KPMG

Assessing crypto and digital asset risks

Actions amidst evolving regulation

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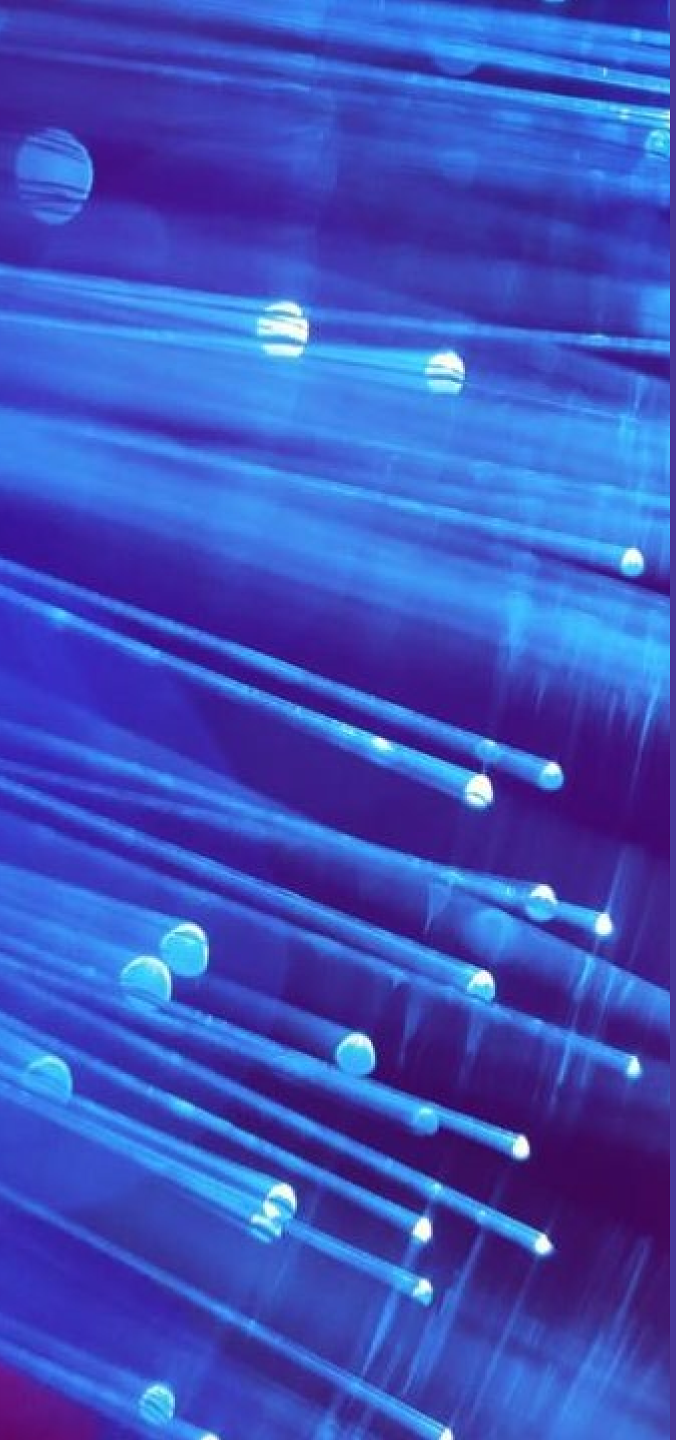

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What's new:

Portions of this paper, highlighted by [flag], have been revised to reflect new regulatory updates. We will continue to iterate and provide updates to the information as regulatory developments occur.

Introduction

"The market for digital assets has evolved significantly over the past few years, expanding to a market capitalization of more than $3 trillion[1] and introducing new assets and technologies, offering several benefits and opportunities, and attracting the global attention of individual investors, financial institutions, central banks, regulators, and legislators."

[1] Executive Order on Ensuring Responsible Development of Digital Assets, March 9, 2022

Digital assets and their underlying technology offer many potential benefits, including:

— Near instantaneous transaction speed, efficiency, and certainty, without geographic limitations

— Automation through smart contracts

— Simplified compliance and enhanced security

— Greater liquidity for assets

— "Democratization" of markets and financial inclusion

The opportunities and potential benefits of digital assets have led to the formation of additional market participants that facilitate the use, trading, and functionality of digital assets, such as dealers, secondary market exchanges, custodians, wallet providers, and repositories, adding further complexity to the digital assets marketplace for regulators to consider.

