June 23, 2022

Nellie Liang
Under Secretary for Domestic Finance
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

Harrel Pettway
General Counsel
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Mark E. Van Der Weide
General Counsel
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Benjamin W. McDonough
Senior Deputy Comptroller and Chief Counsel
Office of the Comptroller of the Currency
400 7th Street SW
Washington, D.C. 20219

Re: Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the Securities and Exchange Commission

Ladies and Gentlemen:

The American Bankers Association, Bank Policy Institute and the Securities Industry and Financial Markets Association (the "Associations") write to call attention to issues arising from the new Staff Accounting Bulletin No. 121 ("SAB 121" or "the SAB") issued by the staff ("SEC Staff") of the Office of the Chief Accountant of the Securities and Exchange Commission (the "SEC").[1] In particular, this letter and its appendices follow preliminary discussions that the Associations have had with SEC Staff, and staff of the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC") and the Federal Reserve Board (the "FRB" and, collectively with the OCC and the FDIC, the "Banking Agencies") and Department of the Treasury, and respond to staff requests for more information and analysis.

The Associations fully support the SEC's goal of helping to ensure that investors receive appropriate protections, including full and transparent disclosure regarding the risks that may arise from activities related to crypto-assets. The scope of assets that fall within the SAB's

[1] More information about the Associations is available in Appendix A.

definition of "crypto-assets", however, is overly broad because there are a range of tokenized and digitally native versions of traditional assets (*e.g.*, securities) that could fall within the crypto-asset definition where the risks described in the SAB are addressed today.[2] Tokenized and digitally "native" versions of traditional assets operate within the existing banking infrastructure and legal and regulatory frameworks and, typically, use permissioned blockchains. In these materials, we refer to such assets as "tokenized assets" and we believe that they should not be within the scope of SAB 121 at all. By contrast, native crypto-assets (*e.g.*, Bitcoin and Ether) typically use permissionless blockchains. We refer to such assets as "crypto-assets". These crypto-assets should be the proper focus of SAB 121 because they may, with respect to *non-prudentially regulated* entities, raise the risks identified in the SAB. We believe, however, that these technological, legal and regulatory risks are substantially mitigated by banking organizations and their federal supervisors, given existing regulation, supervision, legal precedent and related industry practices.

Applying the on-balance sheet recognition requirements of SAB 121 (without modification or clarification) to banking organizations would fail to account for these substantial legal protections and other risk mitigants. In addition, such an application of SAB 121 would result in prudential knock-on effects that would make it economically impractical for banking organizations to provide crypto-asset safeguarding activities. This result should be avoided because the presence of banking organizations in crypto-asset markets ultimately would benefit investors, financial markets and the broader public.

The participation of banking organizations would help mitigate these risks and provide enhanced investor protections by introducing prudential regulation to the crypto-asset markets. For example:

- **Technological Risks**. Banking organizations are involved in many areas of financial innovation involving distributed ledger technology, including the development of safeguarding solutions for crypto-assets. These solutions include practices, processes and controls that protect against theft, loss and unauthorized or accidental transactions. Further, banking organizations are required to follow due diligence, risk review and risk management processes when safeguarding all financial assets (including crypto-assets) and are subject to ongoing evaluation through the supervisory examination process.

- **Legal Risks**. Banking organizations adhere to established standards, and benefit from established legal precedents, for safeguarding assets, such that the assets are not subject to claims from unsecured creditors in a bank insolvency. In addition, bank custody arrangements clearly document and disclose to customers their rights and responsibilities (including allocation of the risks of fraud, loss and theft).

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[2] *See e.g.*, European Investment Bank, Bonds on the blockchain (July 19, 2021) *available at* https://www.eib.org/en/stories/cryptocurrency-blockchain-bonds (describing the European Investment Bank's first bond sale using blockchain technology).

- **Regulatory Risks**. Banking organizations are subject to the comprehensive regulatory and supervisory frameworks established by their primary regulators to ensure that their safeguarding activities are conducted in a safe and sound manner.

Indeed, banking organizations have engaged in safeguarding activities for over 80 years and have developed extensive and unique expertise in doing so. For instance, as of the end of the first quarter of 2022, bank custodians collectively held more than $200 trillion in assets under custody.[3] These custodied assets are held safely and are made available to customers, as the types of risks that the SEC cites as being of concern are mitigated effectively through the legal and regulatory frameworks applicable to banking organizations.

Therefore, and for the reasons described in more detail in these materials, the Associations believe SEC Staff should clarify that the recognition requirements of Question 1 of SAB 121 do not apply to regulated banking organizations that safeguard crypto-assets where the risks outlined in the SAB are mitigated (*e.g.*, as a result of the stringent prudential and supervisory standards outlined in this letter). The Associations further believe SEC Staff should clarify that SAB 121 does not apply to regulated banking organizations that safeguard tokenized assets.

As we have discussed with the agencies, an application of Question 1 of SAB 121 that includes banking organizations' crypto-asset safeguarding activities, or otherwise entrusting banking organizations with crypto-assets, effectively would preclude banking organizations from serving clients seeking crypto-asset safeguarding services. The reason for this result is that SAB 121 appears to have a wide range of knock-on effects in most areas of the prudential regulatory framework that would give rise to significant capital, liquidity and other costs, including with respect to:

- categorization of banks under the tailoring rules;
- leverage and risk-based capital;
- capital stress testing;
- global systemically important bank qualifications and surcharges;
- the liquidity coverage ratio and net stable funding ratio;
- single-counterparty credit limits;
- financial sector concentration limits; and
- deposit insurance assessments.

To our knowledge, before issuing SAB 121, SEC Staff did not engage in discussions of the type or scope that historically were regarded as typical and sound policymaking practice, such as

[3] Global Custodians, Custodians by assets under custody and administration, Q1 2022 Rankings, *available at* https://www.globalcustodian.com/custodians-assets-under-custody/.

having discussions with a range of stakeholders, including other impacted regulatory agencies.[4] The fact that SAB 121 appears to have been developed with limited public consultation may have contributed to the SAB not reflecting how risks outlined in SAB 121 are mitigated for regulated banking organizations, as well as the prudential knock-on effects noted above, as a lack of transparency and public input in policymaking often leads to unintended consequences.

Moreover, applying the recognition requirements of SAB 121 to banking organizations would work at cross purposes with the ongoing governmental project to define the regulatory perimeter for crypto-asset-related activities, including by making it effectively impossible for digital native firms to become subject to federal prudential regulation. In other words, these knock-on effects would seem to have the unintended effect of ensuring that such services could be provided only by those firms that are not insured depository institutions or otherwise regulated by the Banking Agencies.

We are working with SEC Staff to better understand and appropriately scope the types of products and roles that are impacted by SAB 121, including how SAB 121 defines "crypto-assets" broadly as "a digital asset that is issued and / or transferred using distributed ledger or blockchain technology using cryptographic techniques". As noted, this definition arguably would scope in any activity that uses permissioned blockchain systems or cryptographic techniques, including tokenized assets held with regulated financial market infrastructures ("FMIs").

Furthermore, banking organizations are a primary provider of core custodial and fiduciary services and also may safeguard crypto-assets when holding collateral or margin in secured financing and other transactions, subject to appropriate risk mitigation. Depending on the scope of SAB 121, some or all of these core, traditional banking services could trigger application of the recognition requirements of the SAB. The potential breadth of SAB 121 effectively would preclude the ability of banking organizations to provide these core services for crypto-assets or tokenized assets, which in turn very well may impede financial services innovation more generally.

In light of these significant consequences, we have prepared the analysis enclosed with this letter to demonstrate how the risks cited in SAB 121 are adequately addressed for tokenized assets and, for crypto-assets, can be substantially mitigated when safeguarding activities are carried out by banking organizations, as compared to non-prudentially regulated entities. The enclosed analysis also details the knock-on effects on capital, liquidity and other prudential requirements of applying the recognition requirements of Question 1 of SAB 121 to banking organizations. The Associations strongly believe that full and transparent disclosure about the nature and amount of safeguarded crypto-assets (including separate disclosure of each significant crypto-asset class),

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[4] The response of former SEC Chief Accountant Turner to a review by the United States General Accounting Office states, "[g]enerally, *before a SAB is issued*, the general content and staff views to be expressed in the SAB are discussed with registrants, accounting firms, standard setting bodies, *trade groups, other impacted regulatory agencies*, all relevant Commission offices and divisions, *and other interested parties*". United States General Accounting Office, Securities and Exchange Commission Reviews of Accounting Matters Related to Public Filings, GAO-01-718 (June 2001) (*see* Letter at page 7 (emphasis added) from Lynn Turner, Chief Accountant (page 29 of the GAO Report)), *available at* https://www.gao.gov/assets/gao-01-718.pdf.

and the nature of the safeguarding services offered (including the vulnerabilities arising due to any concentration of such services and related risks), as contemplated in Question 2 of SAB 121, is a more appropriate way to achieve SEC Staff's policy aims with respect to regulated banking organizations.

To help facilitate SEC Staff's consideration of these issues, we respectfully request you and your respective agencies to urge SEC Staff (who have advised use that they have not engaged in meaningful dialogue with your respective agencies) to work collaboratively to ensure that the legal and regulatory frameworks applicable to safeguarding activities when carried out by banking organizations, and the risk mitigation that results from those frameworks, are well understood, so that the scope of SAB 121 can be clarified to exclude such activities. This collaboration would be consistent with the "whole of government" approach contemplated by the President's executive order on crypto-assets[5], and would create a path for crypto-asset safekeeping activities to be conducted within the prudential regulatory perimeter. Although we strongly believe that such activities should be excluded from the scope of the on balance sheet recognition contemplated under Question 1 of SAB 121, it is vital to consider how such assets would be treated under the prudential, capital and liquidity frameworks should they remain in-scope. Therefore, in the interim, we request that the banking agencies begin legal, policy and procedural work in earnest to seek to neutralize the impact of SAB 121 on total assets and liabilities reported by banking organizations on regulatory reports and otherwise to take steps necessary to neutralize the knock-on capital, liquidity and other prudential effects that arise from recognizing additional assets on balance sheet under SAB 121 in situations where the technology, legal and regulatory risks are appropriately mitigated.

Although we believe regulated banking organizations currently have limited activities that are directly impacted by SAB 121, innovations in the use of distributed ledger and blockchain technology are occurring rapidly across the financial services industry, but with the issuance of SAB 121 in its current form and scope, further developments could stall. We believe investors and customers, and ultimately the financial system, will be worse off if regulated banking organizations are effectively precluded from providing crypto-asset safeguarding services, accepting crypto-assets as collateral, or conducting tokenized asset activities, as it would limit progress in relation to improved efficiencies across the financial system, as well as limit the market to providers that do not afford their customers the legal and supervisory protections that apply to federally-regulated banking organizations.

To assist the agencies with their evaluation of this matter, the enclosed documents provide a more detailed background and analysis of: the custody and safeguarding activities of banking organizations; the potential wide-ranging breadth of SAB 121; how the technological, legal and regulatory risks cited in SAB 121 are addressed by the legal and regulatory framework that applies to banking organizations' custodial activities; and the knock-on effects that SAB 121 could have on the prudential regulatory framework.

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[5] 87 Fed. Reg. 14143 (Mar. 14, 2022); *see also* SIFMA and BPI Letter to Senator Cynthia Lummis (May 19, 2022), *available at* https://www.sifma.org/wp-content/uploads/2022/05/SIFMA-BPI-Letter-for-the-Record-on-SAB-121-May-2022.pdf.

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Thank you for considering these materials and your attention to this important issue. If you have any questions, please feel free to contact the undersigned (Hugh Carney at hcarney@aba.com; Paige Paridon at paige.paridon@bpi.com; and Joseph Seidel at jseidel@sifma.org).

Respectfully submitted,

Hugh C. Carney
Senior Vice President,
American Bankers
Association

Paige P. Paridon
Senior Vice President and
Associate General Counsel,
Bank Policy Institute

Joseph L. Seidel
Chief Operating Officer,
Securities Industry and
Financial Markets Association

cc: Office of the Chief Accountant
U.S. Securities and Exchange Commission
100 F Street NE
Washington, D.C. 20549

Attention of: Paul Munter, Acting Chief Accountant

Enclosures:

Analysis for the Board of Governors of the Federal Reserve System, Department of the Treasury, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency regarding Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission

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ANALYSIS

for the

Board of Governors of the Federal Reserve System,
Department of the Treasury,
Federal Deposit Insurance Corporation and
Office of the Comptroller of the Currency

regarding

Staff Accounting Bulletin No. 121 Issued by the Staff of the Office of the Chief Accountant of the U.S. Securities and Exchange Commission

June 23, 2022

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I. Executive Summary

A. SEC Staff should clarify Question 1 of SAB 121 with respect to banking organizations

For the reasons discussed below, the Associations believe SEC Staff should clarify that Question 1 of SAB 121 does not apply to regulated banking organizations that safeguard crypto-assets and that are subject to the stringent prudential and supervisory standards outlined in this letter, given that the risks that the SEC cites as being of concern are mitigated effectively for the safeguarding activities carried out by banking organizations. As an interim measure, the ABA and SIFMA had previously requested that SEC Staff delay the effectiveness of SAB 121, to allow for further time to consider the issues discussed herein and to allow for robust consultation with all relevant stakeholders.

To help facilitate SEC Staff's consideration of these issues, we respectfully request the federal banking agencies and Department of the Treasury to urge SEC Staff to work collaboratively to ensure that the legal and regulatory frameworks applicable to safeguarding activities when carried out by banking organizations, and the risk mitigation that results from those frameworks, are well understood by SEC Staff, so that the scope of SAB 121 can be clarified to exclude such activities.[6] Although we strongly believe that such activities should be excluded from the scope of the on-balance sheet treatment contemplated under Question 1 of SAB 121, it is vital to consider how such assets would be treated under the prudential capital and liquidity frameworks should the assets remain in-scope. Therefore, we also request that the federal banking agencies begin legal, policy and procedural work in earnest to neutralize the impact of SAB 121 on total assets and liabilities reported by banking organizations on regulatory reports and otherwise to take steps necessary to neutralize the knock-on prudential capital and liquidity charges that arise from recognizing additional assets on balance sheet under SAB 121. If the banking agencies determine that they are legally constrained from significantly neutralizing these knock-on effects, they should advise the SEC promptly.

