
- Finally, the 2020 Letter may enable broker-dealers to hold cryptocurrencies in customer accounts consistent with the requirements of the Customer Protection Rule (Rule 15c3-3).

- Following the 2020 Letter, the staff of the SEC Strategic Hub for Innovation and Financial Technology (“FinHub Staff”) issued a statement noting the OCC issued a **limited interpretation** regarding holding reserves of a stablecoin associated with hosted wallets that is backed by a single fiat currency and redeemable by the holder of the stablecoin on a 1:1 basis for the underlying fiat currency upon submission of a redemption request to the issuer.
- The FinHub reminded firms that whether a digital asset is a security under the federal securities laws is based on a facts and circumstances analysis.
- On December 23, 2020, the SEC issued a statement and request for comment regarding the custody of digital asset securities by broker-dealers in order to encourage innovation around the application of the Customer Protection Rule to digital asset securities.
- The statement sets forth the SEC’s position that, for a period of five years, a broker-dealer operating under the circumstances set forth in the statement will not be subject to an SEC enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities.

- On January 4, 2021, the OCC published a Chief Counsel’s Interpretative letter (the “2021 Letter”) confirming the authority of national banks’ and federal savings associations’ to participate in independent node verification networks (“INVN”) (distributed ledger technology), and use stablecoin cryptocurrency to conduct payment activities and other bank permissible functions.
- The 2021 Letter concludes a national bank or federal savings association may validate, store, and record payments transactions by serving as a node on an INVN.
- A bank may use INVNs and related stablecoins to carry out other permissible payment activities.

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.

- In the press release (the “Release”) accompanying the 2021 Letter the OCC noted the benefits of block chain technology to the banking system:

[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.

- The Release 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.
- 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.”

- The use of stablecoins by national banks to effect payments is one step away from authorizing the creation of stablecoins by individual banks.
- A major Japanese bank has created its own yen pegged stablecoin and a major U.S. bank has issued its own stablecoin.
- The National Bank Act passed during the presidency of Abraham Lincoln authorized the creation of national banks.
- 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”
- 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.

New York Regulation of Custody of Digital Assets

- On June 24, 2015, NYDFS adopted regulations on virtual currency businesses in New York State.
- Under the regulations, any person that is a resident of or located in or has a place of business or is conducting business in New York and is engaged in a “virtual currency business activity” is required to obtain a license from NYDFS.
- Licensed virtual currency businesses must: (i) have in place certain compliance policies; (ii) meet capital requirements set by NYDFS on a case-by-case basis; (iii) **meet prescribed customer protection and asset custody standards**; (iv) keep certain required books and records; be subject to NYDFS examinations; (v) have implemented anti-money laundering and cyber security programs; (vi) have a business continuity and disaster recovery program in place; and (vii) establish and maintain a customer complaints process.
- Louisiana recently joined New York and became the second state to enact a stand-alone virtual currency law.
- Louisiana’s Virtual Currency Business Act became effective August 1, 2020.

- A three-step analysis helps determine if a business must obtain a BitLicense. First the entity must offer a product or service that involves a “virtual currency.”
- NYDFS Rule 200.2(p) defines “virtual currency” to include “any type of digital unit that is used as a medium of exchange or a form of digitally stored value.”
- If the business involves a virtual currency, the analysis turns to whether the business is engaged in a “virtual currency business activity.”
- The regulations define the term “virtual currency business activity” as the conduct of one or more of several types of activities involving New York or a New York resident, including among others: **storing, holding, or maintaining custody or control of virtual currency on behalf of others**; performing Exchange Services as a customer business; or **controlling**, administering, or issuing a virtual currency.
- The development and dissemination of software alone does not constitute a virtual currency business activity.
- However, the act of serving as a custodian of virtual currency in New York or for New York residents brings a party within the scope of the BitLicense, unless they fall within the scope of an exemption from registration.

BitLicense Exemptions and Reciprocity

- The BitLicense regulations provide limited exemptions from the licensing requirement for entities chartered under the New York Banking Law and “merchants and consumers using virtual currency solely for the purchase of goods or services or for investment purposes.”
- A firm that is subject to regulation by a functional federal regulator, including the *OCC*, the *SEC*, or a futures commission merchant registered with the U.S. Commodity Futures Trading Commission would be required to obtain a BitLicense, if it performs any of the functions discussed above.
- In addition, because the exemption is only for entities chartered under the New York Banking Law, money transmitters registered with the U.S. Office of Financial Crimes Enforcement Network and licensed by NYDFS or other states are not exempt from the BitLicense license requirement.
- Agency principals also do not apply to licensing requirements for the BitLicense as they otherwise might within other regulatory regimes.
- **The BitLicense regime does not provide for any reciprocity for persons similarly registered in other states.**
- Accordingly, a custodian that is not chartered under the New York Banking Law will have to obtain a BitLicense to provide custody of digital assets for New York residents.

New York Limited Purpose Trust Charter

- In New York, virtual currency businesses are exempt from the BitLicense requirements if they are chartered under the New York Banking Law as a limited purpose trust company and are approved by the superintendent to engage in virtual currency business activity.
- An entity chartered as a New York limited purpose trust company must obtain approval from NYDFS when there is a change in the general character of its business or a change in its corporate structure or control.
- Under the limited purpose trust charter, an entity must comply with similar regulatory compliance requirements as required by the BitLicense.

Conclusion

- The issue of custody of digital assets is a complex problem that has plagued the development of the FinTech industry.
- The guidance from the OCC states national banks may hold digital assets, the letter does not address whether such assets are protected by the Federal Deposit Insurance Corporation.
- While trust companies in certain states may be authorized to hold digital assets, the New York BitLicense limits the ability of such firms to provide services to in all states because the BitLicense regime does not recognize trust companies that are chartered in other states as being exempt from the registration requirement.
- At some point in the not too distant future blockchain technology may lead to a reinvention of the custody rules themselves, however, until that time banks will struggle to deal with the gordian knot of custody of digital assets.

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