However, due to the decentralization of the digital asset market, varying product structures, and, in fact, some of the potential benefits described above, regulators have expressed concerns around key risks including:

— Cybersecurity and systems failure

— Compliance with regulatory obligations, including risk management and AML/CFT programs

— Customer due diligence (KYC)

— Accounting and financial reporting

— Tax implications

— Macroprudential economic risk and financial stability

— Resource and energy consumption

"Right now, large parts of the field of crypto are sitting astride of — not operating within — regulatory frameworks that protect investors and consumers, guard against illicit activity, ensure for financial stability, and yes, protect national security."

— SEC Chairman
(Aspen Security Forum—August 3, 2021)

Key actions to take

Digital assets and their market participants have garnered a great deal attention, most recently with the Administration's issuance of an executive order directing various agencies to adopt strategies related to digital assets. Likewise, federal regulators and legislators have similarly indicated their intention to take up policies to protect investors and consumers of digital assets.

Key actions that companies can take today include:

1. Assessing capabilities and developing risk and compliance frameworks around digital assets
2. Establishing and enhancing risk policies, procedures, and controls
3. Producing actionable and relevant information on digital assets

Key action: Capabilities

1

Develop capability assessments for digital asset product offerings and operations, as well as for risk and compliance frameworks adequate for the proper licensing, registration, issuance, and/or use of digital assets

Risk and compliance frameworks may be influenced by:

- Uncertainty regarding whether a digital asset or related product or service constitutes a security, commodity, or derivative
- Meeting individual state requirements, such as licensing under the NMLS for MSB/MTLs, and compliance requirements with the Money Transmitter Model Law, as appropriate
- Integrating the digital asset strategy into existing compliance programs
- IRS reporting requirements for digital asset transactions beginning 2023

“We need additional Congressional authorities to prevent transactions, products, and platforms from falling between regulatory cracks. We also need more resources to protect investors in this growing and volatile sector.”

— SEC Chairman
(Aspen Security Forum – August 3, 2021)

Key action: Risk framework

2

"Although we have not seen widespread evasion of our sanctions using methods such as cryptocurrency, prompt reporting of suspicious activity contributes to our national security…"

— **FinCEN Acting Director**
(Sanctions Evasion: Red Flags Alert – March 7, 2022)

Establish and enhance internal risk policies, procedures, and controls for digital assets and payments, including analyzing risk profiles, customer due diligence (KYC) operations, BSA audit programs, and AML/CFT programs

Regulators are focused on consumer and investor protections across a broad array of risks such as fraud, cyber security, data privacy, misconduct, settlement, liquidity, market integrity, market volatility, transparency, and money laundering/terrorist financing.

— MSB/MTLs will need to assess consumer and investor standards within a digital payments framework as new KYC, AML, and tax regulations and critical guidance evolve

— Digital asset exchanges, brokers, and other market participants should establish a framework for assessing whether a current or proposed offering constitutes a security or commodity under state and federal laws and take steps to avoid transacting in unregistered assets

— Internal compliance policies and procedures, specifically around the custody function, will need to be established or enhanced

— Firms should establish an ongoing dialogue with regulators, including the SEC's FinHub and the OCC's Office of Innovation, to discuss evolving digital asset services/offerings prior to launch

— Firms should evaluate their product and service offerings to determine whether they need to pursue additional licensing and registration, including with SEC, CFTC, FinCEN, IRS, and/or state regulators

— Compliance should be continuously integrated within the digital payments strategy to facilitate upfront assessment of regulatory requirements and testing of associated controls

— Risk appetite and existing risk management frameworks for new technologies and products will need to be continuously reassessed

— Ensure that digital asset ecosystem partners have adequate, functional, and appropriate (for size, volume, and risk profile) governance, compliance and AML programs, and risk management framework

Key action: Reporting

3

Produce actionable and relevant digital asset information for board and senior management reporting

Regulators expect boards to set clear, aligned, and consistent direction regarding a company's strategy and risk appetite based on information that is sufficient in scope, detail, and analysis to enable sound decision-making and consider potential risks.