Absent a holistic policy approach, there would be few (if any) regulated banking organizations available to provide crypto-asset custody services at scale for U.S. investors, as an application of SAB 121 by the SEC that includes banking organizations' safeguarding activities would result in capital and liquidity costs, and application of other standards, so significant that the activities that are in-scope effectively would be prohibited.[7] For example, assuming banks were to have held just half of the $223 billion of crypto-assets estimated to be held in custody at the beginning of the year, SAB 121 could have caused banks to raise well over $5.5 billion in order to maintain

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[6] To do so would be consistent with the efforts of the Biden administration, as reflected in the President's executive order on crypto-assets issued on March 9, 2022, to take a broader and more holistic review of the regulatory framework for crypto-asset-related activities. 87 Fed. Reg. 14143 (Mar. 14, 2022); *see also* SIFMA and BPI Letter to Senator Cynthia Lummis (May 19, 2022), *available at* https://www.sifma.org/wp-content/uploads/2022/05/SIFMA-BPI-Letter-for-the-Record-on-SAB-121-May-2022.pdf.

[7] This result would affect custody services globally because U.S. banking organizations provide custody services around the world and SAB 121 would apply to foreign private issuers that file financial statements with the SEC. Footnote 7 of SAB 121 indicates that the interpretive guidance applies to both GAAP and International Financial Reporting Standards ("IFRS") financial statements.

their tier 1 leverage ratios.[8] At present, estimating the common equity tier 1 ("CET1") risk-based capital impact is difficult because the capital treatment of crypto-assets is under development, but if a 1250% risk weight were to apply, as proposed by the Basel Committee on Banking Supervision ("BCBS"),[9] the impact would amount to many tens of billions of dollars. As custodial activities generally are concentrated in a limited number of banks, those costs likely would have been borne primarily by a few banks. That result would be undesirable for investors and contrary to the government's goal of bringing crypto-asset markets within the regulatory perimeter. Indeed, the result would be perverse – a risky and exponentially growing element of the financial system would be consigned to the least well regulated actors.

B. Knock-on effects to banking organizations are unnecessary

Including assets on a banking organization's balance sheet in respect of safeguarded crypto-assets would contravene regulatory reporting instructions and have such significant effects on capital, liquidity and other prudential requirements, summarized in Section V and Appendix B, that banking organizations effectively would be precluded from providing such services to clients. For example, the effect of including an indemnification-like asset on balance sheet may result in even more than a dollar-for-dollar risk-based capital charge applied to safeguarded crypto-assets,[10] making it prohibitively expensive for banking organizations to engage in such activities. SAB 121 also could create confusion for investors, creditors and other parties by potentially calling into question existing legal precedents that stand for the conclusion that safeguarded assets (as SAB 121 requires) are not the property of the custodian.

Given these adverse effects and the existing stringent requirements to which regulated banking organizations are subject, the Associations believe that SAB 121 should be clarified to exclude the activities of regulated banking organizations from the requirement to reflect assets on the balance sheet where the relevant risks are appropriately mitigated. This analysis demonstrates that for the activities discussed herein, such risks are substantially mitigated. The regulatory and supervisory frameworks applicable to banking organizations address the same risks that SAB 121 cites as concerning to SEC Staff. For example, the OCC, through Interpretive Letter 1179, requires a banking organization to receive supervisory nonobjection regarding risk management

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[8] *See* BlockData, Crypto Custody: The gateway to institutional adoption (Jan. 26, 2022), *available at* https://www.blockdata.tech/blog/general/crypto-custody-the-gateway-to-institutional-adoption (for estimate of total crypto-assets under custody). This example assumes crypto-assets under custody at banks is $111.5 billion and that banks that maintain the minimum capital to be considered well capitalized (*i.e.*, a 5% tier 1 leverage ratio).

[9] BCBS, Consultative Document: Prudential treatment of cryptoasset exposures (June 2021) at 13.

[10] Banking regulators, through the BCBS, are currently engaged in efforts to clarify global standards for the prudential treatment of crypto-assets. The BCBS's original consultation noted that it was not intended to apply to custody services because there is no existing prudential treatment for such services. BCBS, Consultative Document: Prudential treatment of cryptoasset exposures (June 2021) at n. 10. However, if the proposed 1250% risk weight were to be applied in respect of safeguarded crypto-assets, as a result of the recognition of an indemnification-like asset as required by SAB 121, banks would face even more than a dollar-for-dollar capital charge. The BCBS is expected to publish a second consultative paper later this month with a view to finalize standards by the end of this year. *See* BCBS, Basel Committee finalises principles on climate-related financial risks, progresses work on specifying cryptoassets' prudential treatment and agrees on way forward for the GSIB assessment methodology review (May 31, 2022).

systems and controls before conducting crypto-asset custody activities.[11] Therefore, applying only Question 2 to banking organizations would achieve SEC Staff's stated goals of ensuring that investors receive appropriate protections, including full and transparent disclosure, and also would avoid the highly punitive knock-on effects under the prudential regulatory framework.

Specifically, SAB 121 states that the following risks are of concern to SEC staff:

- **Technological risks.** SAB 121 states, "there are risks with respect to both safeguarding of assets and rapidly-changing crypto-assets in the market that are not present with other arrangements to safeguard assets for third parties";

- **Legal risks.** SAB 121 states, "due to the unique characteristics of the assets and the lack of legal precedent, there are significant legal questions surrounding how such arrangements would be treated in a court proceeding arising from an adverse event (*e.g.*, fraud, loss, theft, or bankruptcy)"; and

- **Regulatory risks.** SAB 121 states, "as compared to many common arrangements to safeguard assets for third parties, there are significantly fewer regulatory requirements for holding crypto-assets for platform users or entities may not be complying with regulatory requirements that do apply, which results in increased risks to investors in these entities".

As we describe in Section IV, the legal, regulatory and supervisory frameworks applicable to banking organizations address comprehensively the categories of risks identified by SAB 121. Therefore, we believe the investor protection and risk management concerns cited by SEC Staff are substantially mitigated with respect to banking organizations as contrasted with nonbanking organizations. Accordingly, the policy measures needed to achieve SEC Staff's goals are different for banking organizations than for nonbanks, and banking organizations should be excluded from Question 1.

C. Potential breadth of SAB 121

In all events, however, SAB 121 discusses an entity whose activities include both operating a crypto-asset platform that allows its users to transact in crypto-assets and providing a service where it will safeguard the platform users' crypto-assets, including maintaining the cryptographic key information necessary to access crypto-assets. We understand, however, that SEC Staff has indicated that it interprets SAB 121 as applying to all instances involving the safeguarding of crypto-assets, regardless of whether the entity also operates a trading platform. This interpretation would require a banking organization safeguarding a crypto-asset to present a liability (and recognize a corresponding asset) on its balance sheet equal to the fair value of the

[11] OCC Interpretive Letter No. 1179, Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank (Nov. 18, 2021); *see also* OCC Interpretive Letter No. 1170, Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020). The FDIC imposes similar requirements. *See* FDIC, FIL-16-2022, Notification of Engaging in Crypto-Related Activities (April 7, 2022).

safeguarded crypto-asset.[12] This treatment of crypto-assets deviates from existing accounting treatment of safeguarded assets held in a custodial capacity, which does not result in assets or liabilities reported on the custodian's balance sheet.

Banking organizations are a primary provider of core safeguarding, custody and fiduciary services. For example, banking organizations provide safeguarding and custody services to regulated investment funds, pension plans and other market participants. Banking organizations also provide fiduciary services to a wide range of clients and safeguard assets when holding collateral or margin in secured financing and other transactions. Depending on the scope of SAB 121, which is currently unclear, some or all of these core, traditional banking services could trigger application of SAB 121 if these activities use blockchain technology, such as permissioned blockchains.

At the heart of this definitional issue is that SAB 121 defines "crypto-asset" very broadly, as "a digital asset that is issued and / or transferred using distributed ledger or blockchain technology using cryptographic techniques". This definition arguably could scope in any activity that uses blockchain technology or cryptographic techniques such as the safeguarding of tokenized assets (*e.g.*, versions of traditional securities), as described in the following section.

1. Activities That Use Permissioned Blockchain Systems

Blockchain systems and cryptographic techniques are driving significant changes in the traditional structure of financial assets held at FMIs and banking organizations. Blockchain networks may be "permissionless" or "permissioned". As the Associations have noted in discussions with SEC Staff, banking organizations currently are developing use cases for permissioned (private or public) blockchain technology as part of ongoing industry efforts to enhance efficiencies in the financial markets and the reinvention of core post-trade processes, such as collateral management and securities settlement.[13] Tokenized assets (as defined in the cover letter) operate within the existing infrastructure and legal and regulatory frameworks with appropriate checks and controls, and typically use permissioned blockchains.[14] By contrast, crypto-assets (*e.g.*, Bitcoin and Ether) typically use permissionless blockchains.

Tokenized assets are particularly secure with respect to technological risks because permissioned blockchain networks incorporate strict governance and control mechanisms that effectively address the information technology ("IT") concerns identified in SAB 121, particularly the

[12] As recent events have demonstrated, there could be enormous variance in valuation over a period of time, which, in turn, could lead to banking organizations continuously being in an apparent state of over-capitalization or under-capitalization.

[13] In some cases, these assets already may be reflected on a banking organization's balance sheet. For example, a deposit that is recorded on a blockchain would be a liability of the banking organization and an asset of the customer that holds the deposit account (the database used for recording the deposit does not alter that fact). Any incremental balance sheet recognition for such an asset would result in double counting and, therefore, would be inappropriate.

[14] Tokenized assets referencing traditional assets do not exhibit any additional risk from a price / volatility perspective relative to the traditional underlying assets.

ability to cancel, reconstruct and/or reissue the tokenized asset in the event of loss, theft or other instance of misuse.

Specifically, permissioned systems are restricted to designated parties and incorporate a pre-defined governance structure and ruleset to control user participation and engagement. The banking organization may own and operate, or have administrative abilities with respect to, the nodes on the blockchain; control the operational procedures and the code; and control all access to, and user permissions on, the platform, including the permissioned nodes. Depending on the design and intended use of the permissioned blockchain system, the banking organization may also control the extent to which participants on the platform may view the blockchain ledger and the underlying asset that the tokenized asset represents.

Because the banking organization would have full control over the blockchain system, it would be able to investigate, reconcile and resolve any transaction that may be inadvertent or fraudulent or involves a holder's loss of access to a tokenized asset. Errors may be corrected to the same extent as any other electronic ledger system controlled by the banking organization and in accordance with its existing policies and procedures applicable to such incidents today. In this way, tokenized assets would not raise any new incremental technological or legal risk of loss as compared to other book transfers performed by the banking organization.

The Depository Trust & Clearing Corporation ("DTCC") and other FMIs, including securities exchanges and central securities depositories, may use blockchains that have similar controls to record ownership and transactions in tokenized assets.[15] Therefore, SAB 121's broad definition of crypto-asset could exclude categorically banking organizations that are SEC registrants from participating in safeguarding activities using emerging permissioned-based blockchain systems by making it prohibitively expensive for them to engage in such activities.

In summary, the Associations believe that the use of tokenized assets should not trigger SAB 121's application, because the risks cited in SAB 121 for tokenized assets are adequately addressed today.

2. Referral and Other Banking Activities

It also is unclear whether other traditional banking activities would fall under the scope of SAB 121. For example, SAB 121 broadly states that entities covered by it include "any agent acting on [a covered entity's] behalf in safeguarding the platform users' crypto-assets". This treatment could be read to include banking organizations that merely provide client statements for crypto-assets, including information about crypto-asset balances held at third-party custodians. Another area of ambiguity is where a banking organization, based on its finder authority, merely refers customers to unaffiliated third parties without taking on any safeguarding obligation.[16] In

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[15] For example, the definition of "crypto-asset" under SAB 121 could capture all Australian securities once the CHESS replacement system goes live. If SAB 121 were to apply to such securities, U.S. banking organizations may be unable to participate in the Australian securities markets. Distributed ledger and blockchain technology also is rapidly being adopted by central securities depositories across the globe, including HKEX and SGX, and others are exploring the use of such technology, including Deutsche Börse and DTCC.

[16] *See*, *e.g.*, 12 CFR 7.1002 (finder authority for national banks).

both cases, as applicable, the banking organization would clearly disclose to its customers that their crypto-assets are safeguarded by a third-party custodian and not the banking organization.

When engaging in these activities and other activities permissible for banking organizations involving crypto-assets, the technological, legal and regulatory risks identified in SAB 121 are mitigated as described in Sections IV.B, IV.C and IV.D below. However, without clarification from SEC Staff regarding SAB 121's intended scope, the Associations are concerned that SAB 121 could be interpreted to include a wide range of systems and services provided by banking organizations (both U.S.- and non-U.S.-based),[17] which could have significant adverse effects because many significant statutory and regulatory requirements to which banking organizations are subject are based on balance sheet assets as determined under U.S. generally accepted accounting principles ("GAAP"), as explained below. Thus, the Associations are seeking clarification from SEC Staff that Question 1 of SAB 121 does not apply to banking organizations engaged in activities where the technological, legal and regulatory risks are appropriately mitigated. This analysis demonstrates that for the activities discussed herein, such risks are substantially mitigated.

II. Custody and Safeguarding Activities of Banking Organizations

Banking organizations provide safeguarding services to institutional and other investors globally, playing an essential role in ensuring the safety of client assets and the stability of the financial markets. As described at length by the OCC in Interpretive Letter 1170:

> Safekeeping services are among the most fundamental and basic services provided by banks. Bank customers traditionally used special deposit and safe deposit boxes for the storage and safekeeping of a variety of physical objects, such as valuable papers, rare coins, and jewelry ...
>
> Traditional bank custodians frequently offer a range of services in addition to simple safekeeping of assets. For example, a custodian providing core domestic custody services for securities typically settles trades, invests cash balances as directed, collects income, processes corporate actions, prices securities positions, and provides recordkeeping and reporting services ... OCC guidance has recognized that banks may hold a wide variety of assets as custodians, including assets that are unique and hard to value. These custody activities often include assets that transfer electronically. The OCC generally has not prohibited banks from providing custody services for any particular type of asset, as long

[17] Footnote 7 of SAB 121 indicates that the interpretive guidance applies to both GAAP and IFRS financial statements.

