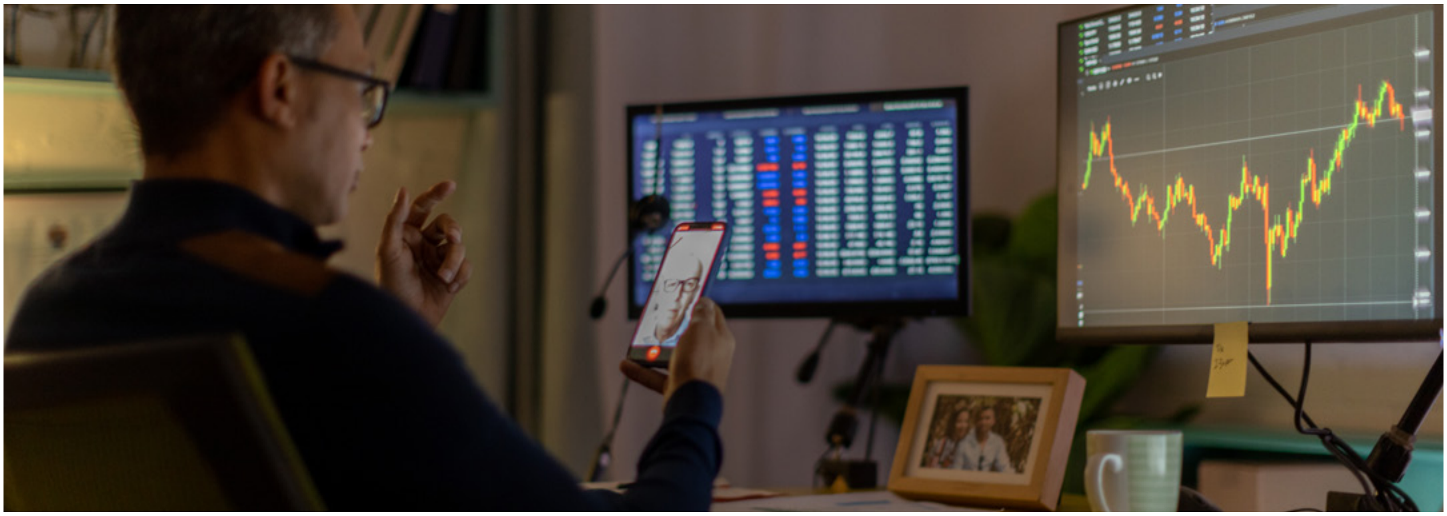
As Digital Assets Infiltrate The Banking Industry, New Risks Abound

Some may call it "imaginary" currency, while others may view it as the preferred currency. Regardless of whether you view it as imaginary or real, digital assets are here and are already impacting the market and the banking industry as we know it. On July 22, 2020, the Office of the Comptroller of the Currency (OCC) issued a legal interpretative letter stating that national banks may arrange custodial services for cryptocurrency ("crypto") assets. This guidance has provided banking institutions with an opportunity to upsell services, create new revenue streams and potentially expand their customer base. However, due to the recent unprecedented growth of crypto, the government has made it known that increased regulation is around the corner.[1] Internationally, the Basel Committee has suggested that they want to limit digital asset exposure to a predetermined percentage of equity, including a risk premium for volatile digital assets. With the anticipated oversight by the regulators comes additional exposures that banks will need to consider.



Cryptocurrency Enters the Mainstream

In recent years, traditional financial institutions have begun making inroads into the digital assets market. In 2021, both Morgan Stanley and J.P. Morgan began offering private banking clients the opportunity to invest in several cryptocurrency funds.[2] Several months later, Mastercard and Bakkt announced a partnership to allow, among other things, consumers to buy, sell and hold digital assets through custodial wallets powered by the Bakkt platform.[3] Numerous regional banks have joined multibank blockchains developed by fintech companies like Figure Technologies and Tassat.[4] Toward the end of 2022, Tassat intends to launch a Digital Interbank Network – to be owned and governed by its members' banks – that will facilitate instantaneous digital transactions between banks.[5]

Regulators Are Beginning to Exert Control Over the Digital Assets Market

Cryptocurrency and other digital assets were built as a way for consumers to complete digital transactions unhindered by a centralized authority.[6] For that reason, digital assets have largely been unregulated since their introduction. However, the unregulated nature of this area has contributed to consumers losing billions of dollars through fraud, cyber hacks and market manipulation.[7] The federal government is now seeking ways to gain control of this largely unsupervised market to better protect consumers. Specifically, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the Treasury Department, among other government agencies, are all jockeying for position as lead regulator of digital assets.