Given complexity in the pace of crypto and digital asset product and market development, it is important to:

- Shape a digital asset strategy that includes clear, digestible action items, including board and senior management reporting
- Provide the board with timely, detailed information on product and market developments including identification and assessment of current and emerging risks (developments may range from cyber threats to products/services to talent management)
- Maintain current, relevant training opportunities for board members and staff
- Establish a new products committee and associated processes for digital asset activities

"The Administration will continue work across agencies and with Congress to establish policies that guard against risks and guide responsible innovation, with our allies and partners to develop aligned international capabilities that respond to national security risks, and with the private sector to study and support technological advances in digital assets."

— Executive Order
(Fact Sheet – March 9, 2022)

Key risks

Cybersecurity for digital assets:

Given the potentially high value of digital assets and their natively technical nature, digital asset companies and their customers are prime targets for cybercriminals. Possession of these assets is based on ownership or knowledge of private keys. Since there are no intermediaries involved with the transfer of digital assets, all transactions are final and cannot be reversed. Properly securing digital assets, is typically viewed as the biggest risk that companies must address.

Compliance with regulatory obligations:

Digital asset companies have been under a considerable amount of regulatory scrutiny over the years. The SEC has challenged whether some digital assets represent unregistered securities (e.g., Bitcoin lending), and in March 2022, the SEC staff issued Staff Accounting Bulletin No. 121 (SAB 121) – see *Accounting and financial reporting*. Additionally, some states have strict compliance obligations such as those imposed under the New York Department of Financial Service's BitLicense. Companies will need to properly inventory all of their regulatory obligations to help ensure proper compliance and subsequently build out appropriate risk management framework, and AML/CFT programs.

Customer due diligence (KYC) and digital asset provenance:

Digital asset owners are identified not by names or account numbers but by cryptographic addresses that can be created at any time, by anyone, anywhere in the world. This presents a unique challenge to KYC programs. How does a crypto business determine asset provenance and build its KYC programs to ensure appropriate levels of due diligence regarding PEPs or other higher-risk clients, and to protect the company from any business with sanctioned parties or other bad actors?

Accounting and financial reporting:

The accounting for digital assets and related activities is an emerging area, and traditional digital assets such as Bitcoin and Ethereum are typically accounted for as indefinite-lived intangible assets. This means the companies carrying these assets on their balance sheet must carry them at cost, subject to an ongoing impairment evaluation. However, the FASB has recently taken up a project that may establish new accounting and reporting requirements for some digital assets (see Page 19), and the SEC staff recently issued Staff Accounting Bulletin No. 121 (SAB 121), which created accounting and reporting requirements for issuers safeguarding digital assets owned by other entities (see Page 13).

Key risks

Tax implications:

Information regarding the tax treatment of crypto remains limited, however, the Infrastructure Investment and Jobs Act of 2021 created IRS reporting requirements for cryptocurrency and other digital asset transactions beginning in 2023. Digital asset companies may face sizable tax liabilities incurred on the sale or exchange of digital assets and bear significant tax accounting burdens with respect to their holdings. Unlike fiat currencies, selling a digital asset or using it for commerce creates a taxable event.

Resource and energy consumption:

Regulators, academics, and digital asset companies themselves have acknowledged the significant amounts of energy and resources that are consumed during the digital asset "mining", or transaction verification, processes. Regulators in particular have raised concerns that digital asset companies are significant sources of GHG emissions.

Macroprudential economic risk and financial stability:

Regulators have pointed to inconsistent asset reserve standards for various digital assets, indication that some of these assets could see "runs" during times of crisis , and may not be able to reimburse investors based on inadequate reserve assets. This has caused some concern among regulators that digital asset companies and their products could present macroprudential economic risks and affect financial stability.

The U.S. regulatory landscape

(1/6)

Administration Focus

In March 2022, the Biden Administration issued an executive order[2] that seeks to ensure responsible innovation in digital assets by outlining a “whole-of-government” strategy, prioritizing the protection of consumers, financial stability, national security, and address climate risks. The order focused on policies and initiatives across key areas (listed below) related to digital assets and called on agencies and regulators to take concretes steps to focus on these priorities.

— Consumer and investor protection, including oversight and safeguards

— Financial stability, economic risks, and regulatory gaps

— Illicit finance, including U.S. government and international coordination

— U.S. leadership in the global financial system and economic competitiveness

— Responsible innovation and financial inclusion

— Technological infrastructure and capacities needed for a U.S. CBDC

A table of select reports and directives follows.

