Banks On Notice As Prudential Regulators Catch Crypto Bug

By **Denise Barnes and Brandy Bruyere** (February 24, 2023)

Denise Barnes

Brandy Bruyere

Last month, the Federal Reserve, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency issued a joint statement on crypto-asset risks to banking organizations.[1]

This statement should signal to banking institutions that cryptocurrency assets will likely receive a lot more attention from prudential regulators. In particular, these institutions should expect more targeted reviews related to crypto-assets and how they affect the safety and soundness of those institutions.

Unmistakably, the joint statement was issued in response to persistent calls for more regulatory oversight over crypto-assets, and recent events involving the bankruptcies of key crypto industry players like FTX Trading Ltd., Celsius and BlockFi.

In particular, the joint statement notes that the volatility of the past year "highlight[s] a number of key risks associated with crypto-assets and crypto-asset participants that banking organizations should be aware of" including, (1) inaccurate or misleading statements by crypto-asset companies; (2) risk management and governance practices "exhibiting a lack of maturity and robustness" and (3) heightened risks associated with the lack of oversight, among other things.[2]

In other words, these prudential regulators cite to the lack of controls and risk governance in the crypto industry as reasons that financial institutions should be mindful of the specific risks associated with the crypto-asset sector.

These prudential regulators assert that certain risks associated with the sector "cannot be mitigated or controlled" and, as such, they are carefully reviewing proposals from banking organizations to engage in activities that involve crypto-assets.[3]

Again, institutions should expect increased scrutiny related to crypto-assets and crypto-related activities that would expose those institutions to additional risks.

Increased Scrutiny in Supervision

The joint statement should come as no surprise to anyone paying attention.

Indeed, prudential regulators have been telegraphing their skepticism for the crypto industry for months. In October 2022 remarks, Acting Comptroller of the Currency Michael J. Hsu noted that regulators "must be able to identify and monitor crypto risks efficiently and effectively," but that can be challenging given how custody of crypto-assets can involve commingling of platform assets.[1]

Hsu also expressed concern that crypto is "an immature industry based on an immature technology" that calls for "guardrails and gates."[4] Simply put, the OCC is doubtful of the crypto industry and its legitimacy.

Likewise, in October 2022, FDIC Acting Chairman Martin J. Gruenberg made similar public comments highlighting the need to manage the risks of crypto-related activities, noting that while innovation can be positive, it is a "double-edged sword" because "a catastrophic failure" is also possible.[5]

Gruenberg made clear that the FDIC has authority to address "the safety and soundness and financial stability risks associated with crypto-asset-related activities," so through bank supervision the FDIC gathers information and provides specific feedback on a bank's crypto-related activities.[6]

For its part, the FDIC can examine certain state-chartered insured banks and conduct special examinations of any insured institution. There are several key things the FDIC expects a bank to establish before engaging in crypto-related activities.

First, the activity is permissible under applicable laws, second, the activity can be done in a safe and sound manner, third, the bank has "appropriate measures and controls to identify and manage the novel risks," and finally, the bank can comply with applicable laws including anti-money laundering provisions and consumer protection laws.[7]

As the FDIC learns more about a bank's crypto-related activities, it provides "case-specific supervisory feedback" based on the bank's specific operations and risk management framework.

Heightened scrutiny is not limited to the OCC and the FDIC. On Feb. 7, the Federal Reserve published a policy statement rulemaking[8] that applies to all state chartered member banks and prohibits certain crypto-related activities.

Because state banks that are members of the Federal Reserve must always operate "with due regard for safety and soundness," crypto-related activities require systems to monitor and control risks.[9] As such, state banks engaged in such activity will be expected to show an effective control environment.

The policy statement goes on to confirm that national and member state banks may not hold crypto-assets as principal, given that the value of such assets is driven by subjective factors like sentiment and future expectations.

Likewise, the Financial Crimes Enforcement Network continues to flag crypto-related activities like virtual currency exchanges for potential money laundering risks. FinCEN issued guidance in 2019[10] clarifying how existing Bank Secrecy Act regulations apply to crypto as money transmission and proposed a more formal rule on this issue in December 2020.

