Summary of Federal Reserve Board Policy Statement on Section 9(13) of the Federal Reserve Act and Related Developments

On January 27, 2023, the Federal Reserve Board ("FRB") and the Biden administration made several policy pronouncements regarding cryptoassets. First, the FRB issued a policy statement setting forth a rebuttable presumption that all state-chartered banks regulated by the FRB and their subsidiaries are limited to engaging as principal in only those activities that are permissible for national banks or under federal statute or the Federal Deposit Insurance Corporation's ("FDIC") regulations. Second, the FRB denied the application of a Wyoming-chartered bank with a cryptoasset-focused business plan to become a member of the Federal Reserve System.[1] And, third, the administration released a statement on its roadmap to mitigate cryptoasset risks.

KEY TAKEAWAYS

- The policy statement appears to have the effect of prohibiting FRB-regulated banks from engaging in most cryptoasset activities as principal. The one exception appears to be certain payment stablecoin activities that comply with the conditions of the Office of the Comptroller of the Currency's ("OCC") Interpretive Letter 1179 (see our summary here).
- The preamble to the policy statement makes clear that its scope is limited to principal activities and that its application would not prohibit a state member bank from providing safekeeping services for cryptoassets in a custodial capacity. Thus, there continues to seem to be a path forward for banking organizations to help bolster the customer protection of cryptoasset markets by serving as custodians.
- Further, the preamble reflects a distinction that is of increasing importance as distributed ledger and other technologies help advance innovation in the financial sector.
- Specifically, the preamble's discussion does not apply to "assets to the extent they are more appropriately categorized within a recognized traditional asset class".
- As an example, the preamble cites 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 applicable federal and state securities laws.
- This distinction is important, as traditional asset classes may use new technologies for book entry and other recordkeeping purposes. Whether the use of technology in this way results in an asset being regarded as a "cryptoasset" (and subject to the associated heighted prudential scrutiny) has become an increasingly important question. With this release, the FRB appears to have provided some indication that such treatment will not be the universal default, a relatively positive development.

- The FRB's decision regarding the Wyoming bank's Federal Reserve membership application provides an example of the FRB's view of the risk management standards that need to be met to engage in cryptoasset-related activities. For instance, the FRB stated that the bank's "risk management framework was insufficient to address concerns regarding the heightened risks associated with its proposed crypto activities, including its ability to mitigate money laundering and terrorism financing risks".
- The administration's statement also reflects a skeptical view, stating that some firms in the cryptoasset ecosystem "ignore applicable financial regulations and basic risk controls".
- The administration called on Congress to "step up its efforts" to pass legislation to provide for greater regulation of cryptoasset markets. Whether Congress does so could dictate the role banking organizations are able to play. For example, the FRB's new policy statement's rebuttable presumption does not apply to the extent a federal statute authorizes a particular activity. Therefore, any forthcoming legislative discussions may involve questions of whether Congress should authorize particular activities for banking organizations.

Below is a more detailed summary of the FRB's policy statement.

FRB POLICY STATEMENT: LEGAL AUTHORITY

The FRB relies on its authority in section 9(13) of the Federal Reserve Act (the "FR Act") for setting the rebuttable presumption. Section 9(13) of the FR Act states that the FRB "may" limit the activities of state member banks and subsidiaries to those activities that are permissible for a national bank in a manner consistent with section 24 of the Federal Deposit Insurance Act ("FDI Act"). Section 24, in turn, prohibits insured state banks (both FRB- and FDIC-regulated) from engaging in activities as principal unless the activity is permissible for a national bank or the FDIC has approved the activity.

The policy statement provides that the FRB interprets this provision of the FR Act as authorizing it to prohibit or otherwise restrict state member banks and their subsidiaries from engaging as principal in any activity (including acquiring or retaining any investment) that is not permissible for a national bank, unless the activity is permissible for state banks by federal statute or under 12 CFR Part 362. Because the FR Act applies to all state member banks (including uninsured member banks), the policy statement is intended to provide for equal treatment of all federally-supervised banks by the FRB, regardless of deposit insurance status.