[2] Executive Order 14067, *Ensuring Responsible Development of Digital Assets*, March 9, 2022

“When new technologies enable new activities, products, and services, financial regulations need to adjust. But, that process should be guided by the risks associated with the services provided to households and businesses, not the underlying technology.”

— **Treasury Secretary**
(Remarks at American University – April 7, 2022)

The U.S. regulatory landscape (2/6)

Select reports and directives included in Executive Order 14067: *Ensuring Responsible Development of Digital Assets*

<table>
<tr><th></th><th>SEC</th><th>CFTC</th><th>FRB</th><th>FDIC</th><th>OCC</th><th>CFPB</th><th>Treasury</th><th>FSOC</th></tr>
<tr><td>Directives from Executive Order</td><td>Joint report on digital asset and payment sector development and implications for investor and business protections, and equitable economic growth</td><td>Joint report on digital asset and payment sector development and implications for investor and business protections, and equitable economic growth</td><td>Continue research and report on CBDC efficiencies, necessary and optimal infrastructure, and develop a strategic plan for adoption
———
Assess the need for authorizing legislation for CBDCs; draft legislative proposal
———
Joint report on digital asset and payment sector development and implications for consumer, investor, and business protections, and equitable economic growth</td><td>Joint report on digital asset and payment sector development and implications for consumer, investor, and business protections, and equitable economic growth</td><td>Joint report on digital asset and payment sector development and implications for consumer, investor, and business protections, and equitable economic growth</td><td>Joint report on digital asset and payment sector development and implications for consumer and business protections, and equitable economic growth

Consider impacts on competition policies and privacy measures</td><td>Report on:
— Future of money and payment systems, including CBDC adoption and implications
— Digital asset and payment sector development, and implications for consumer, investor, and business protections, and equitable economic growth (Joint report)
— Connections between distributed ledger technology and economic and energy transitions over time (with DOE, EPA, and others)

Develop a coordinated action plan for mitigating illicit finance risks related to digital assets (with DOS, DOJ, DOC, DHS, OMB, and DNI)</td><td>Report outlining the specific financial stability risks and regulatory gaps posed by digital assets</td></tr>
<tr><td rowspan="2">Due Date(s)</td><td colspan="6">Joint report due in 180 days</td><td>All reports due in 180 days</td><td rowspan="2">Report due in 210 days</td></tr>
<tr><td colspan="2"></td><td>CBDC authorizing legislation assessment due in 180 day; proposal due in 210 days</td><td></td><td></td><td></td><td>Illicit finance mitigation action plan due in 120 days</td></tr>
</table>

The SEC is exploring which digital assets constitute securities, and the appropriate rulemakings and regulations of market participants who transact with them. SEC regulation would subject these assets and entities to federal securities laws, including licensing, registration, and disclosures mandates. The SEC's stated priorities in regulating digital assets are to protect investors against price manipulation, fraudulent issuances, scams, asset theft, and other potential abuses.

Likewise, the SEC announced in May 2022 that it has nearly **doubled** the examination staff of it's Crypto Assets and Cyber Unit.

In March 2022, the SEC staff issued Staff Accounting Bulletin No. 121. The SAB requires issuers who safeguard digital assets for their customers to recognize a safeguarding obligation liability, and related asset, and to disclose certain information about the digital assets that they safeguard. The SAB reflects the Staff's view that these arrangements involve unique risks from arrangements to safeguard other assets, including:

- Technological risks
- Legal risks
- Regulatory risks

The U.S. regulatory landscape (3/6)

Digital Asset Market Regulation

SEC. As early as 2017, the SEC asserted that, depending on the characteristics and use of a cryptocurrency, they may constitute securities, and therefore their offer and sale could fall within the jurisdiction of the SEC. In April 2019, the SEC released a framework for analyzing whether a digital asset is a security under federal securities law. Traditionally, financial assets have been determined to be securities subject to SEC regulation, through one of two tests:

Howey Test

An investment is a security if it is a contract, transaction, or scheme whereby a person invests their money in an enterprise and is led to expect profits solely from the efforts of the issuer or a third party

