The Importance of OCC Comments and Interpretations on the Crypto Asset Industry

Executive Summary: Recent OCC commentary and updates may provide some long-needed perspective on how crypto assets may be treated from a reporting, accounting, and valuation perspective. In this post, we consider these recent comments, analyze the benefits and challenges, and note key takeaways for industry.

Background

During the second half of 2020 and first half of 2021 there were numerous announcements and updates pertaining to how blockchain technology and specific digital assets can become more fully integrated with the fiat economy. These developments seemed to be illustrative of a mind shift in the perspective of policymakers and regulators. Instead of, as might have been the case previously, viewing crypto and other digital assets as direct competitors to fiat, these developments seemed to indicate that a convergence is, at the very least, beginning. Be it the announcements by the likes of PayPal, Visa, and Mastercard that existing customers can buy, sell, and use cryptocurrencies in transactions, or the regulatory updates from the U.S. Office of the Comptroller of the Currency (the "OCC"), the trend is clear. Moving from an idea and instrument that for many is used primarily as a speculative investment to a financial instrument that can truly be used as a legitimate alternative to fiat currencies will take increased collaboration and dialogue between private sector actors and regulators. Even with this increased dialogue, however there lies at the center of options like DeFi a potential paradox; what is going to be regulated? Regulators and policymakers have supervision, and tend to focus on, third party actors, intermediaries, and payment processing organizations. In a world of decentralized finance, such parties do not exist or at a minimum are not easily identifiable. (*For more on the DeFi sector, as well as what this rapid growth means both in terms of pros and cons, be sure to read the DeFi Whitepaper published by the Accounting Working Group of the Wall Street Blockchain Alliance that can be found here.*)

With this context in mind, the announcements from the OCC carry even more weight; let's break down what these announcements are, as well as some of the implications these changes may have going forward.

Introduction

One of the more significant headwinds to wider blockchain and digital asset adoption as a medium of exchange and of doing business is the fact that, until recent interpretative letters from the Office of the Comptroller of the Currency (OCC), there was significant uncertainty as to what services banking institutions could provide to the sector. The purpose of this comment letter is to summarize these interpretive letters, provide observations as to the impact of these updates, and to hopefully offer constructive suggestions for continued improvement. The Wall Street Blockchain Alliance continues to work to encourage productive engagement and dialogue between market actors and regulators. Building on the progress made possible by the OCC updates is an

important first step toward broader blockchain and digital asset adoption, inclusion, and improved reporting and disclosure. Perhaps the single largest development as it pertains to banking, blockchain, and cryptoassets was the 2021 announcement by BNY Mellon[1], with over $41 trillion in custodial assets or assets under administration, that it would begin holding bitcoin and would begin financing bitcoin and other digital currencies. Eventually, the bank will allow digital currencies to pass through the same established network used by traditional financial instruments such as bonds, equities, and Treasury instruments s. Clearly it is still early days in terms of banking and cryptocurrencies, but the fact remains incumbent financial institutions are embracing crypto at an accelerating pace. With that in mind, the clarifications issued by the OCC are even more important.

Summarization

Recapping briefly the main points of these OCC updates is a logical first step to help level-set terminology and context. In the first update[2], known as "*OCC Interpretive Letter #1172*" and published in September of 2020, the OCC authorized federally chartered banking institutions to hold dollar deposits that served as the reserve asset for dollar-backed stablecoins. Seemingly a technical modification, this clarification allowed stablecoin issuers to benefit fully from the federally chartered banking systems in terms of deposit insurance as well as services that could be offered to stablecoin issuers. Following this September update, which included a coordinated pronouncement[3] from the SEC's FinHub confirming the OCC's interpretation, a further update (*"OCC Interpretive Letter #1174"*) was published in January 2021. This notification from OCC was even more impactful. In this interpretative letter, the OCC ruled that federally chartered financial institutions to buy, sell, and issue stablecoins, as well as participate in what is referred to as independent node verification networks (INVN), the OCC terminology for permissionless blockchains. It is also interesting to note that while private, permissioned, hybrid, or other semi-centralized forms of blockchains have taken center stage during 2019, 2020, and 2021, public or permissionless blockchains seem to be the basis for many DeFi operations. These two letters may have been seen as technical updates or minor tweaks to existing structures, but that perspective overlooks the true impact of these changes. In essence, these two updates allow stablecoins issuers to participate fully in the commercial banking system and allow financial institutions to participate equally in the blockchain and digital asset ecosystem.

Benefits and Challenges

The benefits of the two updates from the OCC are relatively clear to observe for most market participants. Allowing the interconnectivity and the fiat economy, which to this point has only been possible at the periphery, has substantial implications for both economic sectors moving forward. The June 2021 ratification[4] of the status of bitcoin as legal tender in El Salvador provides a look

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[1] https://www.cnbc.com/2021/02/11/bny-mellon-to-offer-bitcoin-services-a-validation-of-crypto-from-a-key-bank-in-the-financial-system.html

[2] https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1172.pdf

[3] https://www.sec.gov/news/public-statement/sec-finhub-statement-occ-interpretation#_ftn2

[4] https://www.reuters.com/world/americas/el-salvador-approves-first-law-bitcoin-legal-tender-2021-06-09/

into the real-world impact of cryptoassets as an integral component of the banking and payment system. These include, but are not limited to, wider payment capabilities, lower fees associated with payments and remittances, improved traceability and transparency for compliance purposes, and a potential hedge against fiat-based inflation. Additionally, the clarification of what products and services are able to be offered, in essence what is allowed to be undertaken, begins to remove some of the uncertainty that can forestall further investment in the crypto asset industry. Yet another benefit of these clarifications is that, from a bigger picture perspective, they might help influence the wider regulatory landscape and conversation regarding how certain blockchains and cryptoassets will be treated from an oversight and rulemaking perspective.