> as the bank has the capability to hold the asset and the assets are not illegal in the jurisdiction where they will be held.[18]

Today, the majority of custody services are provided to customers through securities accounts and cash accounts maintained by banking organizations.[19] The value-added role played by custodians in the financial system is widely understood and appreciated by both market participants and the regulatory community. Custodians are responsible for safeguarding and segregating customer assets, providing a broad range of related financial services, and establishing relationships with central securities depositories that allow records of ownership of securities to be maintained in book-entry form.[20] Custodial services are offered in a manner that protects client assets from misappropriation or loss, and the use of such services is often required by law or regulation.[21] Some custody services may be provided by nonbanks, but clients generally prefer (and in some cases are legally required) to use banking organizations that are subject to robust prudential regulation and oversight and that can provide access to deposit accounts and payment systems. For example, section 17(f) of the Investment Company Act of 1940 (the "ICA"), viewed as the "gold standard" for custody, requires a mutual fund to maintain its securities and similar investments with entities under conditions designed to maintain the safety of fund assets;[22] as a practical matter, most mutual funds place their assets with a bank custodian. Under Rule 206(4)-2 of the Investment Advisers Act of 1940, known as the "custody rule", registered investment advisers that have custody of client assets must use a "qualified custodian", including banking organizations, to maintain those assets.[23]

The ability of the Banking Agencies to appropriately regulate and supervise safeguarding activities is well-recognized. For example, when Congress passed the Gramm-Leach-Bliley Act in 1999, removing the global bank exemption from the definitions of broker and dealer under sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934, Congress provided an exception for banks to continue to provide securities-related safeguarding and custody services for their customers without registering as a broker-dealer.[24] This statutory exception expressly recognizes that the safeguarding activities conducted by banking organizations do not require additional regulation or other oversight (*i.e.*, the SEC through the requirement to register as a broker-dealer).

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[18] OCC Interpretive Letter No. 1170, Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020) at 6-7 (citations omitted).

[19] The ClearingHouse, The Custody Services of Banks (July 2016) at 3-4, *available at* https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2016/07/20160728_tch_white_paper_the_custody_services_of_banks.pdf.

[20] *Id*.

[21] *Id*.

[22] 15 U.S.C. § 80a–17(f).

[23] 17 CFR 275.206(4)-2. Furthermore, the rule imposes certain client notice, account statement and surprise audit mandates.

[24] 15 U.S.C. § 78c(a)(4)(B)(viii).

III. Banking Organizations Are Well-Suited to Safeguard Crypto-assets

While banking organizations today generally do not offer crypto-asset custody services at scale, they are involved in many areas of financial innovation involving decentralized ledger technology, including the development of safeguarding solutions for crypto-assets. For example, to meet the "qualified custodian" requirements of the Investment Advisers Act of 1940 with respect to safeguarded crypto-assets, banking organizations would assume responsibility for maintenance of all of the "key shards" for a private key under the controls described in Section IV.B.2. below. Banking organizations, subject to comprehensive safety and soundness and prudential regulation, historically have adapted controls and practices to evolve with technology, the financial markets and their customers' resulting demands, and have provided custody and other services for a range of asset classes from paper certificates in vaults, to records in computer databases, to tokenized assets. The OCC has acknowledged that custody services change with markets and technology, stating "[w]hile the use of electronic media to store and access items raises additional risks, banks already have extensive expertise in dealing with these risks and OCC has provided guidance on addressing these risks".[25] Indeed, banks have been granted authority to safeguard private encryption keys outside of the context of crypto-assets and have developed appropriate risk management to do so.[26] Bank custodians are therefore well-placed to continue to develop leading risk management approaches for the safeguarding of assets, thereby enhancing efficiencies and reducing risks as various technologies evolve.

Modern custody services have been offered by banking organizations for over 80 years, with significant success. These custodied assets are held safely and are made available to customers, as the types of risks that the SEC cites as being of concern are mitigated effectively through the legal and regulatory frameworks applicable to banking organizations. Their success has instilled confidence in the public in their ability to act as custodian and, as of the end of the first quarter of 2022, bank custodians collectively held more than $200 trillion in assets under custody.[27] Throughout this history, two key principles have remained constant. First, as discussed in further detail in Section IV.C and Appendix C, regulated custodians have been required to properly segregate assets under custody at all times, thereby resulting in assets under custody (including assets held as collateral) being treated as property of the client. Second, banking organizations are subject to stringent supervision and regulation, which has led banks to be the custodian of choice for legislators and regulators as they have developed laws and regulations to protect investors in new asset classes.[28] Similar principles continue to apply today to the

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[25] OCC Conditional Approval No. 479 (July 27, 2001).

[26] OCC Interpretive Letter No. 1170, Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020) (citing OCC Conditional Approval No. 267, granting a national bank authority to safeguard encrypted keys).

[27] Global Custodians, Custodians by assets under custody and administration, Q1 2022 Rankings, *available at* https://www.globalcustodian.com/custodians-assets-under-custody/.

[28] The structure and legislative history of the ICA, which raised a number of concerns about misappropriation of investment company assets in custody, indicates that banks were viewed as appropriate custodians for mutual fund assets as there was no effort to impose specific, additional requirements on bank custodians. *See, e.g.,* 15 U.S.C. § 80a-3 (carving out banks and certain funds maintained by banks from the definition of "investment company"); Hearings S. 3580 Before the Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 264 (1940); *see also* 62 Fed. Reg. 26923, 26925 (May 16, 1997) ("[T]he legislative history of [section 17(f) of

safeguarding of crypto-assets, and the important role of banking organizations in the evolution of the crypto-asset marketplace should be encouraged, not precluded.

IV. Safeguarded Crypto-assets Should Not Be on the Balance Sheet of a Banking Organization Where Risks are Mitigated

A. Public financial statement and regulatory reporting do not require other custodial assets to be held on balance sheet

SAB 121's treatment of crypto-assets differs from the existing accounting treatment of other assets held in custody. Specifically (as SAB 121 requires), an indemnification-like asset that dollar-for-dollar accounts for other custodial assets is not reported on a custodian's GAAP balance sheet or in regulatory reporting submitted to the Banking Agencies, so long as certain conditions are met.[29]

For example, the Call Report instructions for reporting banking organizations state that "[a]ll custody and safekeeping activities (*i.e.*, the holding of securities, jewelry, coin collections, and other valuables in custody or in safekeeping for customers) are not to be reflected on any basis in the balance sheet of the Consolidated Report of Condition unless cash funds held by the banking organization in safekeeping for customers are commingled with the general assets of the reporting bank. In such cases, the commingled funds would be reported in the Consolidated Report of Condition as deposit liabilities of the bank".[30] It follows that fiduciary and nonfiduciary custody assets held by banking organizations are not commingled with the bank's general assets and thus typically reported on Schedule RC-T of the Call Report, on which assets not on balance sheet are reported. In financial reporting, banking organizations disclose basic information about assets under custody and / or administration to investors.[31]

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the ICA] suggests that the section was intended primarily to prevent misappropriation of fund assets by persons having access to assets of the fund."). This legislative history likely reflects the view that the existing regulatory regime for banks would safeguard adequately mutual fund assets.

[29] SAB 121 requires balance sheet recognition of an asset "similar in nature to an indemnification asset". However, notwithstanding the unique nature of the asset from an accounting perspective, we believe that, for banking organizations, the treatment for other assets held under custody should carry through to crypto-assets (*i.e.*, disclosed, but no additional asset or liability included on balance sheet).

[30] Instructions for Preparation of Consolidated Reports of Condition and Income, FFIEC 031 and FFIEC 041 (Mar. 2022) at 12; s*ee also* Instructions for Preparation of Consolidated Financial Statements for Holding Companies, Reporting Form FR Y-9C (Mar. 2022) at GL-23 ("A custody account is one in which securities or other assets are held by a holding company or subsidiary of the holding company on behalf of a customer under a safekeeping arrangement. Assets held in such capacity are not to be reported in the balance sheet of the reporting bank nor are such accounts to be reflected as a liability. *Assets of the reporting holding company* held in custody accounts at banks that are outside the holding company are to be reported on the reporting holding company's balance sheet in the appropriate asset categories as if held in the physical custody of the reporting holding company.") (emphasis added).

[31] *See*, *e.g.*, The Bank of New York Mellon Corporation 2021 Annual Report, Exhibit 13.1, *available at* https://www.bnymellon.com/content/dam/bnymellon/documents/pdf/investor-relations/finann2021.pdf.coredownload.pdf; State Street Corporation, Management's Discussion and Analysis of Financial Condition and Results Of Operations, Table 6: Assets under Custody and/or Administration by Product,

For the reasons detailed below, the Associations believe that Question 1 of SAB 121 does not need to apply to banking organizations' balance sheets to protect investors, particularly because the technological, legal and regulatory risks cited in SAB 121 are addressed comprehensively by the legal and regulatory framework applicable to banking organizations. Furthermore, applying Question 1 of SAB 121 to banking organizations could create confusion for investors, creditors and other parties by potentially calling into question existing legal precedents that stand for the conclusion that safeguarded assets are not the property of the custodian.

B. Technological risks are substantially limited with respect to banking organizations as compared to nonbanks

The technological risks associated with crypto-asset activities are limited for regulated banking organizations because the regulatory and supervisory framework and consistent oversight already applicable to these entities are designed to ensure that such risks are appropriately mitigated.

1. Regulatory and Supervisory Guidance Requiring Mitigation of Technological Risks

The technological risks noted in SAB 121 are limited by the stringent regulatory oversight of the Banking Agencies over banking organizations' safeguarding activities. For example, banking organizations are expected to "gather assets, effectively employ technology and efficiently process huge volumes of transactions" while minimizing "the potential that events, expected or unexpected, may have an adverse impact on a [banking organization's] capital or earnings".[32]

As a gating matter, OCC Interpretive Letter 1179 requires a banking organization to receive supervisory nonobjection regarding risk management systems and controls from the OCC before conducting crypto-asset custody activities under OCC Interpretive Letter 1170.[33] Thus, a banking organization regulated by the OCC would not be permitted to engage in these activities until the OCC is satisfied that the relevant risks are addressed. Other U.S. and non-U.S. banking regulators apply similar processes and standards.[34] Specific risks unique to crypto-asset custody

available at https://s26.q4cdn.com/446391466/files/doc_downloads/2022/STT-2021.12.31-10-K-filed-with-exhibits.pdf.

[32] OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) at 1, 2. *See generally* OCC, *Comptroller's Handbook: Asset Management Operations and Controls* (Jan. 2011), OCC, *Comptroller's Handbook: Unique and Hard-to-Value Assets* (Aug. 2012), OCC, *Comptroller's Handbook: Retirement Plan Products and Services* (Feb. 2014), OCC, *Comptroller's Handbook: Conflicts of Interest* (Jan. 2015) and OCC Bulletin 2013–29, Third-Party Relationships—Risk Management Guidance (Oct. 30, 2013).

[33] OCC Interpretive Letter No. 1179, Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank (Nov. 18, 2021); OCC Interpretive Letter No. 1170, Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020).

[34] FDIC, FIL-16-2022, Notification of Engaging in Crypto-Related Activities (April 7, 2022); BCBS, Consultative Document: Prudential treatment of cryptoasset exposures (June 2021) at 16 ("Banks are also expected to inform their supervisory authorities of their policies and procedures, assessment results, as well as actual and planned cryptoasset exposures or activities in a timely manner and to demonstrate that they have fully assessed the permissibility of such activities, the associated risks and how they have mitigated such risks.").

highlighted in OCC Interpretive Letter 1170 that banking organizations are required to address include the treatment of "forks" (which must be addressed in the custody agreement), settlement of transactions, physical access controls, security servicing and specialized audit procedures.[35]

In contrast to nonbank entities, banking organizations are thus uniquely positioned to address risks arising from custody activities because of their existing risk management processes and infrastructure that have been developed over the years to meet stringent regulatory requirements. In fact, the New York State Department of Financial Services, likely due in part to its assessment of the ability of banking organizations to manage risks associated with crypto-asset activities, exempted New York State banks from the requirement to obtain a license to engage in crypto-asset business activities.[36]

2. Banking Organizations' Practices for Crypto-assets Held Under Custody

The technology-related risks that must be managed when providing safeguarding services for crypto-assets include the comingling of assets, risk of loss, risk of theft and risk of IT failure.[37] Banking organizations manage these risks for other financial assets today by using systems, controls and practices that establish exclusive control over the custodied asset and that are consistent with industry best practices to protect against theft, loss and unauthorized or accidental transactions. Consistent with the regulatory and supervisory standards described above, these practices and processes would be applied to crypto-assets in the manner described in the following table.

Table 1: Summary of Practices for Safeguarding Crypto-assets

Key Principle	*Application to Crypto-assets*
Separation of Custody and Trading Activities	• To ensure appropriate oversight and control, the banking organizations safeguarding function would be functionally separated by internal controls from the banking organizations' trading function (although not necessarily conducted in separate legal entities, *e.g.*, in a trust division).
Segregation of Client Assets from	• As with any other financial asset, banking organizations would ensure the segregation of client assets at all times, and would undertake the daily reconciliation of books and records.

[35] *Id.*; *see also* OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) (providing detailed guidance on risk management practices and risk management controls for banks providing custody services).

[36] 23 CRR-NY 200.3(c)(1); *see also* 23 CRR-NY 200.2(j) (defining "virtual currency").

[37] In the context of crypto-assets, the risk of commingling of assets is the risk that assets belonging to a client are used by either the custodian or another client to satisfy a financial claim or obligation. The risk of loss is the risk that the asset is lost and that it cannot be retrieved by either the custodian or the client. The risk of theft is the risk that a third party gains access to the asset and is able to move the asset to a wallet outside of the control of the custodian or client. The risk of IT failure is the risk that the custodian's systems or controls may fail or otherwise prove inadequate to properly identify and/or protect the client's assets, including from a cyber incident.

