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Federal Reserve Board Policy Statement on Permissible State Member Bank Activities

Policy Statement Severely Restricts “Crypto-Asset-Related” Activities and Imposes New Standards and Requirements for All Activities of State Member Banks “As Principal”

SUMMARY

On January 27, 2023, the Board of Governors of the Federal Reserve System issued a policy statement exercising its authority under Section 9(13) of the Federal Reserve Act to limit the activities of state member banks and their subsidiaries in a manner “consistent with Section 24 of the Federal Deposit Insurance Act.” The policy statement establishes a rebuttable presumption that state member banks may engage as principal in only those activities that are permissible for national banks, unless those activities are permissible for state banks by federal statute or under Part 362 of the FDIC’s regulations. In addition, to the extent that there are conditions to a national bank’s engagement in an activity, the policy statement requires state member banks to comply with the same conditions, including submitting to Federal Reserve supervisory staff the same notice that national banks must submit to OCC supervisory staff prior to engaging in such activities. The policy statement also reminds state member banks that legal permissibility is a necessary, but not sufficient, condition to establish that a state member bank may engage in a particular activity, and that state member banks must at all times conduct their business and exercise their powers with “due regard” to safety and soundness.

Although the policy statement appears designed to restrict severely crypto-asset-related activities, its breadth could impose additional procedural requirements and substantive limitations on the conduct of any activities as principal, regardless of the nature of those activities. By deferring to the FDIC and the OCC with respect to the powers of state member banks, the policy statement may also make it difficult for the

Federal Reserve to facilitate new or innovative services by both insured and uninsured state member banks, even if the Federal Reserve believes that they would be suitable for the banks in question and beneficial to the financial system or the economy as a whole. The policy statement's provisions on crypto-related assets appear to represent a severe restriction on activities involving virtual currencies and other crypto-assets (except for custody services), and could even restrain the use of new technologies, including distributed ledgers, to conduct traditional banking activities.

GUIDANCE

On January 27, 2023, the Board of Governors of the Federal Reserve System (the "Board") issued a policy statement (the "Policy Statement") pursuant to Section 9(13) of the Federal Reserve Act (the "Act"), establishing a rebuttable presumption regarding how it will exercise its discretion under that provision to limit the activities in which state member banks may engage as principal, and to impose new conditions on the conduct of those activities.[1] The Supplementary Information to the Policy Statement provides examples of how the Board intends to apply the statement in the context of certain crypto-asset-related activities.[2]

A. EXISTING LEGAL AUTHORITY

Under Section 9(13) of the Act, a state member bank may "exercise all corporate powers granted it by the State in which it was created ... except that the [Board] may limit the activities of State member banks and subsidiaries of State member banks in a manner consistent with Section 24 of the Federal Deposit Insurance Act [(the "FDIA")]."[3] Section 24 of the FDIA and Part 362 of the FDIC's regulations, in turn, generally prohibit insured state banks (including insured state member banks) from engaging as principal in any type of activity that is not permissible for national banks, unless the FDIC has determined that the activity would not pose significant risk to the Deposit Insurance Fund.[4]

National banks may engage only in activities authorized under federal law, including the National Bank Act, as well as those found by the Office of the Comptroller of the Currency (the "OCC") to be incidental to those activities specifically enumerated in the National Bank Act.[5]

If an insured state bank (or its subsidiary) seeks to engage in an activity that is not permissible for a national bank, whether explicitly under the National Bank Act or the interpretations or regulations of the OCC, then the bank must seek the FDIC's consent pursuant to Section 24.[6]

Beyond the requirements of Section 24, the FDIC, the Federal Reserve and the OCC have established specific prior notice and nonobjection processes for crypto-asset-related activities. The OCC's Interpretive Letter 1179, issued in November 2021, "clarified" three prior OCC interpretive letters by specifying that the activities explicitly authorized in those prior letters could not be exercised until the bank's OCC supervisory office had been given notice of the bank's intent to engage in the activities, and the bank had received written notification of nonobjection.[7] The FDIC and the Federal Reserve adopted similar requirements soon thereafter.[8]

