Testimony of Jonathan V. Gould
Partner, Jones Day
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hearing on
"Coincidence or Coordinated? The Administration's Attack on the Digital Asset Ecosystem"

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Chairman Hill, Ranking Member Lynch and Members of the Subcommittee: thank you for the opportunity to discuss the administration's actions with respect to the digital asset ecosystem.

Over the last 18 months, the Federal banking agencies have issued a number of public guidance documents. This guidance has articulated agency concerns with risks associated with digital asset activities of banks, expressed their skepticism that many of these activities can be conducted in a safe and sound manner, and imposed procedural barriers to their commencement. My testimony summarizes these guidance documents and identifies areas for further Congressional scrutiny and oversight. My testimony is my own. I am speaking today solely in my personal capacity; I am not speaking on behalf of any clients or my law firm.

Following a crypto "sprint" in 2021 and over the course of 2022, the Federal banking agencies each issued guidance documents addressing the digital asset activities of banks. The OCC moved first, issuing an interpretive letter in November 2021 that addressed digital asset activities, among other things.[1] The OCC did not challenge the legal conclusions of its earlier letters addressing certain digital asset activities,[2] but instead emphasized the fact that any banking activity, including digital asset activities, must be conducted in a safe and sound manner. Rather than addressing safety and soundness concerns in the ongoing supervisory process, as is the case with respect to many bank activities, the letter required banks to address them to the OCC's satisfaction *before* the bank could engage in digital asset activities. As part of this supervisory "non-objection" process, the OCC evaluates the bank's risk management and controls, and its understanding of compliance obligations. As a practical matter, this letter

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[1] See OCC Interpretive Letter 1179 (Nov. 18, 2021), https://www.occ.treas.gov/topics/charters-and-licensing/interpretations-and-actions/2021/int1179.pdf.

[2] See Interpretive Letter 1170 (July 22, 2020), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf (concluding that banks may provide cryptocurrency custody services on behalf of customers, including by holding the unique cryptographic keys associated with cryptocurrency); Interpretive Letter 1172 (Sept. 21, 2020), https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf (concluding that banks may accept deposits that serve as "reserves" for stablecoins that are backed by fiat currency on a 1:1 basis and held in hosted wallets); Interpretive Letter 1174 (Jan. 4, 2021), https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf (concluding that banks may serve as a node on an independent node verification network (INVN) such as a distributed ledger and may use INVNs and related stablecoins to conduct permissible banking activities, such as payments).

created a procedural mechanism that the OCC can use to delay or prevent banks from commencing digital asset activities.

Following in the footsteps of the OCC, the FDIC and Federal Reserve each issued similar guidance documents in 2022. In April, the FDIC issued a financial institution letter directing banks it supervises that intend to engage in, or that are currently engaged in, any activities involving or related to crypto assets to notify the FDIC.[3] In addition to prior notice, per this letter, FDIC-supervised banks should provide the FDIC with information sufficient to allow the agency to assess the safety and soundness, consumer protection, and financial stability implications of the proposed digital asset activities. The FDIC promised to provide "relevant supervisory feedback" to the bank.

The Federal Reserve followed suit in August 2022 with guidance identifying potential risks and requiring banks it supervises to provide prior notice before engaging in crypto-asset-related activity with the promise of providing "relevant supervisory feedback, as appropriate, in a timely manner" in return.[4] Neither the FDIC nor the Federal Reserve addressed the legal permissibility of any specific crypto-related activity in their respective 2022 letters.[5]

The pace and coordination of these issuances have increased this year, with two joint agency statements in as many months, and an important policy statement from the Federal Reserve.