Key Principle	*Application to Crypto-assets*
Banking Organization Assets	This segregation can be achieved in a number of ways, which may differ based on the attributes of a particular crypto-asset. • When combined with an agreement by the custodian and client to treat the asset as a "financial asset" under Uniform Commercial Code ("UCC") Article 8, the asset should be bankruptcy-remote as discussed in Section IV.C.2.
Proper Control	• The management of private key technology is a critical and foundational element to exercising control over the asset. A core risk of this technology is the potential of a "single point of failure" with respect to the key (*i.e.*, where one event could result in the loss, theft or other misuse of the asset associated with the key). • The technology supporting private keys has advanced significantly in recent years, and it is now possible to have private keys that are represented by multiple encrypted "shards" where no single party can authorize the transfer or disposition of the asset. • If any one shard is lost or rendered inoperable, the remaining shards can support the retrieval of the asset into a new wallet with a new set of private keys and related shards. • Private key shards are never combined into a single key and are managed within the banking organizations' overall control framework for safeguarding financial assets. This framework includes ensuring that critical information is encrypted and properly stored and client instructions are communicated and verified through secure channels.[38] Private key shards are stored using separate technology systems, providing an additional layer of control and assurance that the asset cannot be inappropriately accessed or compromised. • Banking organizations would ensure that no one employee has access to all of the key shards to control potential internal malfeasance.

[38] Secure messaging to deter inappropriate access to financial assets is a well-established industry practice (*e.g.*, SWIFT messages for the movement of cash and securities).

C. Legal risks are mitigated because appropriate measures are followed by banking organizations

SAB 121's justification for putting safeguarded crypto-assets on the balance sheet is related, in part, to concerns arising from questions surrounding how such arrangements would be treated in a court proceeding arising from adverse events (*e.g.*, fraud, loss, theft or bankruptcy). Banking organizations have a long history of addressing these risks, which are not new, through well-developed legal, contractual and risk management measures.

1. Legal Risk with Respect to Fraud, Loss and Theft

While many of the risks with respect to fraud, loss and theft are already mitigated by the policies and processes of banking organizations described in Section IV.B.2 above, these risks are also contractually allocated between a banking organization and its customer. Importantly, a significant aspect of custody arrangements is the risk sharing established by negotiated contractual arrangements between a custodian and its customers.[39] In general, the contracts set out the scope of the services that the custodian will provide to its customers, the standard of care that the custodian will exercise in carrying out its duties and the governing law of the contractual relationship. The terms of these contracts support the legal treatment of safeguarded assets as property of the customer (as described below) and also allocate the legal risks of fraud, loss and theft for safeguarded assets as between the banking organization and its customers. The terms of a custody agreement also typically include limitations on liability and disclosures about the risks a customer faces. In cases where a banking organization uses a sub-custodian, the risks and obligations of each also may be defined by contract and disclosed to the customer.[40]

For activities ancillary to safeguarding activities, such as referral and other finder activities, the customer would enter into contractual agreements directly with the third-party custodian. The third-party custodian would be responsible for safeguarding services (including maintaining cryptographic key information in the case crypto-assets), and the banking organization would not have any contractual liability for executing trades or safeguarding assets and would include appropriate disclosures and disclaimers in relevant materials made available to customers.

Thus, in all cases, banking organizations would document and disclose clearly to customers their rights and responsibilities under any custody arrangement involving crypto-assets, thereby mitigating the legal risks associated with such activities.

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[39] OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) at 8.

[40] For example, a U.S. customer may own foreign securities through a U.S. banking organization that relies on a foreign sub-custodian to hold the securities. The U.S. banking organization would disclaim liability if the foreign sub-custodian fails to protect the securities (other than as provided for under applicable law). In other cases, the banking organization may open an account for the benefit of its customers at the sub-custodian, without disclosing the sub-custodian to its customers. However, in both cases, the banking organization is subject to stringent due diligence and monitoring requirements with respect to the foreign sub-custodian and must ensure that the sub-custodian has proper internal controls to protect assets. OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) at 16.

2. Legal Risk with Respect to Insolvency

With respect to legal risks in insolvency, there are multiple legal bases to conclude that safeguarded assets are not the property of the custodian upon such events, specifically: (1) treatment under the UCC; (2) case law regarding the insolvency of banking organizations that hold assets under custody; and (3) regulatory and supervisory guidance applicable to banking organizations that safeguard customer assets. These legal bases work together with contractual provisions to help ensure that custodial assets will not be treated as assets of the custodian.[41] Each of these points is discussed below.

Applying Question 1 of SAB 121 to banking organizations would run counter to the core of these precedents. Requiring banking organizations to place indemnification-like assets on balance sheet (as SAB 121 requires) invites investor and creditor confusion with respect to the treatment of custodial assets and creates less efficiency in the financial markets.[42] This confusion could carry through to litigation, as the accounting treatment could be cited as undermining the longstanding precedent that provides that custodians have no ownership interest in custodied assets. In fact, these precedents are often relied upon today in many legal opinions that are issued by law firms in connection with financial transactions to provide comfort to the parties that the property interests in collateral or margin will be protected in insolvency.

a. Treatment Under the UCC

There is well-established legal precedent in the United States that the determination of property rights in the assets of an entity in resolution is a matter of state law.[43] State law, in turn, includes precedent that supports the conclusion that assets held in custody are not the property of the custodian. For example, most states adopt the uniform version of the UCC, which provides one important basis under which courts have held that custodied assets are property of the customer and not of the custodian.

Specifically, under UCC Article 8-503(a), financial assets held by a securities intermediary (*i.e.*, custodian) to satisfy securities entitlements for entitlement holders (*i.e.*, customers) are not the property of the securities intermediary and are not subject to claims of creditors of the securities intermediary. Under UCC Article 8-102(9), a "financial asset" includes any property that is held by a securities intermediary for another person in a "securities account" if the parties have expressly agreed that the property is to be treated as a financial asset under UCC Article 8.

[41] Indeed, the Banking Agencies have acknowledged that "collateral would generally be considered to be bankruptcy-remote if the custodian is acting in its capacity as a custodian with respect to the collateral". 83 Fed. Reg. 64660, 64684 (Dec. 17, 2018).

[42] For example, the FDIC historically has taken the view that, as receiver of a failed bank, it would honor the customer's custodial claim on Treasury bills only if the bank has not carried the bills as an asset on its own balance sheet. FDIC Advisory Op. No. 88-14 (Feb. 4, 1988).

[43] *See Butner v. United States*, 440 U.S. 48, 54, 99 S. Ct. 914, 918, 59 L. Ed. 2d 136 (1979); *O'Melveny & Meyers v. FDIC*, 512 U.S. 79, 86-87 (1994).

Even though it appears that a crypto-asset may be regarded as a "financial asset" for this purpose, there are legislative initiatives underway to confirm the treatment of crypto-assets held under custody.[44] A key premise of the revisions is that, like with other financial assets, crypto-assets falling within the scope of UCC Article 8 and new UCC Article 12 would not constitute property of an intermediary. In this respect, it would be anomalous for SAB 121 to impose a condition that would require securities intermediaries to apply a different accounting treatment to safeguarded crypto-assets as compared to other assets maintained as securities entitlements and create confusion as to whether the intermediary has a property interest in the asset. Additional detail about the UCC and its potential amendments can be found in Appendix C.

b. Case Law Regarding the Insolvency of Bank Custodians

In addition to the UCC, other longstanding legal precedents applicable to banking organizations help ensure that, as a matter of law, safeguarded property held for customers is not subject to the claims of creditors of the bank in the event of a bank insolvency. Unlike nonbanks, banks are generally not eligible to become Chapter 7 or Chapter 11 debtors under the Bankruptcy Code and, instead, are subject to federal or state insolvency regimes, as applicable.[45]

A well-established principle of federal banking law is that custodial assets are not available to creditors of an insolvent bank. By statute and court interpretations, the FDIC, as receiver, generally "takes no greater rights in the property than the insolvent bank itself possessed".[46] For this purpose, a range of asset classes held in custody often are regarded under the law as so-called "special deposits". A "special deposit" is a relationship established under state or federal law that is like a bailor / bailee relationship and is respected under well established case law. In relevant cases, courts have held that the assets held as special deposits are not assets of the bank

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[44] The amendments were approved by the members of the American Law Institute at the Institute's Annual Meeting and are expected to be approved by the members of the Uniform Law Commission at the Commission's Annual Meeting in July 2022. Thereafter, the amendments may be adopted by each of the states into state law.

[45] For brevity, we focus on federal insolvency regimes in this attachment and the accompanying Appendix C.

[46] *See Tobias v. Coll. Towne Homes, Inc.*, 110 Misc. 2d 287, 293, 442 N.Y.S.2d 380, 385 (Sup. Ct. 1981) (noting that this would be true unless there is a specific statutory instruction to the contrary). *See also* 12 U.S.C. § 1821(d)(2)(A)(i); *O'Melveny & Myers v. FDIC*, 512 U.S. at 87; *Peoples-Ticonic Nat. Bank v. Stewart*, 86 F.2d 359, 361 (1st Cir. 1936) (holding that "[a] receiver of a national bank takes title to the assets subject to all existing rights and equities"); *In re Int'l Milling Co.*, 259 N.Y. 77, 83, 181 N.E. 54 (1932) (holding that the New York Superintendent of Banks, when he took over the bank for the purpose of liquidation, acquired no greater interest in the fund than the bank possessed); *In re De Wind*, 144 Misc. 665, 666, 259 N.Y.S. 554 (Sur. 1932) (holding that the trust company never obtained title to the trust funds and title thereto did not pass to the New York Superintendent of Banks when he took over the assets of the trust company); *Williams v. Green*, 23 F.2d 796, 798 (4th Cir. 1928) (holding that the receiver takes the assets of the bank subject to all claims and defenses that might have been interposed as against the insolvent corporation before the liens of the United States and of general creditors attached); *In re Kruger's Estate*, 139 Misc. 907, 910, 249 N.Y.S. 772, 777 (Sur. Ct. King's Cnty. N.Y. 1931) (holding that funds deposited with the trust company "never became its property, and did not pass to the superintendent of banks when he took possession of the trust company") (citing *Corn Exch. Bank v. Blye*, 101 N.Y. 303, 303, 4 N.E. 635 (1886) (holding that "[a] receiver of an insolvent national bank acquires no right to property in the custody of the bank.")).

and that the customer is not a general creditor of the failed custodian bank.[47] As described in more detail in Appendix C, two related requirements for assets to be treated as special deposits in the existing case law are that, first, the custodian must segregate the assets from its own assets and, second, that commingling of assets does not occur.[48] Although, to our knowledge, no court to date has taken a position on whether crypto-assets may be special deposits, the OCC and courts have made clear that special deposits "may be money, securities, or other valuables".[49] Thus, this treatment should extend to safeguarded crypto-assets, as it does to other asset classes, if the relevant conditions are satisfied (which, as described below, regulatory and supervisory guidance require).

3. Regulatory and Supervisory Guidance Require Mitigation of Legal Risks

The well-established principles discussed above have led to requirements for regulated banking organizations to address the legal risks of safeguarding activities by segregating safeguarded assets so that they are not treated as assets of the banking organization in insolvency and that the customer does not become a general creditor of a failed custodian.

The OCC's recent interpretive letter permitting national banks to custody crypto-assets with the agency's approval states:

> A custodian's accounting records and internal controls should ensure that assets of each custody account are kept separate from the assets of the custodian and maintained under joint control to ensure that an asset is not lost, destroyed or misappropriated by internal or external parties. Other considerations include settlement

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[47] *See Merrill Lynch Mortg. Cap., Inc. v. FDIC*, 293 F. Supp. 2d 98, 110 (D.D.C. 2003) (finding under state noninsolvency law that the custodial account was a special deposit entitling the depositor to full recovery and priority over uninsured deposit claims in the receivership proceedings of the failed bank); *In re Mechanics Tr. Co.*, 19 Pa. D. & C. 468, 470 (Com. Pl. 1933) (making a similar finding under applicable state noninsolvency law in the context of a bank receivership); *People v. City Bank of Rochester*, 96 N.Y. 32, 34 (1884) (same). Note also that court review of such claims generally must wait until after the FDIC's administrative claims process (*i.e.*, the court may review *de novo* the FDIC's administrative claims determinations related to special accounts only after the FDIC's administrative claims process). *See* 12 U.S.C. § 1821(j); *Bank of Am. Nat. Ass'n v. Colonial Bank*, 604 F.3d 1239, 1246 (11th Cir. 2010).

[48] *See, e.g.*, *Merrill Lynch Mortg. Capital, Inc. v. FDIC*, 293 F. Supp. 2d 98 (D.D.C. 2003) ("While an implicit agreement could theoretically suffice to overcome the general deposit presumption, the existence of a written agreement—explicitly obligating the bank to segregate deposited funds and leaving legal title with the depositor—seems to be, practically, the dispositive issue in deciding whether a deposit is special."); *Peoples Westchester Sav. Bank v. FDIC*, 961 F.2d at 331 (finding no special deposit in part because "documents generated in opening the [account] do not evidence that [the bank] assumed a duty to segregate those funds from its own general assets" and "that there was no explicit agreement ... to segregate [deposited] funds"); *Keyes v. Paducah & I.R. Co.*, 61 F.2d 611, 613 (6th Cir. 1932) (finding no special deposit because the court "fail[ed] to find in any . . . instruments . . . any indication that it was the intention . . . of the parties that the avails of the draft were to be segregated and kept as a separate fund . . .").

[49] OCC Conditional Approval No. 479 (July 27, 2011). *See, e.g.*, *Montgomery v. Smith*, 226 Ala. 91, 93, 145 So. 822, 824, 1933 Ala. LEXIS 488, *8 [hereinafter, "*Montgomery*"]; 5B Michie Banks and Banking Deposits Sec. 330.