Reves Test

Promissory notes are "presumed" to be securities but can be deemed otherwise in certain circumstances. Courts typically examine the motivation and purpose for the transaction, issuance and distribution plans, reasonable investor expectations, and any applicable regulatory frameworks that could reduce the risk of the instrument

In May 2022, the SEC Chair stated, "My predecessor Jay Clayton said it, and I will reiterate it: Without prejudging any one token, most crypto tokens are investment contracts under the Supreme Court's Howey Test. If a swap is based upon a crypto asset that is a security, then that is a security-based swap. Thus, our rules apply to them. Any offer or sale to retail participants must be registered under the Securities Act of 1933 and effected on a national securities exchange." While the SEC has indicated that while many digital assets are considered securities, some, such as Bitcoin, do not appear to be securities, but rather commodities.

The U.S. regulatory landscape (4/6)

CFTC. The CFTC released a "primer" in August 2021 outlining the following considerations that clarify its authority around digital assets:

Regulatory Authorities

CFTC does not have regulatory authority over commodities, spot or cash markets, but rather regulates the commodities derivatives (futures, swaps, etc.) markets, therefore CFTC currently only regulates the derivatives markets for digital assets (such as futures contracts on Bitcoin and Ether listed for trading on CFTC-regulated exchanges)

If digital assets are considered securities, they are the sole regulatory jurisdiction of the SEC, however CFTC does regulate derivatives on securities, and further analysis would be required to determine regulatory authority over derivatives on digital assets that are securities

Enforcement Authorities

CFTC has enforcement authority over products that it regulates, therefore trading platforms offering derivatives on digital assets to U.S. investors must register and comply with CFTC trading rules

CFTC's enforcement authority includes broader applications to enforce anti-manipulation and anti-fraud authority with respect to commodities underlying the derivatives, and it has utilized this enforcement authority aggressively

In February 2022, the CFTC Chair, in testimony before the Senate Committee on Agriculture, Nutrition, & Forestry, recommended that Congress consider additional CFTC authority, beyond currently enforcement authorities, to regulate certain [limited] commodity spot markets for digital assets. The CFTC suggested this additional authority would enable the CFTC to fill a gap and regulate some of the underlying digital assets that do not currently fall within CFTC's derivatives jurisdiction, or the SEC's securities jurisdiction.

To date in 2022, several bills have been introduced in Congress that, if passed, would authorize the CFTC to register and regulate trading venues that offer spot or cash digital commodity markets.

"In the absence of clear direction from Congress, which I know they're working on, it's our responsibility to work together and to come up with solutions to the extent that we're able to within the authority that we currently have."

— CFTC Chairman
(Bloomberg Interview — May 9, 2022)

The U.S. regulatory landscape (5/6)

Banking Institutions and Digital Assets

Regulatory Actions & Expectations

Interagency Efforts

OCC, FDIC, FRB: Conducted a series of "policy sprints" focused on 1) Developing terminology, 2) Identifying and assessing key risks, and 3) Analyzing the existing regulatory framework around digital assets. These sprints provided a roadmap for potential regulatory rulemakings in 2022 that would allow for banks to engage in certain digital asset activities upon supervisory non-objection, including:

- Digital asset safekeeping and traditional custody services, and ancillary custody services
- Facilitation of customer purchases and sales of digital assets
- Loans collateralized by digital assets
- Issuance and distribution of stablecoins
- Activities involving holding digital assets on balance sheets

Individual Agency Efforts

OCC: Issued several interpretive letters since 2020 addressing whether it is permissible for banks to engage in cryptocurrency, distributed ledger, and stablecoin activities. In general, these letters have concluded that banks:

- May provide cryptocurrency custody services for their customers. The OCC concluded that these services, which include "holding the unique cryptographic keys associated with cryptocurrency," are a permissible modern form of traditional bank activities
- May hold deposits serving as reserves backing stablecoins on a 1:1 basis by single fiat currency and held in hosted digital wallets
- May act as nodes on an independent node verification network (blockchain) to facilitate and verify customers' transactions and payments
- May engage in all of these activities upon submission and written non-objection from their supervisory office, and in a safe and sound manner

In April 2022 remarks, outlined three policy considerations related to the architecture of a U.S. stablecoin system, including stability, interoperability, and separability.

FDIC: Indicated that evaluating digital asset risks is a key priority in 2022 and intends to provide robust guidance on the management of prudential and consumer protection risks to help FDIC-supervised banks conduct associated activities in a safe and sound manner.