In January of this year, the OCC, Federal Reserve and FDIC issued a joint statement on crypto-asset risks that set forth the agencies' approach to digital assets in the most explicit terms yet.[6] After listing a number of risks evident over 2022, the statement noted the importance of preventing risks related to the crypto-asset sector that cannot be mitigated or controlled from migrating to the banking system. Most significantly, the agencies expressed skepticism that crypto-asset-related activities could be conducted in a safe and sound manner at the current time. Although the digital asset activities addressed by earlier OCC guidance may still be legally permissible for banks in the abstract, the agencies' view that these activities are "highly likely to

[3] See FDIC Financial Institution Letter, Notification of Engaging in Crypto-Related Activities (April 7, 2022), https://www.fdic.gov/news/financial-institution-letters/2022/fil22016.html#letter. The FDIC also issued a second financial institution letter addressing misconceptions about the scope of deposit insurance coverage and its application to certain crypto companies. See FDIC Financial Institution Letter, Advisory to FDIC-Insured Institutions Regarding Deposit Insurance and Dealings with Crypto Companies (July 29, 2022), https://www.fdic.gov/news/financial-institution-letters/2022/fil22035.html.

[4] See Federal Reserve, SR Letter 22-6, Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations (Aug. 16, 2022), https://www.federalreserve.gov/supervisionreg/srletters/SR2206.htm.

[5] Unlike the OCC, neither the FDIC nor Federal Reserve is generally charged with defining the scope of bank permissible activities in the first instance since neither is a chartering authority. But see note 9 and accompanying text.

[6] See Federal Reserve Board, FDIC and OCC, Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), https://occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-1a.pdf.

be inconsistent with safe and sound banking practices" makes the path forward narrow or nonexistent barring a change in the agencies' view.[7]

Just last month, the OCC, Federal Reserve and FDIC issued a joint statement on liquidity risks to banks resulting from crypto-asset market vulnerabilities.[8] The guidance focused on funding risks to banks from holding deposits that are associated with crypto-asset-related entities, whether deposits for the benefit of end customers of crypto entities or deposits that constitute stablecoin reserves. The agencies noted the importance of effective risk management to mitigate any such liquidity risks and reminded banks of their need to comply with brokered deposit rules and reporting requirements.

Between these joint agency issuances, the Federal Reserve issued a policy statement imposing limits, including approval requirements, on digital asset activities and other novel activities of state member banks.[9] More specifically, the Federal Reserve created a rebuttable presumption that state member banks may engage as principal only in activities permissible for national banks unless explicitly authorized to do so by Federal statute or FDIC regulation–and may only do so subject to any attendant conditions imposed by the applicable Federal regulator. Otherwise, the Federal Reserve will treat requests to engage in such a "novel and unprecedented" activity as a change in the general character of the business of the bank such that the state member bank must obtain Federal Reserve permission under Regulation H, under a rebuttable presumption that the activity is impermissible. Unlike the guidance documents discussed above, which are technically non-binding, the Federal Reserve's policy statement is framed as a rule and thus purports to be enforceable.

As Congress considers the actions of the Federal banking agencies, there are three attributes of bank supervision that I want to highlight. First, bank supervision is by design confidential, particularized and potent.[10] Although the agency issuances mentioned above are public, their application is not. The confidential nature of the supervisory relationship facilitates the flow of information between bank and regulator, but it can also frustrate accountability and oversight.

Second, safety and soundness, the primary lens through which these agency issuances are framed and the goal of prudential regulators like the OCC, Federal Reserve and FDIC, can be a subjective concept. Banking agencies have issued thousands of pages of public, non-binding guidance detailing their interpretations of what safety and soundness means in a variety of

[7] The agencies also have "significant safety and soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector." *Id.*

[8] See Federal Reserve Board, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2003), https://www.occ.treas.gov/news-issuances/news-releases/2023/nr-ia-2023-18a.pdf.

[9] See Federal Reserve Board, Policy Statement on Section 9(13) of the Federal Reserve Act (Feb. 7, 2023), codified at 12 CFR § 208.12, https://www.federalregister.gov/documents/2023/02/07/2023-02192/policy-statement-on-section-913-of-the-federal-reserve-act.