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[1] Executive Order on Ensuring Responsible Development of Digital Assets, The White House Briefing Room, March 9, 2022 https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/
[2] https://www.cnbc.com/2021/03/17/bitcoin-morgan-stanley-is-the-first-big-us-bank-to-offer-wealthy-clients-access-to-bitcoin-funds.html
https://www.cnbc.com/2021/08/05/bitcoin-jpmorgan-led-by-jamie-dimon-quietly-unveils-access-to-a-half-dozen-crypto-funds.html
[3] https://www.mastercard.com/news/press/2021/october/mastercard-and-bakkt-partner-to-offer-innovative-crypto-and-loyalty-solutions/
[4] https://www.americanbanker.com/news/u-s-banks-give-multibank-blockchains-another-try
[5] https://www.interbanknetwork.com/press-release
[6] https://bitcoin.org/en/faq
[7] See, e.g., https://www.justice.gov/opa/pr/two-arrested-alleged-conspiracy-launder-45-billion-stolen-cryptocurrency

Banking regulators are also starting to take action as banks engage in this space. Many banks are taking steps to be able to provide custodial services for their customers who wish to store cryptocurrency and other digital assets with them. Currently, in order to provide such services, many banks are utilizing third parties to assist them in providing this service, as they themselves do not as of yet have the platform to do so.[8] Another service that banks are eager to provide is assistance with the buying and selling of cryptocurrencies. Many are doing so by providing current customers access to third-party vendors who can provide this service.

The SEC considers cryptocurrency a security, and it has a specialized unit – the Crypto Assets and Cyber Unit – dedicated to protecting investors in the cryptocurrency market. This unit has brought more than 80 enforcement actions related to fraudulent and unregistered crypto asset offerings and platforms since its creation in 2017.[9] The CFTC has declared that derivatives based on virtual currencies are a "commodity" subject to oversight by the CFTC under the Commodity Exchange Act.[10] The CFTC has brought its own enforcement actions,[11] and it is also lobbying Congress to grant it more authority to regulate the cash digital asset commodity market.[12] Not to be outdone, the Treasury Department considers virtual currency akin to "real" currency, meaning that the IRS considers certain transactions involving virtual currency to be taxable events.[13] The Treasury Department recently issued its first-ever sanctions on a virtual currency "mixer" for malicious cyber activities and money laundering of stolen virtual currency.[14] The Treasury Department, along with other federal agencies, has also been tasked by President Biden with creating a comprehensive strategy for the federal government's regulation of cryptocurrency.[15]

As further evidence that the federal government is moving toward greater involvement in the regulation of cryptocurrency and digital assets, the President issued an executive order on March 9, 2022, which established the President's recognition of the unprecedented growth of cryptocurrency and recognized the need to consider its regulation in light of potential risks associated with its growth.[16] The order also directed the Treasury Department and Federal Reserve to continue exploring the adoption of a United States central bank digital currency.

Notable Litigation Involving Digital Assets

Unsurprisingly, the largely unregulated digital asset market has spawned lawsuits, enforcement actions and criminal prosecutions. For example, IRA Financial Trust, a company that allows its users to invest retirement funds in alternative assets including cryptocurrency, lost $36 million of digital assets following a cyber attack in February 2022.[17] The attack targeted digital assets in the custody of Gemini Trust Company, a virtual currency exchange and the custodian of the digital assets belonging to IRA's customers. Now IRA is suing Gemini alleging that Gemini did not implement proper safeguards to protect the digital assets in Gemini's custody.[18]

The Gemini litigation is far from unique. In March 2022, for example, a putative class of cryptocurrency holders filed suit against bZx DAO, a Decentralized Autonomous Organization, and several related entities alleging that the defendants negligently failed to implement adequate safety measures and supervise its software developers, leading to theft of the plaintiffs' assets.[19] In another case, a putative class has alleged that Apple was negligent in failing to perform adequate diligence on the software sold through its approved app store. The plaintiffs allege that Apple's negligence allowed a malicious actor to successfully place a "phishing" application in the store – disguised as a cryptocurrency wallet – resulting in the theft of digital assets from customers who downloaded the app.[20] And in a third case, a federal court allowed negligence claims against a cryptocurrency exchange to survive a motion to dismiss, concluding that the plaintiffs adequately alleged that the defendants failed to exercise reasonable care in the management of the exchange.[21]