B. APPLICATION

The Policy Statement applies to both insured and uninsured state member banks and their subsidiaries, and is not limited to crypto-asset-related activities.[9] The Policy Statement sets out "a clear expectation" that state member banks must look to federal statutes, OCC regulations and OCC interpretations to determine whether an activity is permissible for national banks.[10] If a state member bank determines that such authority exists, the bank may engage in the activity only if it adheres to the terms, conditions and limitations placed on national banks by the OCC with respect to the activity – including pre-clearance. "If the OCC conditions permissibility on a national bank demonstrating, to the satisfaction of its supervisory office, that the bank has controls in place to conduct the activity in a safe and sound manner, and receiving a written nonobjection from OCC supervisory staff before engaging in a particular activity, then the activity would not be permissible for a state member bank unless the bank makes the same demonstration and receives a written nonobjection from Federal Reserve supervisory staff before commencing such activity."[11]

If no such authority exists, the bank must look to any authority for state banks to engage in the activity under other federal statutes or Part 362 of the FDIC's regulations. If there is also no authority under federal statute or Part 362, the bank may not engage in the activity unless it has received the permission of the Board under Section 208.3(d)(2) of Regulation H.[12]

In determining whether to grant permission, the Board will "rebuttably presume that the state member bank is prohibited from engaging as principal in any activity that is impermissible for national banks, unless the activity is permissible for state banks under federal statute or Part 362 of the FDIC's regulations." The presumption may be rebutted only if (1) there is a "clear and compelling rationale" for the Board to do so and thereby allow a deviation in regulatory treatment among federally supervised banks, and (2) the state member bank has "robust plans for managing the risks of the proposed activity in accordance with principles of safe and sound banking."[13] In assessing permissibility, the Board notes that it intends to align its process with that of the FDIC under Section 24 of the FDIA.[14] This language suggests that a "rebuttal" could be successful only in extraordinary circumstances.

A summary of the application of the Policy Statement to proposed activities in different regulatory scenarios can be found in Annex I to this memorandum.

In establishing these requirements for new activities, the Policy Statement appears to rely on the so-called "change in business operations" requirements of Section 208.3(d)(2) of Regulation H.[15] It is not clear whether this reliance presages a broader interpretation of this provision than has been previously thought to be the case.

C. SAFETY AND SOUNDNESS

The Policy Statement reiterates that, although legal permissibility is a necessary condition to a state member bank's authority to engage in an activity, it is not the only condition, and such a bank must conduct

its business and exercise its powers with "due regard" to safety and soundness.[16] For instance, referring to existing regulations regarding safety and soundness,[17] the Policy Statement provides that a state member bank should have in place internal controls and information systems that are appropriate to the nature, scope and risks of its activities. A state member bank must also comply at all times with Regulation H, any conditions of membership prescribed by the Board, and other applicable laws and regulations, including those related to consumer compliance and anti-money laundering.

With respect to "novel and unprecedented activities," the Board requires that a state member bank have in place appropriate systems to monitor and control risks, including liquidity, credit, market, operational (including cybersecurity and the use of third parties), and compliance risks (including compliance with Bank Secrecy Act and Office of Foreign Asset Control requirements to reduce the risk of illicit financial activity). The Policy Statement provides that Federal Reserve supervisors will expect state member banks to be able to explain and demonstrate an effective control environment related to such activities.[18]

D. CRYPTO-ASSET-RELATED ACTIVITIES

Although the Policy Statement applies to all activities in which a state member bank may wish to engage, it is clearly focused on addressing the risks raised by "crypto-asset-related activities." For this purpose, the Board defines the term "crypto-assets" to mean "digital assets issued using distributed ledger technology and cryptographic techniques (for example, bitcoin and ether)."[19] The Supplementary Information discusses how the Board would "presumptively apply" Section 9(13) to crypto-asset-related activities.

With respect to holding crypto-assets as principal, the Board appears to impose a total barrier by asserting that it has "not identified any authority permitting national banks to hold most crypto-assets, including bitcoin and ether, as principal in any amount, and there is no federal statute or rule expressly permitting state banks to hold crypto-assets as principal."[20] In addition, the Board stated that the "absence of a fundamental economic use case" for crypto-assets and the unregulated nature of the market prevent firms from engaging in prudent risk management and assessing market and counterparty exposure risks. The Board also pointed to the illicit finance risks presented by the pseudonymity of transactors and validators. Given these factors, and the "significant cybersecurity risks" relating to these assets, the Board indicated that it would "presumptively prohibit state member banks from engaging in such activity under Section 9(13) of the Act." Insured state member banks would already have been precluded from doing so under Section 24 of the FDIA; uninsured state member banks will now be precluded from doing so as well.