FRB POLICY STATEMENT: APPLICATION

The preamble to the guidance provides a roadmap for state member banks to determine whether an activity is permissible:

- First, the state member bank must look to federal statutes, OCC regulations, and OCC interpretations to determine whether an activity is permissible for national banks.
- If no such source authorizes national banks to engage in the activity, then state member banks should look to whether there is authority for state banks to engage in the activity under federal statute or part 362 of the FDIC's regulations.
- If there also is no authority for a state bank to engage in the activity under federal statute or part 362 of the FDIC's regulations, a state member bank may not engage in the activity unless it has received the permission of the Board under section 208.3(d)(2) of the FRB's Regulation H. Insured state banks also would be required to submit an application to the FDIC under part 362 of the FDIC's regulations.

The rebuttable presumption of impermissibility would apply when the FRB makes determinations under this final step. To rebut the presumption, a state member bank must present "a clear and compelling rationale" for the FRB to allow the proposed deviation in regulatory treatment among federally supervised banks and must provide "robust plans" for managing the risks of the proposed activity in accordance with principles of safe and sound banking. The FRB does not define "clear and compelling" or otherwise provide further guidance on what would be required to rebut the presumption.

The FRB states in the preamble to the policy statement that it intends to align its process with that of the FDIC in assessing permissibility under section 24 of the FDI Act. Specifically, if the FDIC adopts a rule to permit insured state banks to engage in an activity, no FRB approval would be required to

establish permissibility. However, if the FDIC only approves an activity for a particular bank, separate FRB approval would be required for all other state member banks.

The FRB also clarifies that if the activity is permitted for a national bank under OCC regulations or interpretations (for example, certain payment stablecoin activities), a state bank may only engage in that activity subject to the terms, conditions, and limitations placed on national banks by the OCC, including, for example, demonstrating that it has controls in place to conduct the activity in a safe and sound manner and receiving written nonobjection from Federal Reserve supervisory staff before commencing such activity.

FRB POLICY STATEMENT: SAFETY AND SOUNDNESS

The policy statement also reminds state member banks that legal permissibility is a necessary, but not sufficient, condition to establishing that it may engage in a particular activity, and that all activities must be conducted in a safe and sound manner. The policy statement notes that appropriate systems to monitor and control liquidity, credit, market, operational and compliance risks are particularly important for novel activities and that Federal Reserve supervisors will expect banks to be able to explain and demonstrate an effective control environment.

FRB POLICY STATEMENT: SPECIFIC ACTIVITIES OF INTEREST

The FRB discusses how it would apply the rebuttable presumption to two specific fact patterns involving cryptoassets in the preamble to the policy statement:

- **Holding Cryptoassets as Principal**. The FRB has not identified any authority permitting national banks to hold most cryptoassets as principal in any amount. Therefore, the FRB presumptively would prohibit state member banks from engaging in these activities under section 9(13) of the FR Act and highlighted a number of often-cited safety and soundness concerns with respect to such activities, including illicit finance risks and the challenges associated with assessing market and counterparty risks.
- **Issuing Dollar Tokens**. State member banks may issue dollar tokens to facilitate payments if they do so subject to the process and standards set forth in OCC Interpretive Letters 1174 and 1179. The state member bank would be required to demonstrate, to the satisfaction of Federal Reserve supervisors, that it has controls in place to conduct the activity in a safe and sound manner, and it must receive supervisory nonobjection before commencing such activity. The FRB cautions, however, that it generally believes that issuing tokens on "open, public, and/or decentralized networks, or similar systems" is highly likely to be inconsistent with safe and sound banking practices. This statement would appear to include public, permissioned blockchain designs.

1 The Federal Reserve Bank of Kansas City also reportedly denied the same bank's request for a master account with the Reserve Bank. *See, e.g.*, https://subscriber.politicopro.com/article/2023/01/fed-denies-wyoming-firms-bid-for-payment-access-moves-to-dismiss-lawsuit-00080040.

NEW YORK

David L. Portilla
+1-212-474-1410
dportilla@cravath.com

WASHINGTON, D.C.

Will C. Giles
+1-202-869-7728
wgiles@cravath.com

CRAVATH, SWAINE & MOORE LLP

NEW YORK

Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
+1-212-474-1000

LONDON

CityPoint
One Ropemaker Street
London EC2Y 9HR
+44-20-7453-1000

WASHINGTON, D.C.

1601 K Street NW
Washington, D.C. 20006-1682
+1-202-869-7700

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