In April 2022, directed supervised entities to notify the agency of current or planned crypto or digital asset activities.

In May 2022, finalized processes for addressing misrepresentations of FDIC insurance coverage, to reduce confusion related to accounts with nonbank crypto and fintech firms.

FRB: Has not made statements regarding the OCC interpretive letters but has issued both objections and non-objections in the process outlined in the OCC letters.

CFPB: In May 2022, issued a Consumer Financial Protection Circular to other agencies that enforce consumer financial protection laws noting that the misrepresentation of FDIC insurance may be considered a "deceptive" practice under UDAAP.

The U.S. regulatory landscape (6/6)

State Regulatory Authorities. Similar to the fragmentation at the federal regulatory level, there is no consistent state regulatory approach to digital assets or market participants. Those states that have addressed digital assets have taken varied approaches, from requiring licensing and registration (such as New York), to granting bank-like digital asset charters (such as Wyoming or Nebraska), to not explicitly requiring state licensing and registration (such as Colorado). In addition to these initiatives, many more states are discussing potential legislation or regulation around digital assets, market participants, and even mining and validation (staking) activities.

One notable example is New York State's consideration of bills which would:

- Establish a moratorium on certain cryptocurrency mining operations, and subject them to comprehensive environmental impact statement reviews
- Expand NYDFS' budget to develop and execute "assessments" of cryptocurrency companies, in line with traditional assessments of banks and other FS firms

> *"It's important to have a full encompassing conversation about prudential risks, banking risks, clearing and settlement risks, but we really also need to have a conversation about market regulation and the exchange, the purchase and sale, of these coins in a regulatory structure for both the securities and the commodities."*
>
> — **CFTC Chairman**
> (Nomination Testimony – October 27, 2021)

Regulatory events timeline

- Federal Market Regulators & Enforcement
- Standards Setters
- Federal Banking Regulators
- Executive Order

Mar 2019 | Sep 2019 | Mar 2020 | Sep 2020 | Mar 2021 | Sep 2021 | Mar 2022

SEC releases framework to determine whether digital assets are securities (Apr. 2019)

FATF issues Virtual Asset Guidance (Jun. 2019)

BCBS releases discussion paper on regulatory treatment of digital assets (Dec. 2019)

OCC crypto custody services interpretive letter (Jul. 2020)

OCC stablecoin reserves interpretive letter (Sep. 2020)

FinCEN proposes changes to BSA "Travel Rule" requirements (Oct. 2020)

DOJ releases Cryptocurrency Enforcement Network (Oct. 2020)

FSB published a report on the benefits and risks of "global" stablecoins (Oct. 2020)

OCC stablecoin facilitation and verification interpretive letter (Jan. 2021)

FinCEN proposes a rule on un-hosted digital wallets (Jan. 2021)

BCBS published a preliminary proposal on the prudential treatment of banks' digital asset exposures (Jun. 2021)

CFTC releases "primer" on authorities around digital assets (Aug. 2021)

Presidential Working Group report on Stablecoins (Nov. 2021)

SEC statement on DeFi risks, regulations, and opportunities (Nov. 2021)

FRB, FDIC, and OCC joint statement on interagency policy (Nov. 2021)

FATF updates Virtual Asset Guidance (Nov. 2021)

Federal Reserve CBDC Whitepaper (Jan. 2022)

CFTC Chair recommends additional authorities to regulate digital asset spot markets (Feb. 2022)

White House issues an Executive Order on Digital Assets (Mar. 2022)

FinCEN provided financial institutions with red flags on potential sanctions evasion attempts using digital assets (Mar. 2022)

SEC Staff Accounting Bulletin No. 121 creates new accounting and disclosure requirements for issuers safeguarding digital assets for others (Mar. 2022)

FDIC directs supervised entities to notify of current/planned digital asset activities (Apr. 2022)

FASB initiates digital asset accounting project on technical agenda (May 2022)

Source: KPMG Regulatory Insights, *Assessing crypto and digital asset risks | Actions amidst evolving regulation*, May 2022

International regulatory attention

On a global level, there is similarly no consistent or coordinated approach to digital asset regulation and enforcement. This is particularly significant given the cross-border payment abilities of most digital assets and the decentralized validation of those transactions.