Moreover, language in the Policy Statement may raise the question of whether banks may issue or hold traditional financial products that are provided, held or transferred using any of the technological methodologies that may bring them within the broad scope of the term "crypto-assets." As noted above, the Board defines "crypto-assets" to mean "digital assets issued using distributed ledger technology and cryptographic techniques,"[21] but notes that the term does not include assets that "are more appropriately

categorized within a recognized, traditional asset class." The only example of such an "appropriately categorized" traditional asset that is given is:

> securities with an effective registration statement filed under the Securities Act of 1933 that are issued, stored, or transferred through the system of a regulated clearing agency and in compliance with all applicable federal and state securities laws.

This very specific exclusion raises the question as to how the Board would view a variety of other traditional assets issued utilizing distributed ledger technology, including securities that may be issued in full compliance with applicable securities and other laws on a private or exempt basis. Of particular concern is language in the Policy Statement to the effect that even a traditional asset may be treated as a "crypto-asset" if "transmission using distributed ledger technology and cryptographic techniques changes the risks of a traditional asset (for example, through issuance, storage, or transmission on an open, public, and/or decentralized network, or similar system)."[22]

The Board acknowledges that a national bank may issue "dollar tokens," subject to all of the conditions the OCC has placed on national banks with respect to such activity in OCC Interpretive Letters 1174 and 1179.[23] The Board does not define "dollar tokens," raising the question of whether the position it is taking in the release relates to stablecoins of the type authorized by the OCC in those interpretive letters, or could extend to traditional bank deposits represented by, recorded on, or otherwise issued utilizing distributed ledgers or cryptographic technology. Although the Policy Statement is not clear, we believe that the reference to the OCC's interpretations, all of which related to stablecoins backed by a cash reserve and not to bank deposits recorded on a distributed ledger, indicates that bank deposits are not included within the term "crypto-assets," even when recorded on a distributed ledger. However, even if the term is intended to include traditional bank deposits recorded in this manner, the Board appears to acknowledge that issuing "dollar tokens," in the manner described in the OCC's letter, would be permissible for national banks and for state member banks, subject to safe and sound banking practices. However, the Board is clear in its view that issuing such tokens on open, public, and/or decentralized networks is "highly likely to be inconsistent with safe and sound banking practices," including because of operational, cybersecurity, run and illicit finance risks—risks that are pronounced where the bank lacks visibility into the identity of all transacting parties.[24]

The Board does acknowledge that nothing in the Policy Statement would prohibit a state member bank from providing safekeeping services for crypto-assets in a custodial capacity, provided the activities are conducted in a safe and sound manner and in compliance with consumer, anti-money-laundering and anti-terrorist-financing laws.[25] This position is, to a degree, seemingly compelled by the FDIC's Part 362, which notes that custodial services generally are not considered to be within the scope of the ambit of Section 24 and Part 362, and therefore would not be within the scope of the Policy Statement.[26] It remains to be seen what criteria will be applied by the Board in evaluating conformance with these requirements.

E. IMPLICATIONS

The Policy Statement requires a state member bank to assess any new activity in which it seeks to engage as principal, whether or not involving crypto-assets under the Policy Statement.[27] If a state member bank or its subsidiary wishes to engage as principal in any activity for which the OCC requires formal notice and nonobjection or any other formalities, the state member bank will now need to submit the same notice and receive the same response from the Federal Reserve. This is in addition to any other notice or application required, including under the Federal Reserve's Supervision and Regulation Letter 22-6 for activities involving crypto-assets.

If a state member bank wishes to engage in an activity that is not permissible for a national bank or for an insured state bank under the FDIC's Part 362, it may not do so unless it obtains the consent of both the FDIC and the Board. Banks should assume that the Board is unlikely to give such consent for any activity in which a state member bank would hold, as principal, crypto-assets recorded on an open, public and/or decentralized ledger.

As noted above, the Policy Statement's discussion of its application to traditional banking activities using distributed ledger technology, such as deposits issued on a blockchain, could create ambiguity. No doubt there will be complex issues presented by the Board's "reserving the right to treat ... as a 'crypto-asset'" any traditional asset to the extent that "transmission using distributed ledger technology and cryptographic techniques changes the risks" of the asset.

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ENDNOTES

[1] Board of Governors of the Federal Reserve System, *Policy Statement on Section 9(13) of the Federal Reserve Act* (Jan. 27, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230127a2.pdf. On the same day, the Board announced that it had denied the application by Custodia Bank, Inc., an uninsured Wyoming state bank, to become a member of the Federal Reserve System and to open a master account. *See Federal Reserve Board announces denial of application by Custodia Bank, Inc. to become a member of the Federal Reserve System* (Jan. 27, 2023), *available at* https://www.federalreserve.gov/newsevents/pressreleases/orders20230127a.htm.