> of transactions, physical access controls, and security servicing. Such controls may need to be tailored in the context of digital custody.[50]

This approach is consistent with current regulations requiring segregation of all assets held by a national bank acting as custodian or fiduciary. For example, 12 U.S.C. § 92a(c) and 12 CFR 9.13(b) generally require that national bank fiduciary account assets be kept separate from bank assets. The OCC's Part 9 regulations and OCC guidance also require maintenance of accounting records and internal controls that ensure that these requirements are met.[51] Many states have incorporated the OCC's fiduciary standards into their own banking laws.[52]

The Banking Agencies also have significant expectations regarding non-fiduciary custody activity, including, for example: (1) separation and safeguarding of custodial assets; (2) due diligence in selection and ongoing oversight of sub-custodians; (3) disclosure in custodial contracts and agreements of the custodian's duties and responsibilities; and (4) effective policies, procedures and internal controls for the proper maintenance of internal books and records, the daily reconciliation of assets with the various entities in the chain of custody, the deployment of robust data privacy and cybersecurity controls, and the maintenance of comprehensive business continuity and resiliency protocols. These regulatory standards effectively require banking organizations to address the legal risks to customers of safeguarding crypto-assets cited by SAB 121 because they "focus on protecting client assets from loss due to . . . bankruptcy or insolvency of a custodian and enhance the safety and soundness" of the banking organization engaged in the safeguarding activity.[53] These standards also mitigate the risks associated with fraud and inaccurate or improper accounting. By contrast, there are no similar regulations or requirements for nonbanks that provide crypto-asset safeguarding services today.

D. Regulatory risks are addressed because banking organizations are extensively regulated and supervised

Banking organizations must follow the same due diligence, risk review and risk management processes when engaging in all activities, including when providing custody services. To help ensure compliance with custody regulations and supervisory standards, bank examiners are required to determine whether a banking organization has adequate systems in place to identify, measure, monitor and control risks, including policies, procedures, internal controls and management information systems.[54] Thus, banking organizations must establish, maintain and

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[50] OCC Interpretive Letter No. 1170, Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers (July 22, 2020) at 10.

[51] OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) at 15; OCC, *Comptroller's Handbook: Asset Management Operations and Controls* (Jan. 2011) at 16.

[52] *See, e.g.*, Cal. Fin. Code § 1560 (West).

[53] 84 Fed. Reg. 17967, 17970 (Apr. 29, 2019).

[54] OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002). Notably, the handbook highlights that operational risk is inherently high in custody services because of the high volume of transactions processed daily. Accordingly, banking organizations already understand that effective policies and procedures, a strong control

enforce policies and procedures that assess technological, legal and regulatory risks prior to engaging in any new activities, including crypto-asset safeguarding activities. In addition to these requirements, banking organizations are subject to stringent prudential regulation, including capital, liquidity, stress testing and other financial resiliency requirements (on top of general principles of safety and soundness) described in Section V below. The prudential oversight of banking organizations ensures that all activities and operations, including safeguarding activities, are conducted in a safe and sound manner through proper assessment and management of risk. Regulatory oversight is conducted through a comprehensive and frequent examination process. Larger banking organizations have special, separate examinations of, among other areas, custody and technology. This oversight includes the robust evaluation and management of IT risk, the implementation of proper internal controls, the adequate assessment of potential legal risk, the operation of comprehensive cybersecurity programs and the identification and mitigation of potential conflicts of interest. Banking organizations also must meet regulatory expectations with respect to other operational resiliency obligations, recovery and resolution planning mandates[55] and anti-money laundering and financial crimes regulation.[56] Adherence to these standards is monitored by the oversight and review of dedicated teams of on- and off-site examiners from the Banking Agencies. This comprehensive regulatory risk management framework distinguishes banking organizations from nonbanks, protects clients and promotes safety and soundness regardless of the activity in which a banking organization is engaged. As a result, banking organizations, including those that provide safeguarding services, are a key source of stability in the financial ecosystem and ensure high levels of investor protection.

V. Significant Knock-on Effects of SAB 121

SAB 121's potential approach deviates from the well-established regulatory framework for banking organizations.[57] Assets held in custody do not directly factor into risk-based capital, leverage capital or quantitative liquidity requirements as they are neither liabilities nor assets of the custodian, and do not result in additional assets or liabilities being recorded on the

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environment and efficient use of technology are essential risk management tools that must be applied to crypto-asset custody activities.

[55] Banking organizations are subject to exams that evaluate how well management addresses risk related to the availability of critical financial products and services, including cyber events, and requires adoption of processes for management to oversee and implement resiliency, continuity and response capabilities to safeguard employees, customers and products and services. *See* FFIEC, *FFIEC Information Technology Examination Handbook: Business Continuity Management* (Nov. 2019).

[56] *See, e.g.*, FFIEC, BSA/AML Examination Manual, *available at* https://bsaaml.ffiec.gov/manual.

[57] Banking organizations that use the advanced approaches risk-based capital rule must calculate an operational risk capital charge and hold additional capital to account for many of the risks of custodial activities. 12 CFR 3.162; 12 CFR 217.162; 12 CFR 324.162; OCC, *Comptroller's Handbook: Asset Management Operations and Controls* (Jan. 2011) at 5. Clarifying that Question 1 of SAB 121 does not apply to banking organizations would be consistent with the Banking Agencies' calibrated approach to safekeeping activities.

custodian's balance sheet.[58] If Question 1 of SAB 121 were to be applied to banking organizations, it could give rise to prudential requirements that would render tokenized asset[59] and crypto-asset activities economically unviable for banking organizations because many regulations are triggered by, or increase in stringency based on, asset size and composition.

The following table summarizes the main prudential regulatory impacts of SAB 121 if the interpretation in Question 1 were to apply to banking organizations. A more detailed summary of the issues can be found in Appendix C. Given the potential wide-ranging effects, this list is not exhaustive.[60] As one example, SAB 121 also would likely have an impact on the SEC and Commodity Futures Trading Commission ("CFTC") rules applicable to banking organizations, to the extent such rules rely on similar asset-based thresholds.[61]

Table 2: Summary of Potential Knock-on Effects of SAB 121

Regulatory Standard	***Potential Effects of SAB 121***
Categorization Under the Tailoring Rules	• The post-financial crisis regulatory framework for banking organizations in the United States tailors regulation based, in part, on asset-based thresholds.[62] • Crossing a threshold as a result of increasing asset size would, absent clarification, have significant regulatory effects and costs for banking organizations because it would change the regulatory requirements to which a firm would be subject. • Assets representing safeguarded crypto-assets would, absent clarification, lead to smaller institutions being subject to stress testing for the first time.
Credit and Market RWAs	• The calculation of credit and market risk-weighted assets ("RWA") would be impacted, absent clarification. Although the prudential treatment of crypto-assets has not yet been finalized, the BCBS is expected to publish a second consultative paper later

[58] This result logically fits within the prudential framework for banking organizations because asset size is loosely used as a proxy for balance sheet risk, which would not apply to custodied assets because the custodian has no ownership interest or risk exposure to the corresponding asset.

[59] *See* Section I.C.1 above discussing the overbreadth of the definition of "crypto-asset" in SAB 121.

[60] For an overview of numerous asset-size thresholds applicable to banking organizations, *see generally* Congressional Research Service, *Over the Line: Asset Thresholds in Bank Regulation*, R46779 (May 3, 2021), *available at* https://sgp.fas.org/crs/misc/R46779.pdf.

[61] *See*, *e.g.*, 17 CFR 23.23(a)(13) (using $50 billion asset threshold for banking organizations as part of the CFTC's swap dealer registration requirements).

[62] 84 Fed. Reg. 59230, 59032 (Nov. 1, 2019).

Regulatory Standard	*Potential Effects of SAB 121*
	this month with a view to finalize standards by the end of this year.[63]
Tier 1 Leverage Ratio	• A larger asset-based denominator for purposes of the tier 1 leverage ratio calculation would require banking organizations to hold more tier 1 capital.
Supplementary Leverage Ratio	• Additional buffers above the minimum capital requirements include a risk-insensitive minimum supplementary leverage ratio of 3%, which applies to certain banking organizations[64] based, in part, on balance sheet assets.[65] An increase in assets would require banking organizations to hold additional capital.
Community Bank Leverage Ratio	• For smaller banking organizations to be eligible for the community bank leverage ratio framework under the Economic Growth, Regulatory Relief, and Consumer Protection Act ("Regulatory Relief Act"), they must meet certain criteria, including having total consolidated assets calculated in accordance with the reporting instructions to the Call Report or Form FR Y-9C of less than $10 billion.[66]
Well Capitalized Status	• Banking Agencies require institutions to exceed minimum capital requirements for a banking organization to be considered well capitalized and to operate without regulatory restrictions.[67]
Identification of Banks Subject to Capital Stress Testing, Capital	• Banking organizations would, absent clarification, have to hold additional CET1 capital to meet their capital conservation buffers ("CCB")[68] and stress capital

[63] BCBS, Basel Committee finalises principles on climate-related financial risks, progresses work on specifying cryptoassets' prudential treatment and agrees on way forward for the GSIB assessment methodology review (May 31, 2022). Based on the BCBS' original consultation, most crypto-assets are likely to be classified as intangibles and deducted from CET1 capital or be subject to a 1250% RWA.

[64] 12 CFR 217.10(a)(1)(v); 12 CFR 3.10(a)(1)(v); 12 CFR 324.10(a)(1)(v).

[65] A BHC that is a U.S. GSIB is subject to the enhanced supplementary leverage ratio standards. *See* 12 CFR part 217, subpart H; 12 CFR 217.11(d).

[66] 12 CFR 217.12(a); 12 CFR 3.12(a); 12 CFR 324.12(a).

[67] 12 CFR 6.4(b)(1)(i)(D); 12 CFR 208.43(b)(1)(i)(D); 12 CFR 324.403(b)(1)(i).

[68] 12 CFR 217.11(a)(4)(ii); 12 CFR 3.11(a)(4)(ii); 12 CFR 324.11(a)(4)(ii).

Regulatory Standard	*Potential Effects of SAB 121*
Conservation Buffer and Stress Capital Buffer	buffers ("SCB"), even though they do not incur additional risk of loss as a custodian.[69]
Identification of GSIBs and Increase GSIB Surcharges	• SAB 121 would, absent clarification, increase a banking organization's total exposures, and therefore its systemic indicator score and ultimately its global systemically important bank ("GSIB") status and GSIB capital surcharge.
Liquidity Coverage Ratio and Net Stable Funding Ratio	• The application and stringency of the liquidity coverage ratio ("LCR") and net stable funding ratio ("NSFR") requirements depend, in part, on asset size. • Moreover, it is not clear what required stable funding ("RSF") factor should be assigned to safeguarded crypto-assets and whether the corresponding "safeguarding liability" would fall under any of the categories of liabilities that flow into the available stable funding ("ASF") amount.[70]
Single-Counterparty Credit Limits	• The issues discussed above with determining thresholds for GSIBs would apply to the single-counterparty credit limit rules as well.
Financial Sector Concentration Limits	• These rules are keyed off of definitions that reference a banking organization's RWA, total regulatory capital and total liabilities. As a result, including an indemnification-like asset on balance sheet (as SAB 121 requires) also would, absent clarification, increase the calculations for financial sector concentration limits for the reasons discussed above.
Deposit Insurance Assessments	• SAB 121 would increase a banking organization's Deposit Insurance Fund ("DIF") assessment, which is based, in part, on total assets.

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[69] 12 CFR 217.11(a)(2)(vi)(A).

[70] 12 CFR 50.104; 12 CFR 249.104; 12 CFR 329.104.

APPENDICES

Appendix A: Overview of the Associations

The American Bankers Association ("ABA") is the voice of the nation's $24 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $19.9 trillion in deposits and extend $11.4 trillion in loans.

The Bank Policy Institute ("BPI") is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans and are an engine for financial innovation and economic growth.

The Securities Industry and Financial Markets Association ("SIFMA") is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate on legislation, regulation and business policy affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association.

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Appendix B: Analysis of Significant Effects of SAB 121 on the Prudential Regulatory Framework

A. Categorization of banking organizations under the tailoring rules

Many asset-based thresholds were implemented in the post-financial crisis regulatory framework for banking organizations in the United States.[71] Notably, the Regulatory Relief Act enacted in 2018 introduced or raised a number of thresholds based on asset size, including exempting banks with total assets of less than $10 billion from the Volcker Rule,[72] raising the asset threshold at which certain enhanced prudential standards apply from $50 billion to $250 billion, raising the asset threshold at which company-run stress tests are required from $10 billion to $250 billion and raising the asset threshold for mandatory risk committees from $10 billion to $50 billion.[73]

Both the enhanced prudential standards implementing section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA")[74] and the Banking Agencies' regulatory capital and liquidity requirements increase in stringency based on risk indicators. One risk indicator is asset size, which is measured based on total consolidated assets as reported on the banking organization's Call Report, FR Y-9C, FR Y-15 and FR Y-7Q.[75]

Based on these indicators, a banking organization subject to enhanced prudential standards falls into one of four categories, with Category I having the most stringent regulatory capital and liquidity requirements and Categories II-IV representing various degrees of tailoring.[76] For banking organizations, the Call Report instructions state that an institution should use GAAP "as

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[71] *See, e.g.*, 84 Fed. Reg. 59230, 59032 (Nov. 1, 2019).

[72] Regulatory Relief Act, Pub. L. No. 115-174, tit. II, § 203, 132 Stat. 1296, 1309 (2018) (codified at 12 U.S.C. § 1851(h)(1)).

[73] Regulatory Relief Act, Pub. L. No. 115-174, tit. IV, § 401, 132 Stat. 1296, 1356-59 (2018) (codified at 12 U.S.C. § 5365).

[74] *See* 84 Fed. Reg. 59032 (Nov. 1, 2019). Under section 165 of the DFA, as amended by the Regulatory Relief Act, BHCs with "total consolidated assets" equal to or greater than $250 billion are required to comply with enhanced prudential standards that are more stringent than those applicable to BHCs that do not present similar financial stability risks. Section 165 also grants the FRB discretion to apply enhanced prudential standards to any BHC with between $100 billion and $250 billion in total consolidated assets. DFA, Pub. L. No. 111-203, tit. I, sub. C, § 165, 124 Stat. 1376, 1423-32 (codified at 12 U.S.C. § 5365).