Financial Action Task Force

In June 2019 the FATF issued guidance to assist national authorities in developing regulatory and supervisory guidance on digital asset activities, and to help digital asset service providers understand their AML/CFT obligations.

FATF released clarifications and updates to this guidance in November 2021, notably addressing definitions, stablecoins, and additional tools to address AML/CFT risks.

Basel Committee on Banking Supervision

In 2019, the BCBS published a discussion paper on the prudential regulatory treatment of digital assets, including their features and risk characteristics, and general principles and considerations to guide the design of prudential treatment of bank's exposures to digital assets.

Building on this discussion paper, in 2021 BCBS released a consultative document outlining:

- Recommendations for the prudential treatment of digital assets
- Guidance for supervisory review
- Approaches for determining minimum risk-based capital requirements for various types of digital assets.

Financial Stability Board

In 2020, the FSB released a report discussing the benefits of "global stablecoin" arrangements (GSCs), namely efficiencies in payments and validations, but also warned of risks to financial stability, particularly if adopted at a multi-jurisdictional (global) scale. To promote coordinated and effective regulation, supervision, and oversight of GSCs, both at the domestic and global level, the FSB outlines the following 10 high-level recommendations for pertinent regulatory and supervisory authorities:

- Have and utilize the necessary powers, tools, and resources, to comprehensively regulate, supervise, and oversee GSCs and associated functions and activities, and enforce relevant laws and regulations effectively
- Apply comprehensive regulatory, supervisory and oversight requirements and relevant international standards to GSCs on a functional basis and proportionate to their risks
- Cooperate and coordinate with each other, both domestically and internationally, to foster efficient and effective communication and consultation to support each other in fulfilling respective mandates and to ensure comprehensive regulation, supervision, and oversight of GSCs across borders and sectors
- Ensure that GSCs have in place:
  - A comprehensive governance framework with a clear allocation of accountability for the functions and activities within the GSC
  - Effective risk management frameworks, especially regarding reserve management, operational resilience, cyber security safeguards and AML/CFT measures
  - Robust systems for collecting, storing, and safeguarding data
  - Appropriate recovery and resolution plans
  - Programs providing users and stakeholders with comprehensive, transparent information necessary to understand the functioning of the GSC, including its stabilization mechanism
  - Disclosures providing legal clarity to users on the nature and enforceability of any redemption rights and the process for redemption
  - Compliance with all applicable jurisdictional requirements before commencing any operations in that jurisdiction, and adapt to new regulatory requirements as necessary

Other considerations

Agency/Body	Subject	Actions/Expectations
Financial Accounting Standards Board/ International Accounting Standards Boards	Accounting and reporting for digital assets	In May 2022, the FASB added a project on the accounting and reporting for digital assets to its technical agenda. The project is expected to focus on whether to require or permit ongoing fair value measurement for digital assets with specified characteristics. Key decisions about the project's scope and new accounting/disclosure requirements have not yet been made or substantively discussed; those will be made at future Board meetings (timeline uncertain). In April 2022, the IASB decided not to add a project on the accounting and reporting for digital assets and related activities to its technical agenda; The IASB staff memo suggested that a project "would be complex and maybe premature, given [that] such crypto-assets and liabilities are part of a new and rapidly evolving ecosystem." Depending on the direction the FASB project takes, these decisions of the two Boards may increase or decrease accounting and reporting differences between U.S. GAAP and IFRS Standards related to digital assets.
Department of Justice Cyber Digital Task Force	Cryptocurrency Enforcement Framework	In October 2020, the task force released a Cryptocurrency Enforcement Framework, outlining three primary categories of illicit uses of digital assets: — Financial transactions associated with the commission of crimes, such as ransoms, blackmail, extortion, or terrorism — Money laundering; operating unlicensed, unregistered, or non-compliant exchanges; or generally shielding activities from taxes, reporting, and disclosures — Direct crimes, such as theft, fraud, or hacking that take place in the digital asset marketplace The report states that interagency collaboration on enforcement is critical, but that sufficient legal and regulatory authorities exist to enforce against illicit uses of digital assets.
Financial Crimes Enforcement Network	BSA	In general, individuals or entities that offer money transmitting services involving digital assets, such as issuers, broker dealers, and exchanges, are considered MSBs under the BSA and are subject to AML and CFT regulations, registration and licensing (MTLs), and reporting requirements overseen by FinCEN, as well as licensing, registration, and disclosures requirements overseen by either SEC or CFTC, or both.