While that rule is not expected to be finalized until early 2024, the agency continues addressing the risks crypto-related activities pose relative to money laundering and illicit activity. This includes the January order identifying Bitzlato Limited as a primary money laundering concern under the Combating Russian Money Laundering Act.[11]

As FinCEN continues to raise concerns about the role crypto can play in illicit activities, the federal regulators tasked with supervising financial institutions will, in turn, review for these risks when examining an institution and take enforcement action if there are BSA violations.

These concerns are not unfounded. In fact, Hsu's admonitions turned prophetic with the collapse of FTX in November 2022. Based on testimony from FTX insiders, customer funds deposited with FTX were commingled and subsequently loaned to Alameda Research despite FTX's assurances to customers to the contrary.

Based on testimony by Caroline Ellison, ex-CEO of FTX sister company Alameda Research, Ellison and others "prepared certain quarterly balance sheets that concealed the extent of Alameda's borrowing and the billions of dollars in loans that Alameda had made to FTX executives and to related parties."[12]

In short, FTX failed to implement the appropriate guardrails and gates to safeguard the deposits of its customers.

For the time being, banking regulators are unlikely to expand the currently limited universe of permissible crypto-related activities, and the burden of proof lies with financial institutions that want to become involved in crypto. Banks will demonstrate to regulators that the risks can be managed and the activity can be done in a compliant fashion.

As regulators are increasingly wary of crypto-related activities, when seeking preapproval or a nonobjection to a proposed activity through notice to the regulator, banks should take particular care with the supporting documents to ward off skepticism.[13]

For example, banks should detail the risk assessment of crypto-related activities, the internal controls that will be used to manage risk, the plan for ongoing monitoring of quickly evolving risks, and how compliance with applicable rules and guidance will be achieved.

In particular, this would include, as applicable, information on how the bank will meet third-party relationship risk management requirements and how the compliance management system will ensure obligations are met under various laws like the BSA and consumer protection requirements.

Once approved for crypto-related activities, the need to prove the bank is managing risks will be ongoing. Regulators' supervisory priorities clearly indicate that examiners will continue to review for continued compliance.

For example, the OCC 2023 Bank Supervision Operating Plan outlines key supervisory goals and specifically, where a bank is involved in crypto-related products and services, examiners must evaluate the bank's risk management practices, and determine whether the bank has the appropriate expertise to manage the technology, financial, operational, compliance, strategic and reputational risks involved.

Prior to an examination, it will be beneficial to review the risk management process, be able to identify how any increased risks were mitigated, and ensure staff engaged with examiners can provide clear answers to any questions that may arise.

Increased Enforcement

In light of both the increased focus on crypto-assets by prudential regulators and recent events in the crypto markets, one would also expect increased enforcement activity by the U.S. Department of Justice and U.S. Securities and Exchange Commission related to crypto-assets. And, the DOJ and SEC have already stepped up enforcement in these areas considerably.

Indeed, the SEC announced in May 2022 that it was doubling its Crypto-Assets and Cyber Unit. Just in the last four months, the DOJ announced the following:

- "Man Charged in $110 Million Cryptocurrency Scheme": The DOJ charged Avraham Eisenberg with various fraud charges, including wire fraud and commodities market manipulation related to his manipulation of the Mango Markets decentralized cryptocurrency exchange. According to the DOJ, Eisenberg allegedly fraudulently obtained roughly $110 million of cryptocurrency from the crypto exchange Mango Markets and its customers.[14]

- "Founder and Majority Owner of Cryptocurrency Exchange Charged with Processing Over $700 Million of Illicit Funds": The founder and majority owner of crypto exchange Bitzlato Ltd. was arrested for allegedly operating a business that transported and transmitted illegal funds. The founder also failed to meet U.S. regulatory safeguards, including anti-money laundering requirements.[15]

- "Two Estonian Citizens Arrested in $575 Million Cryptocurrency Fraud and Money Laundering Scheme": Sergei Potapenko and Ivan Turõgin were arrested for their alleged involvement in a $575 million crypto fraud and money laundering conspiracy. According to the DOJ, Potapenko and Turõgin allegedly induced hundreds of thousands of victims to enter into fraudulent equipment rental contracts with HashFlare, the defendants' cryptocurrency mining service. Likewise, Potapenko and Turõgin also allegedly caused victims to invest in Polybius Bank, a fake virtual currency bank.[16]

Then, just last month, the SEC announced the following:

- "SEC Charges Genesis and Gemini for the Unregistered Offer and Sale of Crypto Asset Securities through the Gemini Earn Lending Program": The SEC charged Genesis Global Capital LLC and Gemini Trust Company LLC for the unregistered offer and sale of securities to retail investors. The two companies conducted the offer and sale through the Gemini Earn crypto asset lending program and raised billions of dollars' worth of crypto assets.[17]

- "SEC Charges Creator of CoinDeal Crypto Scheme and Seven Others in Connection with $45 Million Fraud": The SEC charged Neil Chandran, Garry Davidson, Michael Glaspie, Amy Mossel, Linda Knott, AEO Publishing Inc., Banner Co-Op Inc. and BannersGo LLC related to their participation in a fraudulent investment scheme. The scheme, CoinDeal, raised more than $45 million from sales of unregistered securities to thousands of investors.[18]

- "SEC Charges Avraham Eisenberg with Manipulating Mango Markets' 'Governance Token' to Steal $116 Million of Crypto Assets": In addition to the charges brought by the DOJ, Avraham Eisenberg also faces charges from the SEC for manipulating the trading platform Mango Markets. Allegedly, Eisenberg manipulated the MNGO token, which was offered and sold as a security.[19]

- "Nexo Agrees to Pay $45 Million in Penalties and Cease Unregistered Offering of Crypto Asset Lending Product": The SEC charged Nexo Capital Inc. with failing to register the offer and sale of its retail crypto asset lending product, the Earn Interest Product. Nexo agreed to pay a penalty of $22.5 million to resolve the allegations. Nexo also agreed to cease its unregistered offer and sale of the EIP to U.S. investors.[20]

Simply put, the SEC, DOJ and the prudential banking regulators all appear to share similar views on the inherent danger of participating in the crypto markets. The joint statement simply further amplifies those views.

For example, in addition to the enforcement activity, in December 2022, the SEC also published guidance warning that "[c]ompanies may have disclosure obligations under the federal securities laws related to the direct or indirect impact" of "[r]ecent bankruptcies and financial distress among crypto asset market participants."[21]

In other words, the SEC is not only concerned about fraud by crypto market participants, but also companies that may be affected in some way by "widespread disruption" in the crypto markets.

This guidance by the SEC is substantially similar to recent warnings by prudential regulators to safeguard the safety and soundness of the banks, and, like with the joint statement, companies should heed the SEC's warnings.

Like the prudential banking regulators, the DOJ and the SEC will also likely consider the effectiveness of the compliance program in evaluating any culpability for banks as it relates to crypto-assets.

To the extent that banks provide their customers with and advertise access to certain crypto platforms, banks should consider whether they are actively managing risks associated with providing access to these platforms and providing adequate disclosures related to these third parties.

As with other types of potential fraud, effective compliance programs and ethical corporate culture have a direct and significant impact on the terms of a corporation's potential resolution with the DOJ.

Prosecutors generally look at a company's compliance program at two critical points: (1) the time of the offense and (2) the time of a charging decision. Thus, banks should consider those same issues here in the crypto context, especially given the known issues in the industry.

Arguably, given recent guidance and activity in the crypto industry, banks are on notice that they should provide heightened oversight to the extent that they maintain third-party relationships with these crypto platforms.

Finally, though it remains to be seen whether Congress will pass legislation specifically addressing concerns regarding the crypto industry, in the meantime, the prudential regulators, FinCEN, the SEC and the DOJ all make clear that they are monitoring the crypto markets and their impact on more regulated entities like financial institutions and publicly traded companies.

It appears that, in the absence of crypto-specific legislation by Congress, we can expect higher scrutiny from traditional regulators in an effort to safeguard these institutions and the integrity of the financial markets. In other words, stay tuned!

Denise Barnes and Brandy Bruyere are partners at Honigman LLP.

Honigman associate Morgan L. Esters contributed to this article.

[1] Joint Statement on Crypto-Asset Risks to Banking Organizations, FDIC & OCC (Jan. 3, 2023), https://www.fdic.gov/news/press-releases/2023/pr23002a.pdf.

[2] Id. at 1.

[3] Id.

[1] Acting Comptroller of the Currency Michael J. Hsu, remarks at DC Fintech Week 2022, "Skeuomorphism, Commingling, and Data Gaps in Crypto," OCC, 1 (Oct. 11, 2022), https://www.occ.gov/news-issuances/speeches/2022/pub-speech-2022-125.pdf.