[75] *See, e.g.*, 12 CFR 3.2; 12 CFR 50.3; 12 CFR 217.2; 12 CFR 249.3; 12 CFR 324.2; 12 CFR 329.3. "Total consolidated assets" is defined to mean, for a U.S. BHC or IHC "the total consolidated assets of such banking organization calculated based on the average of the balances as of the close of business for each day for the calendar quarter or an average of the balances as of the close of business on each Wednesday during the calendar quarter, as reported on the FR Y-9C" and "Combined U.S. assets" is defined to mean "the sum of the consolidated assets of each top-tier U.S. subsidiary of the foreign banking organization (excluding any section 2(h)(2) company, if applicable) and the total assets of each U.S. branch and U.S. agency of the foreign banking organization, as reported by the foreign banking organization on the FR Y-15 or FR Y-7Q." 12 CFR 252.2.

[76] In addition, large FBOs are required to form or to designate an IHC to conduct certain U.S. activities if they have average U.S. non-branch assets of $50 billion or more as reported on the FR Y-7Q. 12 CFR 252.153(a).

set forth in the FASB's Accounting Standards Codification".[77] Similarly, the FR Y-9C, FR Y-15 and FR Y-7Q instructions state that holding companies are required to prepare and file the form in accordance with GAAP.[78] It is difficult for banking organizations to interpret these instructions, without modifications or clarifications to SAB 121, other than to include the indemnification-like asset in respect of safeguarded crypto-assets as part of total assets. Thus, safeguarded crypto-assets likely would figure into whether a firm is assigned to Category I, II, III or IV and determine the applicable capital and liquidity and enhanced prudential standards.

Moving up a category, or having to form an intermediate holding company ("IHC") of a foreign banking organization ("FBO"), could have significant regulatory effects and costs for banking organizations. Enhanced prudential standards for large bank holding companies ("BHCs") and IHCs include capital planning requirements; supervisory and company-run stress testing; liquidity risk management, stress testing, and buffer requirements; and single-counterparty credit limits.[79]

Most importantly, however, these asset-based thresholds may not be revised like a Staff Accounting Bulletin may be revised. Banking organization capital and other regulatory requirements are largely the product of notice and comment rulemakings and generally must be revised through the same procedure. Moreover, such rulemakings and other requirements are based in part on statutory directives that reference GAAP or otherwise limit the Banking Agencies' discretion. For example, section 37(a)(2)(A) of the Federal Deposit Insurance Act ("FDIA") provides that the accounting principles applied in reports on which insured depository institutions' capital requirements are derived must be consistent with "generally accepted accounting principles" and that the Banking Agencies may not prescribe accounting principles that are less stringent than GAAP.[80] Section 171 of the DFA also limits the discretion of the Banking Agencies to amend the tier 1 leverage ratio and risk-based capital standards, which are based on balance sheet values.[81]

In sum, a firm's total assets or total liabilities factors into many aspects of the prudential framework for banking organizations.

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[77] FFIEC, *Instructions for Preparation of Consolidated Reports of Condition and Income, FFIEC 031 and 041, General Instructions* (Mar. 2022) at 14.

[78] FR Y-9C, General Instructions (Sep. 2021), GEN-3; FR Y-15 (June 2020), GEN-3; FR Y-7Q (Dec. 2019), GEN-5.

[79] 84 Fed. Reg. 59032, 59033 (Nov. 1, 2019).

[80] FDIA, Pub. L. No. 102-242, tit. I, § 121(a), 105 Stat. 2236, 2250 (1991) (codified at 12 U.S.C. § 1831n(a)(2)(A)).

[81] DFA, Pub. L. No. 111-203, tit. I, sub. C, § 171, 124 Stat. 1376, 1435-38 (codified at 12 U.S.C. § 5371).

B. Effects on the leverage and risk-based capital measures

1. Credit and Market RWAs

Banking organizations are required to meet minimum risk-based capital measures, meaning that they must maintain amounts of capital commensurate to the particular risk characteristics of their assets. For example, banking organizations must meet a common equity tier 1 capital ratio of 4.5% of RWA,[82] a tier 1 capital ratio of 6% of RWA[83] and a total capital ratio of 8% of RWA.[84] Importantly, should SAB 121 apply to require banking organizations to hold additional risk-based capital in respect of safeguarded crypto-assets, the assets would have to have a standardized risk weight. The U.S. capital rules do not, at present, explicitly provide a treatment for crypto-asset exposures.

The BCBS is expected to publish a second consultative paper later this month with a view to finalize standards by the end of this year.[85] If SAB 121 were to require banking organizations to recognize indemnification-like assets on their balance sheet, banking organizations could be forced to hold significant additional capital.[86] For example, if the BCBS were to adopt a conservative 1250% risk weight for many crypto-assets without separate trading book and banking book treatment, as proposed in the BCBS's first consultative paper,[87] and this treatment were to apply to the asset required to be on balance sheet per SAB 121, banking organizations would be required to take at least a dollar-for-dollar capital charge for safeguarded crypto-assets. It seems that this result should be avoided, particularly because the BCBS's original consultation noted that it was not intended to apply to custody services because there is no existing prudential treatment for such services.[88]

The additional capital charge also would be contrary to the Banking Agencies' carefully calibrated capital requirements, which would not require banking organizations to account for the credit and market risk of custodied assets, and could be significant for banking organizations

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[82] 12 CFR 217.10(a)(1)(i); 12 CFR 3.10(a)(1)(i); 12 CFR 324.10(a)(1)(i).

[83] 12 CFR 217.10(a)(1)(ii); 12 CFR 3.10(a)(1)(ii); 12 CFR 324.10(a)(1)(ii).

[84] 12 CFR 217.10(a)(1)(iii); 12 CFR 3.10(a)(1)(iii); 12 CFR 324.10(a)(1)(iii).

[85] *See* BCBS, Basel Committee finalises principles on climate-related financial risks, progresses work on specifying cryptoassets' prudential treatment and agrees on way forward for the GSIB assessment methodology review (May 31, 2022).

[86] SAB 121 requires the recognition a liability as well as an asset. As SAB 121 makes clear, such an asset is not the crypto-asset itself. The recognition is rather "similar in nature to an indemnification asset", although it is clearly distinguishable from an indemnification asset. In considering the appropriate risk-based capital treatment, the Banking Agencies would need to consider whether it is appropriate to recognize such a novel balance sheet asset at all. At a minimum, however, it would be consistent with SAB 121 to not provide the same capital treatment for the balance sheet asset as the capital treatment of the crypto-asset itself.

[87] BCBS, *Consultative Document: Prudential treatment of cryptoasset exposures* (June 2021) at 13-14.

[88] *Id*. at n. 10. This statement presumably was made because it is well established that assets under custody are not reflected on the balance sheet.

that have specialized in custody activities. For example, the OCC has not identified market risk, which is typically the risk associated with trading books or banking organizations' portfolios of traded instruments for short-term profits (which are exposed to the risk of losses resulting from changes in the prices of instruments),[89] as one of the risks of custody activities.[90]

Moreover, unless the custodian advances funds to settle trades, engages in crypto-asset lending activity, or uses a sub-custodian, there is virtually no credit risk present.[91] As with traditional assets, legal settlement finality for crypto-asset transactions is determined by commercial law and contract between transacting parties. Currently, in crypto-asset markets, transacting parties address settlement finality through contractual agreements that specify the timing of settlement of transactions governed by those contracts. Market participants have been developing standardized approaches to manage the risks emanating from the operational and legal settlement finality issue in spot crypto-asset markets, including (1) pre-funding of the crypto-asset spot transactions (to mitigate counterparty risk), (2) liquidity provider arrangements to reduce liquidity risks, such as access to credit and liquidity facilities, (3) payment or close-out netting mechanisms, (4) confirmation from the custodian of the receipt of the spot crypto-asset from the transferor or seller and (5) clear terms of agreement as to when legal finality is deemed to have been achieved in the transaction.[92]

2. Tier 1 Leverage Ratio

Banking organizations in the United States are required to maintain certain leverage ratios of tier 1 capital to total assets (tier 1 leverage ratio) or total leverage exposure (supplementary leverage ratio). The Banking Agencies require regulated institutions to maintain a minimum tier 1 leverage ratio of 4%.[93] An institution's tier 1 leverage ratio is calculated as the ratio of its "tier 1 capital", which includes the institution's shareholders' equity and retained earnings, to average total consolidated assets as reported on the institution's Call Report (for a bank) or FR Y-9C (for a BHC) minus certain amounts deducted from tier 1 capital.[94] As noted above, a banking organization or BHC does not include custodied assets as part of its balance sheet assets when completing these reports. If indemnification-like assets were to be recognized on balance sheet under SAB 121, then such assets also could have to be included in the total consolidated assets

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[89] BCBS, *The market risk framework – In brief* (Jan. 2019) at 1.

[90] OCC, *Comptroller's Handbook: Custody Services* (Jan. 2002) at 2 ("The primary risks associated with custody services are: transaction, compliance, credit, strategic, and reputation.").

[91] *See*, *e.g.*, *id.* at 4. ("The U.S. market settlement practice of delivery versus payment (DVP) virtually eliminates counterparty credit risk in the settlement process. However, a custodian may be exposed to credit risk if it advances funds to settle trades for a customer. In addition, securities lending activities may expose a bank to counterparty credit risk.").

[92] *See* Letter from the Global Financial Markets Association, the Financial Services Forum, the Futures Industry Association, the Institute of International Finance and the International Swaps and Derivatives Association to Mr. Pablo Hernández de Cos, Chairman and Mr. Neil Esho, Secretary General BCBS (Apr. 19, 2022) at 22.

[93] 12 CFR 217.10(a)(1)(iv); 12 CFR 3.10(a)(1)(iv); 12 CFR 324.10(a)(1)(iv).

[94] 12 CFR 217.10(b)(4); 12 CFR 3.10(b)(4); 12 CFR 324.10(b)(4).

reported on the banking organization's Call Report or FR Y-9C.[95] This would lead to a larger denominator for purposes of the leverage ratio calculation under the Banking Agencies' rules. Accordingly, institutions that engage in crypto-asset custody activities will be required to hold more tier 1 capital to account for these assets in order to meet the minimum ratio requirements.

For example, if a bank maintained a 4% minimum tier 1 leverage ratio, and the bank custodied $100 worth of crypto-assets for its clients, it would need to maintain an additional $4 worth of tier 1 capital to account for those crypto-assets. In contrast, for "traditional" assets, the leverage capital charge would be zero, reflecting that assets held in custody are not reported on the custodian's balance sheet and do not factor into the tier 1 leverage ratio denominator. In addition, the actual thresholds that banking organizations must maintain are much higher to meet the well-capitalized requirements and additional capital buffers required for large banking organizations as described below.

The consequences of not meeting regulatory capital requirements are significant and, in many cases, statutorily prescribed. For example, failure to meet the leverage ratio can result in restriction of the banking organization's dividends and growth and even cause the banking organization to enter receivership.[96] There are also restrictions on the Federal Reserve providing credit or discount window access to undercapitalized institutions.[97]

3. Supplementary Leverage Ratio

Certain banking organizations, must maintain a risk-insensitive minimum supplementary leverage ratio of 3%.[98] Banking organizations that qualify as GSIBs are required to maintain an additional buffer above the minimum supplementary leverage ratio to avoid limitations on the firm's distributions and certain discretionary bonus payments.[99] The minimum supplementary leverage ratio is calculated as the ratio of tier 1 capital to total leverage exposure.[100] The total leverage exposure is the sum of: (1) the mean of the on-balance sheet assets calculated as of each day of the reporting quarter; and (2) the mean of the off-balance sheet exposures calculated as of the last day of each of the most recent three months, minus the applicable deductions. Because indemnification-like assets will be on-balance sheet under SAB 121, it could be the case that such amounts will also be included in the supplementary leverage ratio calculation. Any

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[95] *See, e.g.*, FRB, *Instructions for Preparation of Consolidated Financial Statements for Holding Companies* (Mar. 2022) at GEN-3 ("Holding companies are required to prepare and file the Consolidated Financial Statements for Holding Companies in accordance with generally accepted accounting principles.").

[96] *See* 12 U.S.C. § 1831o(h)(3).

[97] FRB, *General Information: The Discount Window* (Dec. 14, 2021), *available at* https://www.frbdiscountwindow.org/pages/general-information/the%20discount%20window.

[98] 12 CFR 217.10(a)(1)(v); 12 CFR 3.10(a)(1)(v); 12 CFR 324.10(a)(1)(v).

[99] 12 CFR 217.11(d).

[100] 12 CFR 217.10(c)(1); 12 CFR 3.10(c)(1); 12 CFR 324.10(c)(1). Note that clearing members and banking organizations have a slightly different calculation set forth in 12 CFR 217.10(c)(2); however, in no case is a customer's custodial assets appropriately held under custody included in calculation of total leverage exposure.

banking organizations that engage in crypto-asset custody activities therefore would be required to hold more capital relative to peers that do not engage in crypto-asset custody activities.

These leverage ratios are only a measure of the minimum amounts of capital that banking organizations must maintain, as the Banking Agencies generally require institutions to exceed these minimum capital requirements.[101]

4. Community Bank Leverage Ratio and Well-Capitalized Status

Other knock-on effects related to leverage ratios could apply. For example, for smaller banking organizations to be eligible for the less burdensome community bank leverage ratio framework under the Regulatory Relief Act, they must meet certain other criteria, including having a leverage ratio of greater than 9% and total consolidated assets calculated in accordance with the reporting instructions to the Call Report or Form FR Y-9C of less than $10 billion.[102] Moreover, *de novo* banking organizations are subject to higher initial capital requirements, including a leverage ratio of at least 8% for the first three years of operations or until the banking organization is expected to maintain stable profitability.[103] All of these thresholds would be disproportionately more burdensome to meet for banking organizations that engage in crypto-asset safeguarding activities, if SAB 121 were to apply to them.

In addition, for a banking organization to be considered well capitalized and to operate without regulatory restrictions, it must maintain at least a 5% leverage ratio and, for the largest banking organizations, a 6% supplementary leverage ratio.[104] Banking organizations that are less than well capitalized are subject to certain restrictions. For example, they may only accept brokered-deposits with an FDIC waiver.[105]

Generally speaking, insured depository institutions ("IDIs") will not receive merger approval if the resulting entity does not meet the minimum leverage capital requirement or will not be well capitalized and "well-managed" upon the consummation of the transaction.[106]

C. Identification of banks subject to capital stress testing, capital conservation buffer and stress testing buffer

Banking organizations must meet a CCB of 2.5% over and above the each of the minimum CET1, tier 1 and total capital ratios to avoid any restrictions on capital distributions and

[101] *See* 12 CFR 217.10(e); 12 CFR 3.10(e)(1); 12 CFR 324.10(e)(1).