From the perspective of market actors, the OCC clarifications make seemingly mundane items such as issuing and writing insurance policies more straight-forward and economically efficient. The crypto marketplace (and by extension, economy) may have a market capitalization in the trillions, and involve much of the institutional financial sector, but remains a relatively small economic sector when compared to traditional financial markets. By linking together crypto transactions and the current payment infrastructure, the OCC opens the door toward greater integration and more sustainable growth in the future.

An additional benefit of this intersection and integration of the fiat economy with the crypto economy is also an item that can often fly beneath the surface, the importance of liquidity. During the second half of 2020, and beginning into 2021, prices of cryptoassets (virtually across the board) experienced a significant increase. In order to both liquidate and realize these gains, as well as potentially enable the utilization of cryptocurrencies as a fiat alternative, access to financial institutions will be crucial. Especially as larger institutions continue to acquire ownership stake in bitcoin and other cryptocurrencies, ensuring liquidity for individuals and institutions to actually use various cryptoassets as a medium of exchange.

A benefit or potential upside to the increased access of stablecoin issuers and cryptoassets at large might be something that is not always obvious on the surface; the importance of accounting rules and reporting frameworks. The lack of crypto-specific authoritative accounting guidance has the potential to complicate accounting, reporting, and disclosures at multiple publicly traded organizations. These include firms such as Tesla, MicroStrategy, Square, and invariably others that have not made such high-profile investments into the space, seeking to leverage crypto as an alternative reserve asset. Ideally, announcements such as those by the OCC will help encourage - and some would say it has - other regulators to move forward with crypto-focused regulations and policies. To fully actualize the benefits of blockchain and cryptoassets, there is an increased need for integration; issuers and users need to have the confidence that transactions and reserves are secure.

From an accounting-centric perspective, it could also be hoped that these large investments and (virtually) simultaneous clarifications from a major regulator might encourage accounting standard setting bodies to consider crypto-specific standards.

Challenges

While these updates from the OCC are certainly welcome news from the perspective of market participants, there is still ambiguity and gaps in the regulatory framework that can continue to serve as substantive headwinds. The 2020 U.S. Presidential election, change of leadership in Washington D.C., and subsequent reshuffling of policymakers has led to a flurry of regulatory interpretations and actions toward the cryptoasset sector. For example, the complaint filed against Ripple (and by extension XRP) has been seen by some as sending a chilling effect through the broader blockchain and cryptoasset space.

It is uncertain as to how these, and other legal actions, will ultimately play out, but it does illustrate just how ambiguous the regulatory landscape remains. From an accounting perspective there are several critical considerations that opening up the financial institution to broader blockchain and crypto integration will create. Granted, these control considerations are merely a handful of the items that practitioners and market participants need to consider but should form the basis for further conversation and analysis.

For example, how will the controls and existing banking regulations adapt to a blockchain and crypto based payment system? While it is true that several of the largest exchanges and stablecoin issuers have - in essence - fully embraced existing regulations and laws, it remains to be seen how compliance and enforcement will fare once volumes increase. One need only look at the routine outages at crypto exchanges at peak times to see how this might play out.

Building on that first point, seemingly mundane questions to be asked would be, will insurance organizations (outside of the FDIC) be willing to grant, extend, or modify existing coverage? This is not an idle concern or statement, but rather an integral part of how financial institutions will be able to offer and expand blockchain and crypto products and services. Especially with the growing pains that accompany any fast growing and emerging sector, including bad actors and potentially unethical activity, these risks and costs will need to be properly safeguarded against.

Internal controls at financial institutions will invariably have to evolve and modify to contend with the new and unique issues created with the integration of blockchain and cryptoassets within existing financial systems. Highlighted most specifically by the rise of stablecoins, and other asset-backed coins or tokens, this creates a two-tier or two-fold obligation on the side of institutions to provide security for clients. Put simply, a cryptocurrency that is backed and supported by an external asset will create additional control, custody, and provenance issues that will need to be addressed. Refer to our Stablecoin 2.0 whitepaper for more discussion on these issues.

Takeaways

The two (2) recent updates from the OCC provided some much-needed clarity for financial institutions and crypto-native organizations seeking to become more integrated into the existing fiat banking system. From a financial markets and payments perspective it is difficult to overstate the positive impact of these regulatory updates on opening up the blockchain and cryptoasset

sector for broader adoption and implementation. Stablecoin issuers can now fully access incumbent financial institutions (and benefit from FDIC insurance), and those same incumbent financial institutions can become full members of public blockchains as well as buying and selling certain cryptocurrencies, and also have the ability to confirm certain blockchain-based transactions.

s institutions the world over continue to invest tens of billions of dollars into the blockchain and cryptoasset sector, the importance for clear and transparent regulation and policy cannot be exaggerated. These recent updates and clarifications from the OCC are positive steps in the direction toward wider utilization of blockchain and cryptoassets as both a medium of exchange and accepted base of economic and financial activity. The Wall Street Blockchain Alliance welcomes such clarifications, will continue along with its members, to engage in this critical dialogue, and will continuously seek to inform and encourage these advancements moving forward.

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