[2] The Policy Statement defines "crypto-assets" as digital assets issued using distributed ledger technology and cryptographic techniques (for example, bitcoin and ether). However, as discussed in Section D, the term generally does not include assets that are more appropriately categorized as falling within a recognized, traditional asset class, such as securities with an effective registration statement filed under the Securities Act of 1933 and that are issued, stored, or transferred through the system of a regulated clearing agency and in compliance with all applicable federal and state securities laws.

[3] 12 U.S.C. § 330 (as amended by Federal Deposit Insurance Corporation Improvement Act of 1991 § 303(b), Pub. L. 102-242, 105 Stat. 2236, 2353).

[4] 12 U.S.C. § 1831a(a) (providing that insured state banks may not engage as principal in any type of activity that is not permissible for a national bank unless (1) the FDIC has determined that the activity would pose no significant risk to the Deposit Insurance Fund, and (2) the state bank is, and continues to be, in compliance with applicable capital standards); 12 C.F.R. Part 362. Under the FDIC's regulations and the terms of the statute itself, this prohibition generally does not apply to activities conducted as agent for a customer, in a brokerage, custodial, advisory or administrative capacity, conducted as trustee, or in any substantially similar capacity; interests in real estate to be used in the business of the bank; or equity interests acquired in satisfaction of debts previously contracted. 12 C.F.R. § 362.1(b).

[5] *See* 12 U.S.C. § 24 (Seventh) (generally authorizing national banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking").

[6] An uninsured state bank is not subject to the FDIC's jurisdiction and is not subject to this requirement.

[7] OCC Interpretive Letter #1179 (Nov. 2021), *available at* https://occ.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf. For our client memo on OCC Interpretive Letter 1179, *see* https://www.sullcrom.com/files/upload/sc-publication-occ-issues-interpretive-letter-regarding-authority-of-banks-to-engage-in-cryptocurrency.pdf.

[8] Federal Deposit Insurance Corporation, Notification of Engaging in Crypto-Related Activities (April 7, 2022), *available at* https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html?source=govdelivery&utm_medium=email&utm_source=govdelivery#letter; Federal Reserve Supervision and Regulation Letter 22-6 (Aug. 16, 2022), *available at* https://www.federalreserve.gov/supervisionreg/srletters/SR2206.pdf. For our client memos on the FDIC notice and the Board's Regulation Letter, *see* https://www.sullcrom.com/files/upload/sc-publication-FDIC-requires-notification-crypto-related-activities.pdf and https://www.sullcrom.com/files/upload/sc-publication-federal-reserve-requires-notification-of-crypto-asset-related-activities.pdf.

[9] As an interpretation of a Federal Reserve Act provision applying to state member banks and their subsidiaries, the Policy Statement does not apply to bank holding companies or to their subsidiaries that are not subsidiaries of a state member bank. However, the views expressed in the statement regarding the safety and soundness of certain activities may be indicative of the view that the Federal Reserve would take with respect to the conduct of those activities by non-banking entities as well.

ENDNOTES (CONTINUED)

[10] Policy Statement at 5.

[11] *Id.* at 6.

[12] *Id.* at 5. The relevant section of Regulation H provides that "[a] member bank may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership." Accordingly, a state member bank may be required to submit an application pursuant to this provision even for an activity that is permissible for a national bank, depending on the activities conducted by the bank prior to the commencement of the new activity.

[13] *Id.* at 5-6.

[14] *See, e.g.*, FDIC FIL-54-2014: Filing and Documentation Procedures for State Banks Engaging, Directly or Indirectly, in Activities or Investments that are Permissible for National Banks (November 19, 2014).

[15] 12 C.F.R. § 208.3(d)(2) ("A member bank may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership.").

[16] 12 C.F.R. § 208.3(d)(1).

[17] 12 C.F.R. § 208, app. D-1.

[18] Policy Statement at 7.

[19] *Id.* at 2 n.2.