[102] 12 CFR 217.12(a); 12 CFR 3.12(a); 12 CFR 324.12(a).

[103] OCC, *Licensing Manual: Charters* (Dec. 2021) at 25.

[104] 12 CFR 6.4(b)(1)(i)(D); 12 CFR 208.43(b)(1)(i)(D); 12 CFR 324.403(b)(1)(i).

[105] *See* 12 CFR 303.243(a).

[106] *See, e.g.*, 12 U.S.C. § 1831u(b)(4)(B); 12 CFR 324.10(e)(3)(iii).

discretionary bonus payments.[107] BHCs and IHCs with $100 billion or more in total consolidated assets are required to hold an institution-specific add on, known as the SCB, based on the results of the FRB's supervisory stress tests.[108] The SCB must be at least 2.5% of risk-weighted assets and would apply in additional to the minimum risk-based capital requirements and any GSIB surcharge (discussed in the following section).[109]

The SCB requirement is generally calculated as (1) the difference between the banking organization's starting and minimum projected CET1 capital ratios under the severely adverse scenario in the FRB's supervisory stress test plus (2) four quarters of planned common stock dividends as a percentage of risk-weighted assets.[110]

Assuming that Question 1 of SAB 121 were to apply to banking organizations, the impact may be significant to banking organizations' ability to meet their SCB and CCB requirements, which would be breached before any of the minimum capital ratios described above. Some banking organizations may also be subject to SCB requirements for the first time as inclusion of indemnification-like assets on balance sheet could move them above the $100 billion threshold.

Banking organizations also would need to determine how safeguarded crypto-assets affect capital planning and stress testing. Stress testing is a core element of the FRB's framework for supervising large banking organizations (*i.e.*, Comprehensive Capital Analysis and Review and DFA Stress Tests) and helps the FRB determine whether large firms have sufficient capital to absorb losses and continue lending under severely adverse conditions.[111] If banking organizations were required to apply Question 1 of the SAB, it could lead to unpredictable and difficult-to-interpret results during stress tests, such as banking organizations experiencing significant variation in their balance sheets as a result of a crypto-asset stress event.

Importantly, the requirements for stress testing are also dependent on categorization under the changes to the DFA made by the Regulatory Relief Act, so including indemnification-like assets on balance sheet may cause banking organizations to be subject to more frequent supervisory stress testing or supervisory stress testing for the first time.

D. Identification of GSIBs and increase in GSIB surcharges

In addition to the minimum capital requirements that all banking organizations are required to satisfy under the Basel framework, banking organizations that qualify as GSIBs are required to maintain an additional capital buffer, known as the GSIB surcharge. There are currently 30 banking organizations, including eight U.S. banking organizations, which qualify as GSIBs, with GSIB surcharges for these entities ranging from 1.0% to 2.5% in 2021.

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[107] 12 CFR 217.11(a)(4)(ii); 12 CFR 3.11(a)(4)(ii); 12 CFR 324.11(a)(4)(ii).

[108] 12 CFR 217.11(a)(2)(vi)(A).

[109] 12 CFR 217.11; 12 CFR 225.8(f).

[110] *Id.*

[111] 86 Fed. Reg. 7927, 7928 (Feb. 3, 2021).

In the United States, the size of the GSIB surcharge depends on the GSIB's systemic indicator score, which is calculated by using one of two prescribed methods. Method 1 for calculating an entity's systemic indicator score considers a weighted average of twelve systemic indicators across five categories.[112] Method 2 for calculating an entity's system indicator score considers nine systemic indicators across four categories.[113] Under both methods, the systemic indicators are calculated using the Systemic Risk Report on Form FR Y-15.[114] In addition, both methods of calculating a systemic indicator score consider the size of the banking organization based on the "total exposures" line item in Form FR Y-15, a figure which is calculated by reference to various on- and off-balance sheet liabilities.[115] Further, the instructions for Form FR Y-15 specify that "U.S. banking organizations and FBOs are required to prepare and file the FR Y-15 in accordance with U.S. generally accepted accounting principles."[116]

Should SAB 121 apply to require banking organizations to recognize additional liabilities in respect of crypto-assets under custody, it would in turn require banking organizations to report these amounts on Form FR Y-15. This reporting would have the effect of increasing a banking organization's total exposures, and therefore its systemic indicator score and ultimately its GSIB surcharge. It could also cause banking organizations that are not currently considered GSIBs to begin to qualify as GSIBs, and to be subject to a stringent regulatory environment that today is considered necessary only for the largest and most complex banking organizations in the world. In addition to the GSIB surcharge, GSIBs face increased supervisory scrutiny, such as through the FRB's Large Institution Supervision Coordinating Committee ("LISCC") supervisory program,[117] and are required to prepare resolution plans that are subject to heightened standards.[118]

Furthermore, Method 1 for calculating a banking organization's systemic indicator score already considers the banking organization's assets under custody as a systemic indicator under the substitutability category.[119] Per the Systemic Risk Report on Form FR Y-15, Line Item 3 of Schedule C is "assets held as a custodian on behalf of customers".[120] Application of SAB 121,

[112] 12 CFR 217.404.

[113] 12 CFR 217.405.

[114] 12 CFR 217.404(b); 12 CFR 217.405(b).

[115] Form FR Y-15, Schedule A.

[116] FRB, *Instructions for the Preparation of Systemic Risk Report* (Sept. 2021) at GEN-3.

[117] LISCC firms include (i) any firm subject to Category I standards under the regulatory tailoring framework, (ii) any non-commercial, non-insurance savings and loan holding company that would be identified for Category I standards if it were a bank holding company and (iii) any nonbank financial institution designated as systemically important by the Financial Stability Oversight Council. 84 Fed. Reg. 59032 (Nov. 1, 2019); FRB, SR 20-30, *Financial Institutions Subject to the LISCC Supervisory Program* (revised Mar. 31, 2021).

[118] 84 Fed. Reg. 1438 (Feb. 4, 2019).

[119] *See* 12 CFR 217.404.

[120] Form FR Y-15, Schedule C.

as described above, therefore could lead to double counting of safeguarded crypto-assets, potentially causing crypto-asset safeguarding activities to have an unintentionally outsized impact on a banking organization's systemic indicator score.

E. Impact on banking organizations' liquidity coverage ratio and net stable funding ratio

The Banking Agencies require banking organizations to maintain an adequate level of unencumbered, high-quality liquid assets to meet net cash outflows under a stress scenario lasting for 30 days by maintaining an LCR that is equal to or greater than 1.0.[121] Banking organizations also are required to maintain an NSFR that is equal to or greater than 1.0 under the Banking Agencies' rules.[122] Broadly speaking, the NSFR is intended to ensure that banking organizations do not engage in excessive maturity transformation and hold sufficient stable funding in relation to the composition of their assets.[123]

These requirements are reduced based in part on asset size and categorization. For example, a Category III organization with less than $75 billion of weighted short-term wholesale funding is subject to an adjustment of 85% of the full LCR and a Category IV organization with less than $50 billion of weighted short-term wholesale funding is subject to an adjustment of 70% of the full LCR.[124] The rules include similar NSFR adjustments.[125] Accordingly, SAB 121 could result in some banking organizations being subject to more stringent LCR and NSFR requirements or to those requirements for the first time.

Moreover, the denominator of the NSFR, the RSF amount, is determined by assigning an RSF factor to the banking organization's asset exposure.[126] If SAB 121 were to apply to banking organization, it is not clear what RSF factor should be assigned to the balance sheet asset required by SAB 121. At the same time, it is not clear whether the corresponding "safeguarding liability" required by SAB 121 would fall under any of the categories of liabilities that flow into the numerator of the NSFR, the ASF amount.[127] On the one hand, there is a strong argument that the safeguarding liability should not count in the numerator at all, as it is not a portion of the banking organization's regulatory capital and it is impossible to determine whether such liability will remain with the institution for more than one year.[128] If that is the case, then the corresponding asset should be assigned a 0% RSF factor. However, none of these points have been clarified by the BCBS or the Banking Agencies; should they do so, it may be necessary to

[121] 12 CFR 249.10; 12 CFR 50.10; 12 CFR 329.10.

[122] 12 CFR 50.100(a); 12 CFR 249.100(a); 12 CFR 329.100(a).

[123] BCBS, Basel III: the net stable funding ratio (Oct. 2014).

[124] 12 CFR 249.30(c); 12 CFR 50.30(c); 12 CFR 329.30(c).

[125] *See* 12 CFR 50.105(b); 12 CFR 249.105(b); 12 CFR 329.105(b).

[126] 12 CFR 50.106; 12 CFR 249.106; 12 CFR 329.106.

[127] *See* 12 CFR 50.104; 12 CFR 249.104; 12 CFR 329.104.

[128] *See* BCBS, *Net Stable Funding Ratio (NSFR) - Executive Summary* (June 28, 2018).

engage in a consultation and notice and rulemaking process with the public. In that case, banking organizations that wish to provide crypto-asset custody services may effectively be unable to engage in such activities until there is further regulatory clarification.

F. Impact on institutions' single-counterparty credit limits

Section 165(e) of the DFA also requires the FRB to prescribe regulations to limit the risk of contagion posed by a large banking organization in a financial crisis.[129] The FRB's final rule, among other things, provides that "[n]o covered company may have an aggregate net credit exposure to any counterparty that exceeds 25% of the tier 1 capital of the covered company" and "[n]o major covered company may have aggregate net credit exposure to any major counterparty that exceeds 15% of the tier 1 capital of the major covered company."[130]

A covered company is defined to include a GSIB BHC, a Category II BHC and a Category III BHC.[131] A major covered company is defined to mean "any covered company that is a global systemically important BHC".[132] Accordingly, the issues discussed above with determining thresholds for GSIBs and whether a firm falls into Categories II, III or IV would apply to the single-counterparty credit limit rules as well. Becoming subject to the single-counterparty credit limits could disrupt existing relationships and exposures with other banking organizations.

G. Impact on the calculation of financial sector concentration limits

Section 622 of the DFA prohibits a financial company (including an IDI or BHC) from combining with another company if the resulting financial company's liabilities exceed 10% of the aggregate consolidated liabilities of all financial companies.[133] The FRB's implementing rules define liabilities of a financial company as the difference between its RWA, as adjusted to reflect exposures deducted from regulatory capital, and its total regulatory capital.[134] For companies not subject to consolidated risk-based capital rules, consolidated liabilities are equal to "the total liabilities of such company on a consolidated basis, as determined under applicable accounting standards".[135] For the reasons discussed above, safeguarded crypto-assets could increase risk-based capital requirements, although the extent to which they would do so is unclear, and also could increase total liabilities of a company. Thus, such banking organizations and other companies could effectively be limited in their ability to engage in transactions under the financial sector concentration limit rules.

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[129] DFA, Pub. L. No. 111-203, tit. I, sub. C, § 165(e), 124 Stat. 1376, 1427-28 (codified at 12 U.S.C. § 5365(e)).

[130] 12 CFR 252.72.

[131] 12 CFR 252.70(a)(2)(i).

[132] 12 CFR 252.70(a)(2)(ii).

[133] DFA, Pub. L. No. 111-203, tit. IV, § 622, 124 Stat. 1376, 1632-34 (codified at 12 U.S.C. § 1852).

[134] 12 CFR 251.3(c)(1).

[135] 12 CFR 251.3(c)(2).

H. Increase in banking organizations' deposit insurance assessments

The DFA also required the FDIC to amend its regulations to define an IDI's assessment base as its average consolidated total assets minus its average tangible equity.[136] Thus, if a banking organization were to be required by SAB 121 to include indemnification-like assets as part of its consolidated total assets calculation, this could have the effect of increasing its DIF assessment relative to banking organizations of similar size that do not conduct crypto-asset safeguarding activities.

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[136] DFA, Pub. L. No. 111-203, tit. III, sub. C, § 331(b), 124 Stat. 1376, 1538.

Appendix C: Legal Precedents Applicable to Banking Organizations

As explained below, the long-standing conclusion that custodied assets are not the legal property of the custodian is supported by a number of different areas of commercial, contract and insolvency law. These well-established principles have led to requirements for regulated banking organizations to address the legal risks of safeguarding activities by segregating custodied assets so that they are not treated as assets of the banking organization in insolvency and that the customer does not become a general creditor of a failed custodian.

A. Uniform Commercial Code

Under UCC Article 8-503(a), financial assets held by a securities intermediary (*i.e.*, custodian) to satisfy securities entitlements for entitlement holders (*i.e.*, customers) are not property of the securities intermediary and are not subject to claims of creditors of the securities intermediary. UCC Article 8 applies to any person, including a regulated bank, that acts as a "securities intermediary" that maintains "securities accounts" for others and is acting in that capacity.[137] Under UCC Article 8-102(9), a "financial asset" includes any property that is held by a securities intermediary for another person in a "securities account" if the parties have expressly agreed that the property is to be treated as a financial asset under UCC Article 8.

There are legislative initiatives underway to confirm the treatment of crypto-assets held under custody. Specifically, draft amendments to the UCC proposed by the Council of the American Law Institute and the Uniform Law Commission propose legislative revisions that allow for certain crypto-assets falling within the scope of UCC Article 12, to be called "controllable electronic records", to be "financial assets".[138] The amendments were approved by the members of the American Law Institute at the Institute's Annual Meeting and are expected to be approved by the members of the Uniform Law Commission at the Commission's Annual Meeting in July 2022. Thereafter, the amendments may be adopted by each of the states into state law.