[8] Hannah Lang, Factbox: How U.S. banks are dipping their toes in the crypto water, REUTERS, (April 5, 2022)
[9] https://www.sec.gov/news/press-release/2022-78
[10] https://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6
[11] https://www.cftc.gov/PressRoom/PressReleases/8498-22#:~:text=Customers%20and%20other%20individuals%20can,or%20contact%20the%20Whistleblower%20Office.
[12] https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam20
[13] https://www.irs.gov/irb/2014-16_IRB#NOT-2014-21
[14] U.S. Treasury Issues First-Ever Sanctions on Virtual Currency Mixer, Targets DPRK Cyber Threats, U.S. Dept. of the Treasury, May 6, 2022, https://home.treasury.gov/news/press-releases/jy0768
[15] Executive Order on Ensuring Responsible Development of Digital Assets, The White House Briefing Room, March 9, 2022, https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/
[16] Executive Order on Ensuring Responsible Development of Digital Assets, The White House Briefing Room, March 9, 2022 https://www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/
[17] Hackers Snagged $36 Million in Crypto in Breach of IRA Financial, Bloomberg (Feb. 14, 2022), https://www.bloomberg.com/news/articles/2022-02-14/ira-financial-hacked-36-million-in-cryptocurrency-stolen
[18] IRA Financial Trust Brings Lawsuit Against Gemini Trust Company Alleging Crypto Exchange Security Failures, PR Newswire (June 6, 2022), https://www.prnewswire.com/news-releases/ira-financial-trust-brings-lawsuit-against-gemini-trust-company-alleging-crypto-exchange-security-failures-301561916.html
[19] See Complaint, Sarcuni et al. v. bZx DAO et al., No. 3:22-cv-00618-LAB-DEB (S.D. Cal. May 2, 2022)
[20] See Complaint, Diep v. Apple, Inc., No. 8:21-cv-02359-CBD (D. Md. September 16, 2021)
[21] Fabian v. LeMahieu, No. 19-CV-00054-YGR, 2019 WL 4918431, at *12 (N.D. Cal. Oct. 4, 2019)

Recently, a federal judge greenlit the first-ever criminal prosecution against an unnamed individual accused of transmitting more than $10 million worth of bitcoin to a virtual currency exchange located in a sanctioned country in violation of the International Emergency Economic Powers Act (IEEPA) and with the intent to defraud the United States.[22] The court ruled that the federal government can criminally prosecute individuals and entities for willful violations of the IEEPA involving virtual currencies. This ruling relied, in part, on the Office of Foreign Assets Control's (OFAC) recent guidance concerning sanctions compliance for virtual currency.[23] Beyond providing that "OFAC sanctions compliance obligations apply equally to transactions involving virtual currencies and those involving traditional fiat currencies," OFAC's guidelines also provide a number of best practices for the virtual currency industry to comply with OFAC's regulations.[24]

As traditional financial institutions begin dipping their toes into the digital asset marketplace, they should keep in mind the risk of costly litigation. Institutions relying on third-party vendors to provide or support digital asset services should perform appropriate diligence to make sure that vendors are able to protect assets from potential theft and are otherwise desirable contracting partners. Banks and credit unions should also consider whether their current insurance policies would cover losses resulting from the provision of digital asset services and, if not, whether steps can be taken to address such risk through different policies or endorsements. If solutions are unattainable, are best practices being implemented?

Conclusion

As banks welcome digital assets, new vulnerabilities present themselves. Banks are operating in an environment that includes heightened compliance, regulatory and transactional risk. Although banking institutions have fared well in controlling financial risk, market risk and liquidity, evolving operational risk has proven to be a challenge.

Digital assets remain uncharted territory, posing new threats to banks that even the federal government has yet to determine how to regulate. As such, banks should be thinking about potential new exposures and the impact to their institution.

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Please contact your local insurance agent or broker for assistance.

[22] See In re: Criminal Complaint, Case No. 22-mj-067-ZMF (D.D.C. May 13, 2022), https://www.dcd.uscourts.gov/sites/dcd/files/22mj00067CriminalOpinion.pdf
[23] Sanctions Compliance Guidance for the Virtual Currency Industry, Office of Foreign Assets Control, Oct. 2021, https://home.treasury.gov/system/files/126/virtual_currency_guidance_brochure.pdf
[24] Id. at p. 1 and 10