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FRB Issues Policy Statement on Permissible Activities of State Member Banks While Denying Uninsured Crypto-focused Bank's Membership Application



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The Federal Reserve Board (“FRB” or “Board”) issued two seemingly related press releases late last week. The [first](#) announced the denial of the Federal Reserve membership application by Custodia Bank, a Wyoming special purpose depository institution. The [second](#) announced the issuance of a [policy statement](#) interpreting section 9(13) of the Federal Reserve Act (codified at [12 U.S.C. § 330](#)) (“Policy Statement”) that provides a rebuttable presumption that the FRB would not allow a state member bank (“SMB”) to engage in activities as principal that are not permitted for a national bank or consistent with [Section 24 of the Federal Deposit Insurance Act](#) (“FDI Act”). On the same day, the Federal Reserve Bank of Kansas City (“FRBKC”) and the FRB filed a [motion to dismiss](#) Custodia Bank’s pending litigation with the Federal Reserve System as moot because the FRBKC had denied Custodia’s request for a master account at the FRBKC.

These three coordinated actions make clear that the FRB believes the risks associated with crypto-asset related activities are not appropriate for state member banks as principal, and is consistent with the [Joint Statement on Crypto-Asset Risks to Banking Organizations](#) (the “Joint Crypto Risk Statement,” as previously [reported in Cabinet News and Views](#)) that the FRB issued together with the Federal Deposit Insurance Corporation (“FDIC”) and the Office of the Comptroller of the Currency (“OCC”) in January. With regard to the Policy Statement, the FRB stated it would serve to “promote a level playing field for all banks with a federal supervisor, regardless of deposit insurance status.”

Summary of the Policy Statement

As noted above, the Policy Statement sets out a rebuttable presumption that the FRB would limit SMBs “to engaging as principal in only those activities that are permissible for national banks – in each case, subject to the terms, conditions, and limitations placed on national banks with respect to the activity – unless those activities are permissible for state banks by federal statute or under part 362 of the FDIC’s regulations.”

The focus on activities as principal is very much in line with section 24 of the FDI Act and the FDIC’s implementing regulations at 12 CFR Part 362, and the FRB noted that “[i]f the FDIC, by rule, permits insured state banks to engage in the activity, no [FRB] approval would be required to establish permissibility.” The FRB stated that “legal permissibility is a necessary, but not sufficient, condition to establish that a [SMB] may engage in a particular activity” and emphasized the need to focus on the safety and soundness of the activity. The Policy Statement noted the presumption of impermissibility discussed above could be rebutted “if there is a clear and compelling rationale for the Board to allow deviations in regulatory treatment among federally supervised banks, and the state member bank has robust plans for managing the risks of such activities in accordance with principles of safe and sound banking.” While the Policy Statement is very much issued in the context of crypto-related activities, it applies broadly to any activity a SMB would want to engage in that isn’t permissible for national banks.

The FRB discussed its current views on permissibility of some particular crypto-related activities. As custody services are not an as-principal activity, it stated that SMBs would not be prohibited “from providing safekeeping services for crypto-assets in a custodial capacity if such activities are conducted in a safe and sound manner and in compliance with consumer, anti-money-laundering, and anti-terrorist-financing laws.” On the other hand, however, the FRB stated that it would presumptively prohibit a SMB from holding crypto-assets, such as Bitcoin and Ether, when it was holding them as a principal. The issuing of dollar tokens has been found permissible by the OCC, per Interpretive Letters [1174](#) and [1179](#), but pursuant to the conditions in those letters, the SMB would be required to seek the FRB’s non-objection before conducting such an activity. Finally, the FRB also stated unequivocally that, consistent with the Joint Crypto Risk Statement, 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.”

Impact on Cryptocurrency Activities in the United States

These actions involving Custodia Bank combine to demonstrate that U.S. bank regulators are taking strong action to prevent the contagion risk from volatile cryptocurrency markets from spreading to the banking system. While the vehemence of such action may be disheartening for proponents of a crypto-based future, there is still hope that cryptocurrency may yet be tamed sufficiently to become a part of the banking system eventually. Nevertheless, the clear takeaway is that cryptocurrency-related companies should no longer view themselves as being exceptional in terms of having greater capacity and flexibility when it comes to ensuring their own safety and soundness than more traditional financial institutions.

Custodia Bank Litigation

The same day the Policy Statement was issued, the FRB denied Custodia Bank's application to become a member of the Federal Reserve System, and the FRBKC denied its request for a master account. A master account provides access to the Federal Reserve's payment services and access to the wholesale payments system, among other benefits. Custodia – which markets itself as a “bridge connecting digital asset companies to the U.S. payments system” – sought a master account to eliminate transacting through correspondent banks. *See Custodia Bank v. Fed. Reserve Bd. of Governors*, Case No. 1:22-cv-00125 (D. Wy.), ECF No. 1 (Complaint).

Custodia is a special purpose depository institution chartered by the State of Wyoming. The bank specializes in payments and digital asset custody services. Under the Federal Reserve Act, to obtain a master account, a financial institution must be either a member of the Federal Reserve System or a “depository institution,” defined as either (1) a bank insured by the FDIC, or (2) a bank eligible to be insured by the FDIC. 12 U.S.C. § 461(b)(1)(A)(i). Custodia has claimed that, as a state-chartered SPDI, it is “eligible” to be insured by the FDIC because it is “authorized and expected to take deposits.” Custodia Compl. ¶ 33.

On June 7, 2022, Custodia sued the FRB and the FRBKC for their “unreasonable delay” in deciding Custodia's application for a master account. It alleged that the FRB and FRBKC's delay in determining its application for a master account violated, among other things, the Administrative Procedures Act and the Constitution's due process clause. As a remedy, Custodia asked the court to compel the FRB and FRBKC to process and decide Custodia's application. *See generally* Custodia Compl.

As noted above, the FRB announced that it had denied Custodia's application to become a member of the Federal Reserve System. The Board noted that Custodia “proposed to engage in novel and untested crypto activities” and that its “business model and proposed focus on crypto-assets presented significant safety and soundness risks.” The Board also found that “Custodia's risk management framework was insufficient to address” these concerns.

In the FRB and FRBKC's motion to dismiss Custodia's complaint, they stated that the FRBKC had denied Custodia's request for a master account and had provided a letter to Custodia “providing the basis for that decision.” As a result, the FRB and FRBKC moved the court to dismiss Custodia's lawsuit as moot. The denial by the FRBKC appears to be consistent with [final guidance](#) issued by the FRB in August, and which we previously [discussed](#).

We expect more to come in this litigation. Custodia will have an opportunity to respond to the motion to dismiss. In addition, Custodia may seek to amend its complaint to allege that the decision to deny the application was improper. For example, Custodia could seek to bring a claim under the Administrative Procedures Act alleging that the FRB and FRBKC's decision was arbitrary and capricious or contrary to law. Regardless, the case remains one to watch as companies specializing in digital assets seek access to the U.S. banking system.