[4] Id. at 6.

[5] Acting Chairman Martin J. Gruenberg, remarks at the Brookings Institution on the Prudential Regulation of Crypto-Assets, October 20, 2022, available at: https://www.fdic.gov/news/speeches/2022/spoct2022.html.

[6] Acting Chairman Martin J. Gruenberg, remarks at the Brookings Institution on the Prudential Regulation of Crypto-Assets, October 20, 2022, available at: https://www.fdic.gov/news/speeches/2022/spoct2022.html.

[7] Acting Chairman Martin J. Gruenberg, remarks at the Brookings Institution on the Prudential Regulation of Crypto-Assets, FDIC (Oct. 20, 2022), https://www.fdic.gov/news/speeches/2022/spoct2022.html.

[8] Policy Statement on Section 9(13) of Federal Reserve Act, 88 Fed. Reg. 7848 (February 7, 2023) (to be codified at 12 C.F.R pts 208.

[9] Id. at 7848.

[10] Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies, Financial Crime Enforcement Network, FIN-2019-G01 (May 9,

2019), https://www.fincen.gov/sites/default/files/2019-05/FinCEN%20Guidance%20CVC%20FINAL%20508.pdf.

[11] Press Release, FinCEN Identifies Virtual Currency Exchange Bitzlato as a "Primary Money Laundering Concern" in Connection with Russian Illicit Finance, FinCEN (January 18, 2023), https://www.fincen.gov/news/news-releases/fincen-identifies-virtual-currency-exchange-bitzlato-primary-money-laundering.

[12] Luc Cohen and Tom Hals, Bankman-Fried, FTX exec received billions in hidden loans, ex-Alameda CEO says, Reuters (Dec. 23, 2022 6:59 PM), https://www.reuters.com/legal/alamedas-ex-ceo-tells-judge-she-hid-billions-loans-ftx-execs-2022-12-23/.

[13] See, 12. C.F.R. §16.30.

[14] Press Release, Man Charged in $110 Million Crytocurrency Scheme, DOJ (Feb. 2, 2023), https://www.justice.gov/opa/pr/man-charged-110-million-cryptocurrency-scheme.

[15] Press Release, Founder and Majority Owner of Cryptocurrency Exchange Charged with Processing Over $700 Million of Illicit Funds, DOJ (Jan. 18, 2023), https://www.justice.gov/opa/pr/founder-and-majority-owner-cryptocurrency-exchange-charged-processing-over-700-million.

[16] Press Release, Two Estonian Citizens Arrested in $575 Million Cryptocurrency Fraud and Money Laundering Scheme, DOJ (Nov. 21, 2022), https://www.justice.gov/opa/pr/two-estonian-citizens-arrested-575-million-cryptocurrency-fraud-and-money-laundering-scheme.

[17] Press Release, SEC Charges Genesis and Gemini for the Unregistered Offer and Sale of Crypto Asset Securities through the Gemini Earn Lending Program, SEC (Jan.12, 2023), https://www.sec.gov/news/press-release/2023-7.

[18] Press Release, SEC Charges Creator of CoinDeal Crypto Scheme and Seven Others in Connection with $45 Million Fraud, SEC (Jan. 4, 2023), https://www.sec.gov/news/press-release/2023-2.

[19] Press Release, SEC Charges Avraham Eisenberg with Manipulating Mango Markets' "Governance Token" to Steal $116 Million of Crypto Assets, SEC (Jan. 20, 2023), https://www.sec.gov/news/press-release/2023-13.

[20] Press Release, Nexo Agrees to Pay $45 Million in Penalties and Cease Unregistered Offering of Crypto Asset Lending Product, SEC (Jan. 19, 2023), https://www.sec.gov/news/press-release/2023-11.

[21] Guidance Statement, Sample Letter to Companies Regarding Recent Developments in Crypto Asset Markets, SEC Division of Corporate Finance (Dec. 8, 2022), https://www.sec.gov/corpfin/sample-letter-companies-regarding-crypto-asset-markets#_ftn1. "The statements in th[e] guidance [letter] represent the views of the staff of the Division of Corporation Finance. Th[e] guidance [letter] is not a rule, regulation, or statement of the Securities and Exchange Commission (the 'Commission'). The Commission has neither approved nor disapproved its content. Th[e] guidance [letter], like all staff guidance, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person." Id.