[20] Policy Statement at 8. As the Policy Statement notes, the OCC has not yet made a determination addressing the permissibility of a national bank holding crypto-assets as principal, other than "stablecoins," which may be held to facilitate payments subject to the conditions of OCC Interpretive Letter 1179. *See* OCC Interpretive Letter No. 1174 (Jan. 4, 2021) (Interpretive Letter 1174); OCC Interpretive Letter No. 1179 (Nov. 18, 2021) (Interpretive Letter 1179). The OCC conditioned its recent approval of the merger between Flagstar Bank, FSB and New York Community Bank into Flagstar Bank, NA on the divestiture of New York Community Bank's holdings of "Hash," a crypto-asset, after a conformance period, as well as a commitment not to increase holdings of any crypto-related asset or token "unless and until the OCC determines that … Hash or other crypto-related holdings are permissible for a national bank." OCC Conditional Approval Letter No. 1299, at 9 (Oct. 27, 2022).

[21] Policy Statement at 2, n.2.

[22] *Id.*

[23] Interpretive Letter 1174; Interpretive Letter 1179.

[24] *See* Board, FDIC and OCC, Joint Statement on Crypto-Asset Risks to Banking Organizations, at 2 (January 3, 2023). For our client memo on the Joint Statement, please *see* https://www.sullcrom.com/sc-publication-prudential-regulators-issue-joint-statement-on-crypto-asset-risks. The Board cites operational, cybersecurity and run risks, as well as illicit finance risks, and believes such risks are especially pronounced where the issuing bank does not have the capability to obtain and verify the identity of all transacting parties, including for those using unhosted wallets. Interpretive Letter 1174, at 4 (quoting the President's Working Group on Financial Markets, Statement on Key Regulatory and Supervisory Issues Relevant to Certain Stablecoins, at 3 (Dec. 23, 2020)).

[25] *Id.* at 8.

[26] "This subpart does not cover … (1) Activities conducted other than 'as principal,' defined for purposes of this subpart as activities conducted as agent for a customer, conducted in a brokerage, custodial, advisory, or administrative capacity, or conducted as trustee, or in any substantially similar capacity." 12 C.F.R. § 362.1(b).

ENDNOTES (CONTINUED)

[27] The Policy Statement does not state explicitly that it applies only to new activities. However, although the substantive standards as to the permissibility of activities appear to apply to all activities conducted by state member banks, it does not appear that the Board is seeking to require retroactive application of the notice and application requirements established by the Policy Statement.

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Annex I – Treatment of State Member Bank Activities

<table>
<tr><th>Type of Activities</th><th colspan="2">Treatment</th></tr>
<tr><td>Activities that are not engaged in “as principal” and therefore outside scope of notice (e.g., custody)</td><td colspan="2">No change in treatment. A state member bank or its subsidiaries may engage in these activities without reference to the Policy Statement, but must comply with the Federal Reserve’s Supervision and Regulation Letter 22-6 (“Letter 22-6”) (or other guidance) to the extent applicable. The exclusion of these activities (including custodial services relating to crypto-assets) from the Policy Statement would appear to exclude them as well from the requirement to provide notice to Federal Reserve supervisory staff and receive a notice of nonobjection, but notice under Letter 22-6 would be required.</td></tr>
<tr><td rowspan="4">Activities that are engaged in “as principal”</td><td>Activities that the OCC permits without prior notice or application (e.g., activities permitted under the OCC’s Part 7 regulations without prior approval)</td><td>No change in treatment. A state member bank or its subsidiaries may engage in these activities without prior notice to the Federal Reserve, but must comply with the conditions established by the OCC and Letter 22-6 to the extent applicable.</td></tr>
<tr><td>Activities that the OCC permits subject to prior notice and nonobjection (e.g., activities allowed under OCC Interpretive Letters 1172, 1174 and 1179 and other activities that require prior notice and nonobjection, or affirmative application, under OCC guidance)</td><td>The Policy Statement requires a state member bank or its subsidiaries to submit the same notice or application to the Federal Reserve’s supervisory staff and to receive the same type of response prior to engaging in the activity. The notice and nonobjection process contemplated by the OCC interpretive letters is a more formal process than required under Letter 22-6, but is not a formal application notice under Regulation H.</td></tr>
<tr><td>Activities that the OCC does not permit, but that are authorized by Part 362 or another federal statute</td><td>No change in treatment. A state member bank or its subsidiaries may engage in these activities provided it complies with the conditions of Part 362 or the other federal statute.</td></tr>
<tr><td>Activities that the OCC does not permit and that are not authorized by Part 362 or another federal statute</td><td>A state member bank or its subsidiaries must submit a formal application for the permission of the Board under Regulation H as a condition to continued membership. The Federal Reserve has said that activities involving bitcoin, ether or other public blockchains are not likely to be permitted pursuant to any such application.</td></tr>
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