[10] For more on the differences between bank regulation and supervision, see then Federal Reserve Vice-Chairman Randy Quarles's "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision" (Jan. 17, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm.

contexts to help banks achieve it and to facilitate consistency in the agencies' supervisory expectations and approach.

Finally, although agency guidance is technically non-binding,[11] banks rarely challenge or disregard it. The practical consequences of doing so can be significant in light of the supervisory process through which guidance is applied.

Given the attributes of bank supervision noted above, generalized and negative statements raising safety and soundness concerns about particular industry sectors must be made carefully lest they be interpreted by the public or bank examiners as an outright prohibition.[12] Anecdotal evidence suggests that agency actions over the last 18 months, while responsive to developments in the digital asset ecosystem, are indeed having a chilling effect on banks' practical ability to engage in digital asset activities as well as their willingness to entertain or maintain digital asset entities as banking customers. Because of the confidential nature of the supervisory relationship, it is impossible for the public to assess the actual causal effect of these agency actions.

There are several areas that would benefit from Congressional attention. First, the agencies' actions might be disproportionate – whether in nature or magnitude – to the risks posed by digital assets. This is a judgment call, but it may be helpful to consider the extent to which the risks the agencies cite in their guidance are unique to digital assets and the magnitude of the harm to the banking system posed by these risks, particularly as compared to other risks confronting the banking system. Some of the risks posed by digital assets are well known and understood to banks and supervisors alike. Congress might also consider whether the agencies are responding to other risks to the banking system, such as rising consumer debt, cyber threats and the impact of interest rate risk on bank investment portfolios, in similar or proportionate fashion, and whether the harms posed by those risks exceed potential harms posed by digital asset activity.[13]

Relatedly, the strategy to address the risks posed by digital assets may be less than optimal. Regardless of intent, the agencies' actions seem to be having the practical effect of prohibiting banks from engaging in digital asset activities or providing banking services to digital asset customers. Risk elimination strategies are often less effective over the long term than risk management strategies. As we have seen repeatedly, risk elimination strategies tend to push financial risk into less visible corners of the economy where our ability to monitor and manage it can be challenging, rather than eliminating that risk outright.

Second, the agencies' actions might be overbroad and risk chilling innovative activities. Precluding banks from exploring new technologies, like distributed ledgers, to achieve traditional banking activities, like payments or deposit-taking, risks diminishing the important

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[11] See, *e.g.*, 12 CFR §§ 4.81 *et seq* (Statement Clarifying the Role of Supervisory Guidance).

[12] Note the inclusion in certain agency issuances of the following disclaimer: "Banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation." See *e.g.*, Federal Reserve Board, FDIC and OCC, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2003).

[13] See, *e.g.*, OCC Semiannual Risk Perspective (Fall 2022), https://www.occ.treas.gov/publications-and-resources/publications/semiannual-risk-perspective/files/pub-semiannual-risk-perspective-fall-2022.pdf.

role played by banks in our economy. The vague and occasionally shifting definitions used in agency guidance may cause banks to think twice about any use of distributed ledger technology or decentralized networks. And the Federal Reserve's recent policy statement applies to any novel and unprecedented activity of state member banks – whatever those may be – not just digital asset activities.

Finally, safety and soundness pronouncements are, in some sense, a reflection of the agencies' risk tolerance for individual banks and the banking system as a whole. Congress should have a key role in defining the risk tolerance of our banking system, especially when it involves industry-specific attention as seems to be the case here. And if it disagrees with the agencies' risk assessment or risk tolerance, it can and should do something about it.

The confidential nature of the supervisory relationship necessarily limits the public's ability to assess the actual effects of the banking agencies' guidance. Congress is not so limited. It has the oversight ability to move beyond anecdote to examine how these guidance documents are being implemented and their effect. Armed with this information, it can then make an informed decision about the propriety or prudence of the banking agencies' actions. I encourage it to do so.

Thank you again for the opportunity to testify. I look forward to your questions.