A key premise of the revisions is that, like with other financial assets, crypto-assets falling within the scope of UCC Article 8 and UCC Article 12 would not constitute property of an intermediary to the extent necessary for the intermediary to satisfy all securities entitlements with respect to such asset. In particular, securities entitlements are treated consistently for all financial assets under the UCC framework, even under the proposed revisions. Under UCC Article 8, a person generally acquires a security entitlement if a securities intermediary: "(1) indicates by book entry that a financial asset has been credited to the person's securities account; (2) receives a financial asset from the person or acquires a financial asset for the person and, in either case, accepts it for credit to the person's securities account; or (3) becomes obligated under other law,

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[137] UCC § 8-102(a)(14). A "securities account" is defined as "an account to which a financial asset is or may be credited in accordance with an agreement under which the person maintaining the account undertakes to treat the person for whom the account is maintained as entitled to exercise the rights that comprise the financial asset." UCC § 8-501(a).

[138] Uniform Law Commission, *Uniform Commercial Code and Emerging Technologies* (May 31, 2022 informal session discussion draft), *available at* https://www.uniformlaws.org/viewdocument/2022-informal-session-draft-1?CommunityKey=cb5f9e0b-7185-4a33-9e4c-1f79ba560c71&tab=librarydocuments.

regulation, or rule to credit a financial asset to the person's securities account".[139] Among other duties, the securities intermediary is required to "promptly obtain and thereafter maintain a financial asset in a quantity corresponding to the aggregate of all security entitlements it has established in favor of its entitlement holders with respect to such financial asset".[140] Thus, the underlying principle of UCC Article 8 is that all financial assets within its scope are held by the securities intermediary for the entitlement holders and are not the property of the securities intermediary that can be reached by unsecured creditors.[141]

B. Contract law

For over a century, a considerable body of law has developed addressing banks' ability to safeguard money and other assets for customers and the requirements for doing so, which, if met, ensure that the safeguarded assets are not considered property of the custodian. In addition to being authorized to accept cash deposits generally, banks also may accept other types of assets as so-called "special deposits" under state and federal law.[142] As described in more detail below, special deposits, unlike general deposits, are considered assets of customer rather than the bank.[143]

Although, to our knowledge, no court to date has taken a position on whether crypto-assets may be special deposits, the OCC and courts have made clear that special deposits "may be money, securities, or other valuables".[144] Historically, courts have placed some limits on the types of assets banks may accept as special deposits in that the asset generally must be related to the banking activities that state or federal law authorize the bank to conduct.[145] In this respect, the OCC has found safeguarding crypto-assets to be part of the traditional bank activities of national banks and thus part of the business of banking.[146]

Due to the significantly different treatment of general and special deposits, deposits at banks are treated as "general" deposits rather than "special" or "specific" deposits unless a special

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[139] UCC § 8-501(b).

[140] UCC § 8-504(a).

[141] *See* UCC § 8-503(a). Under Article 8 of the UCC, secured creditors also generally do not have priority to the financial assets over the interests of the entitlement holders, except where the creditor is secured and has control of the financial asset. UCC § 8-511(a)-(b).

[142] This authority has been found explicitly or implicitly in statutes prescribing the scope of banks' permissible activities. *See, e.g.*, ALM GL ch. 167G, § 4; NY CLS Bank § 96(3); *Myers v. Exch. Nat. Bank*, 96 Wash. 244, 164 P. 951, 1917 Wash. LEXIS 577.

[143] *See*, *e.g.*, 5B Michie Company, *Michie on Banks and Banking* § 346 (2002).

[144] OCC Conditional Approval No. 479 (July 27, 2011); *see, e.g.*, *Montgomery*, 226 Ala. at 93; 5B Michie Company, *Michie on Banks and Banking* § 330 (2002).

[145] *E.g.*, *Britton v. Elk Valley Bank*, 54 N.D. 858, 862-863, 211 N.W. 810, 812, 1926 N.D. LEXIS 97, *10, 50 A.L.R. 243; *Am. Nat'l Bank v. E. W. Adams & Co.*, 1914 OK 425, 44 Okla. 129, 143 P. 508, 1914 Okla. LEXIS 655. For example, banks may take gold as a special deposit but not shoes. *See id.*; Montgomery.

[146] OCC Interpretive Letter No. 1170 (July 22, 2020) (not specifically addressing special deposits).

agreement or circumstance exists sufficient to create a bailor / bailee or trust relationship.[147] If a deposit is a general deposit, then the banking organization may use the funds of the deposit in its commercial banking business.[148] Accordingly, banking organization custodians and their customers that wish to establish special deposit relationships take care and seek to ensure there is a written agreement and other evidence that courts will cite as sufficient to establish a special deposit rather than a general deposit. Two related requirements for assets to be treated as special deposits in the existing case law are that the custodian must segregate the custodial assets from its own assets and that commingling of assets does not occur.[149] Relevant banking regulation underscores this requirement and requires banking organizations to abide by its mandate.[150]

Entities operating outside of this developed body of banking law and related protections that purport to be custodians of customers' crypto-assets could be considered the owners of the customers' crypto-assets themselves in insolvency proceedings.[151] By contrast, existing requirements and practices of banking organizations help ensure that customers' crypto-assets would not become assets of a custodian banking organization's estate if the banking organization were to fail, as banks would segregate the crypto-assets being custodied for customers and not commingle them with the banks' assets. Indeed, banking regulators require such segregation and other practices. As explained in Section IV.C.3, sound risk management of custodial activities required by the Banking Agencies includes: (1) separation and safeguarding of custodial assets;

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[147] *See Peoples Westchester Sav. Bank v. FDIC*, 961 F.2d 327, 330 (2d Cir. 1992) ("Whether a deposit in a bank is general or special depends upon the mutual understanding and intention of the parties at the time such deposit is made, and a deposit made in the ordinary course of business is presumed to be general, and the burden of proof is on the depositor to overcome such presumption by proving that the deposit was made upon such terms and conditions as constituted a special deposit, or a deposit for a specific purpose, as distinguished from a general deposit"). Although some jurisdictions further distinguish special deposits from "specific" deposits, which is similar to a specific deposit but also includes a specific purpose for the deposit (*e.g.*, money to pay a particular note). *See* Thomas H. DeLay, Banks and Banking—Special and General Deposits—Glass v. Nebraska State Bank (Neb. 1963), 43 Neb. L. Rev. 652 (1964). For simplicity, we do not otherwise separately discuss specific deposits in this letter.

[148] *See Peoples Westchester Sav. Bank v. FDIC*, 961 F.2d at 330 (in the case of a general deposit, "the depositor, for his own convenience, parts with the title to his money, and loans it to the banker; and the latter, in consideration of the loan of the money and the right to use it for his own profit, agrees to refund the same amount, or any part thereof, on demand".) (quoting *Marine Bank v. Fulton Bank,* 69 U.S. (2 Wall.) 252, 256, 17 L.Ed. 785 (1864)).

[149] *See Merrill Lynch Mortg. Capital, Inc. v. FDIC*, 293 F. Supp. 2d 98 (D.D.C. 2003) ("While an implicit agreement could theoretically suffice to overcome the general deposit presumption, the existence of a written agreement—explicitly obligating the bank to segregate deposited funds and leaving legal title with the depositor—seems to be, practically, the dispositive issue in deciding whether a deposit is special."); *Peoples Westchester Sav. Bank v. FDIC*, 961 F.2d at 331 (finding no special deposit in part because "documents generated in opening the [account] do not evidence that [the bank] assumed a duty to segregate those funds from its own general assets" and "that there was no explicit agreement ... to segregate [deposited] funds"); *Keyes v. Paducah & I.R. Co.*, 61 F.2d 611, 613 (6th Cir. 1932) (finding no special deposit because the court "fail[ed] to find in any . . . instruments . . . any indication that it was the intention . . . of the parties that the avails of the draft were to be segregated and kept as a separate fund . . .").

[150] *See* Section IV.C.3.

[151] *See* Adam J. Levitin, *Not Your Keys, Not Your Coins: Unpriced Credit Risk in Cryptocurrency*, 101 Tex. L. Rev. (June 5, 2022) at 45, *available at* https://ssrn.com/abstract=4107019; Coinbase Global, Inc., Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2022 (May 20, 2022) at 83.

(2) due diligence in selection and ongoing oversight of sub-custodians; (3) disclosure in custodial contracts and agreements of the custodian's duties and responsibilities; and (4) effective policies, procedures and internal controls for the proper maintenance of internal books and records, the daily reconciliation of assets with the various entities in the chain of custody, the deployment of robust data privacy and cybersecurity controls and the maintenance of comprehensive business continuity and resiliency protocols.

C. Insolvency law

It is a well-established principle of federal banking law that custodial assets are not generally available to creditors of an insolvent bank.[152] In cases involving a "special deposit", courts have held that the assets held as special deposits are not assets of the bank and that the customer is not a general creditor of the failed custodian bank.[153] Furthermore, by statute and court interpretations, the FDIC, as receiver, generally "takes no greater rights in the property than the insolvent bank itself possessed".[154] In fact, the FDIC often transfers custodial assets from the

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[152] *See, e.g.*, FDIC Advisory Op. No. 03-01 (Jan. 3, 2003) (advising that "trust assets" held in an account with the trust department of an FDIC-insured depository institution under FDIC receivership may be recoverable in full by the trust customers if the trust customers (i) establish the existence of a "fiduciary relationship" between themselves and the failed bank and (ii) trace the assets into the hands of the FDIC, separate and apart from the failed bank's general assets); *see* 12 U.S.C. § 92a(e) (clarifying that owners of trust assets in a national bank have a lien against such assets in the event of the failure of the bank); Edward H. Klees, *How Safe Are Institutional Assets in a Custodial Bank's Insolvency*, 68 Bus. LAW. 103, 115 (2012) (explaining why a customer holding a custody account at a national bank will have the same insolvency rights as a comparable state bank). In addition, the FDIA largely prevents unsecured creditors of failed banks from restraining the exercise of powers or functions of the FDIC as a conservator or a receiver (including, for example, the FDIC's power to transfer trust assets) through court injunctions or other court actions. *See* 12 U.S.C. § 1821(j).

[153] *See Merrill Lynch Mortg. Cap., Inc. v. FDIC*, 293 F. Supp. 2d at 110 (D.D.C. 2003) (finding under state noninsolvency law that the custodial account was a special deposit entitling the depositor to full recovery and priority over uninsured deposit claims in the receivership proceedings of the failed bank); *In re Mechanics Tr. Co.*, 19 Pa. D. & C. 468, 470 (Com. Pl. 1933) (making a similar finding under applicable state noninsolvency law in the context of a bank receivership); *People v. City Bank of Rochester*, 96 N.Y. 32, 34 (1884) (same). Note also that court review of such claims generally must wait until after the FDIC's administrative claims process (*i.e.*, the court may review *de novo* the FDIC's administrative claims determinations related to special accounts after the FDIC's administrative claims process). *See also* 12 U.S.C. § 1821(j); *Bank of Am. Nat. Ass'n v. Colonial Bank*, 604 F.3d 1239, 1246 (11th Cir. 2010).

[154] *Tobias v. Coll. Towne Homes, Inc.*, 110 Misc. 2d 287, 293, 442 N.Y.S.2d 380, 385 (Sup. Ct. 1981) (noting that this would be true unless there is a specific statutory instruction to the contrary). *See also* 12 U.S.C. § 1821(d)(2)(A)(i); *O'Melveny & Myers v. FDIC*, 512 U.S. 79, 87 (1994); *Peoples-Ticonic Nat. Bank v. Stewart*, 86 F.2d 359, 361 (1st Cir. 1936) (holding that "[a] receiver of a national bank takes title to the assets subject to all existing rights and equities"); *In re Int'l Milling Co.*, 259 N.Y. 77, 83, 181 N.E. 54 (1932) (holding that the New York Superintendent of Banks, when he took over the bank for the purpose of liquidation, acquired no greater interest in the fund than the bank possessed); *In re De Wind*, 144 Misc. 665, 666, 259 N.Y.S. 554 (Sur. 1932) (holding that the trust company never obtained title to the trust funds and title thereto did not pass to the New York Superintendent of Banks when he took over the assets of the trust company); *Williams v. Green*, 23 F.2d 796, 798 (4th Cir. 1928) (holding that the receiver takes the assets of the bank subject to all claims and defenses that might have been interposed as against the insolvent corporation before the liens of the United States and of general creditors attached); *In re Kruger's Estate*, 139 Misc. 907, 910, 249 N.Y.S. 772, 777 (Sur. Ct. King's Cnty. N.Y. 1931) (holding that funds deposited with the trust company "never became its property, and did not pass to the superintendent of banks when he took possession of the trust company") (citing *Corn Exch. Bank v. Blye*, 101 N.Y.

insured depository institution's books to a designated successor custodian in cases of receivership before the creditors are even able to object.[155] Even for certain uninsured banks, the OCC's regulations make clear that assets held "in a fiduciary or custodial capacity, as designated on the bank's books and records, will not be considered as part of the bank's general assets and liabilities held in connection with its other business, and will not be considered a source for payment of unrelated claims of creditors and other claimants".[156] Thus, crypto-assets properly held in a custodial capacity should not be considered part of the bank's general assets and liabilities.

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303, 303, 4 N.E. 635 (1886) (holding that "[a] receiver of an insolvent national bank acquires no right to property in the custody of the bank.")).

[155] *See* FDIC Advisory Op. No. 03-01 (Jan. 3, 2003) (stating that the FDIC (as the failed institution's receiver) will surrender trust assets to the trust customers, or arrange for the holding of the trust assets by a substitute fiduciary, without requiring any action by the trust customers). *See also* Report to the Supervisors of the Major OTC Derivatives Dealers Regarding Centralized CDS Clearing Solutions (June 30, 2009), *available at* https://www.newyorkfed.org/medialibrary/media/markets/Full_Report.pdf at n. 44 (stating that, with one exception involving a small national bank trust department, the authors are not aware that the FDIC has ever liquidated a trust department of a failed bank but rather has transferred trust assets to another depository institution promptly after the closing of the institution, either to the acquiror in a bridge bank or other purchase and assumption or similar transaction, or to a third-party institution where there was a liquidating receivership of the original institution).

[156] 12 CFR 51.8(b). *See also* 12 CFR 9.16 ("If the OCC appoints a receiver for an uninsured national bank, or if a national bank places itself in voluntary liquidation, the receiver or liquidating agent shall promptly close or transfer to a substitute fiduciary all fiduciary accounts, in accordance with OCC instructions and the orders of the court having jurisdiction.").

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