NUTTER NOTES

OCC Letter Sheds Light on Cryptocurrency Risk and Reward

Compliance Risk, Fraud Must Be Guarded Against

By Thomas J. Curry, Kate Henry and Armand J. Santaniello | Special to Banker & Tradesman | Mar 14, 2021 |
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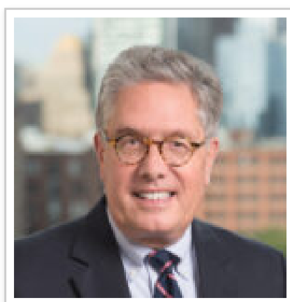


Tom Curry

In recent years, financial institutions and regulators have witnessed the fast-paced and widespread evolution of financial technologies that have challenged the traditional financial market’s procedures and processes. Although modes of financial technology use digital solutions to quickly and effectively address banking and financial needs, there exists significant risk associated with relying entirely on financial technology. As state and local governments work feverishly to adapt regulations, laws and policies to address the increasing number of financial technologies, gaps still remain at the federal level to provide important prudential and consumer protection safeguards.

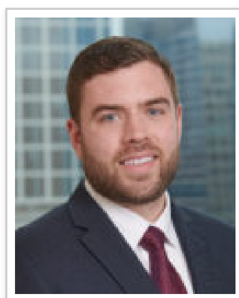
One of the most unpredictable but interesting examples of financial technology is the concept of digital assets, or cryptocurrency, in such forms as Bitcoin and stablecoin. Cryptocurrency has endured a turbulent history since its inception, but recent actions across the entire financial spectrum indicate growing acceptance amongst Big Tech, traditional financial firms, central banks and general consumers. In the past few weeks, trading in cryptocurrencies such as Bitcoin, the most well-known cryptocurrency, has rapidly risen to record highs, likely partially in response to measures taken by financial institutions and regulators.

Kate Henry

Cryptocurrency Attractive, Carries Risk

The belief that consumers and investors would feel most comfortable having traditional financial institutions store, manage and process digital assets has caused those institutions to begin exploring and implementing cryptocurrency into their suite of product offerings.

Another reason financial institutions are exploring these new opportunities is Interpretive Letter 1174 issued by the Office of the Comptroller of the Currency on Jan. 4, which discusses permissible crypto-related activities for national banks and federal savings associations. The letter reiterates longstanding OCC precedent holding that the business of banking should evolve and adapt to technological changes as they occur. Accordingly, the letter clarifies that OCC-regulated financial institutions have the authority to participate in independent node verification networks (INVN) and use stablecoins to conduct payment activities and other bank-permissible functions. OCC banks, as a matter of law, may validate, store, and record payments transactions by serving as a node on an INVN. The letter also states that OCC banks may use INVNs and related stablecoins to carry out other permissible payment activities.



Armand J. Santaniello

However, the letter concludes with the OCC's caution that while OCC-regulated banks may legally participate in INVNs and use stablecoins to conduct payment activities, they must do so in a manner that is consistent with safe, sound and fair banking practices. These words of caution were echoed by newly appointed U.S. Treasury Secretary Janet Yellen, who recently stressed that cryptocurrency is prone to misuse. European Central Bank President Christine Lagarde went one step further on Feb. 10, stating that Bitcoin was not real currency and that more regulation was warranted given its propensity for misuse.

Specific risks associated with INVN-related activities include operational risks, compliance risks such as BSA/AML and fraud. OCC-regulated banks should develop and implement sound risk management practices that reflect the unique risks posed by cryptocurrency transactions, and possess the technological expertise to manage these risks effectively. Institutions across the financial spectrum have taken this advice, understanding that regulatory and safety considerations are just as important as whether or not the services work for consumers.

Regulators Allow Testing

Other financial regulators have also taken steps to provide traditional financial institutions with opportunities to test innovative new products to allow for financial innovation while protecting investors and the financial system. The Commodity Futures Trading Commission recently launched their platform LabFTC, which facilitates greater communication between the CFTC and the market on financial technology innovations. The Securities and Exchange Commission also launched their FinHub platform to provide regulatory guidance to banks and financial technology companies around innovative technologies such as cryptocurrencies and distributed ledger technology.

Additionally, the Consumer Financial Protection Bureau released policy guidance on its Compliance Assistance Sandbox in September 2019. The Sandbox allows financial institutions to test innovative products or services where there otherwise exists regulatory uncertainty. Upon evaluation of the new product or service under relevant law, the CFPB may approve an applicant's product, which provides the applicant with a "safe harbor" against certain liability for specified conduct during the testing period. Programs such as the Sandbox could spur innovation in traditional financial institutions and allow them to keep current in a market increasingly inundated with financial technology companies with considerably less burdensome regulatory oversight.

Financial technology will become more prevalent in the market as innovation continues and consumers respond favorably. However, the increased prevalence of financial technology further underscores the need for oversight and regulation by financial regulators to enact appropriate safeguards. The speed at which financial technology develops makes it difficult for traditional financial regulators to create regulatory parameters for safe consumer use and engagement. Understanding and developing the technology as well as the risks will be important moving forward and will determine whether cryptocurrency continues its forward progress.

Thomas J. Curry is a partner in Nutter's corporate and transactions department. Kate Henry and Armand J. Santaniello are associates in Nutter's corporate and transactions department. Curry is former U.S. comptroller of the currency and all are members of the firm's banking and financial services group.