Other considerations

Agency	Subject	Actions/ Expectations
Financial Crimes Enforcement Network	BSA (continued)	Typically, enforcement actions under BSA, both regulatory and criminal, brought by the DOJ, SEC, CFTC, FRB, FDIC, OCC, and/or FinCEN, have focused on licensing and registration failures, but have also prosecuted failures to maintain adequate compliance and AML programs or file suspicious activity reports (SARs). To avoid these enforcement actions, it is important for MSBs to maintain adequate compliance and AML/CFT programs, which include proper governance structures, training, and customer due diligence (KYC) programs. One of the most critical and complex functions for AML/CFT programs is customer due diligence, and FinCEN has noted that even if a business is owned and operated internationally, they are subject to BSA regulations if they have U.S.-based customers, which can be particularly challenging if customers are using VPNs to hide their physical locations.
	"Travel Rule" Reporting Proposal	The "travel rule" under the BSA dictates that information travels with a transaction, and that MSBs need to be aware of the unique identifying information of each counterparty for reporting purposes. The travel rule is being reviewed by many agencies considering the evolution of digital assets, both internationally at FATF, and domestically at IRS for tax purposes and OCC for regulatory and enforcement purposes. In 2020, FinCEN proposed that BSA reporting under the travel rule be expanded by: — Reducing the reporting threshold for transactions from $3,000 to $250 — Applying to international transactions — Explicitly applying to digital asset transactions
	Proposed Rule on "Un-hosted" Digital Wallets	In 2020, FinCEN proposed a rule on un-hosted virtual currency wallets (not provided by financial institutions) that would require money services businesses to report transactions with value greater than $10,000 to FinCEN, like current reporting on traditional currency transactions. The report would comprise the unique identifiers of the transaction, including names and physical addresses of the counterparties, as well as the amount, type, and assessed value of the digital asset(s) being exchanged.
	Sanctions Evasion and Digital Assets	In March 2022, FinCEN issued an alert advising financial institutions to be vigilant against attempts to circumvent recently imposed OFAC sanctions and other restrictions. The alert outlined certain "red flags" to assist in identifying potential sanctions evasion activity through several different channels, including the U.S. financial system, convertible virtual currency (CVC) transactions, and cybercrime, as well as BSA reporting obligations, specifically with respect to CVC. Similarly, in April 2022, OFAC clarified that sanctions apply to transactions in virtual currency and cautioned that certain exchanges may permit illicit transactions.

Appendix: What are digital assets?

Broadly defined, digital assets are units of account in which cryptography and open-source software are used to regulate the generation and distribution of units, which get tracked on a public ledger, known as a blockchain. Several different types of digital assets and their purposes and uses are listed below, with deeper dives into the regulatory considerations on stablecoins and CBDCs on the following pages:

Cryptoassets

Assets native to Layer 1 public blockchain protocols, which are used to drive network incentives, process transactions, and maintain security

Utility Tokens

Tokens issued on top of public blockchains used for governance and to access features within middleware and decentralized applications

Security Tokens

Security tokens issued through an initial coin offering (ICO) where tokens represent ownership interest in the underlying security instrument

Stablecoins

Asset-backed tokens issued on public and private blockchains that attempt to maintain stable value relative to underlying stable assets (e.g. fiat currencies or precious metals) by using algorithmic processes or offering par redemptions and backing with reserve assets

CBDCs

Digital currency issued by a central bank in wholesale or retail models, many of which utilize permissioned blockchain or distributed ledger technology (DLT)

Appendix: Stablecoins

Stablecoins are digital assets that are created or "minted" in exchange for another underlying asset, such as fiat currencies or other digital assets, that the issuer receives from a user or third-party. To maintain stable value relative to the underlying asset, many stablecoins offer par redemptions and are backed by reserve assets. Due to their structure, stablecoins attempt to capture the advantages of stable value that are typical of fiat currencies, and offer the benefits of digital assets, including speed, efficiency, certainty, automation, and simplified compliance and enhanced security. Further, stablecoins may generally promote financial inclusion in the United States and could potentially be used as a widespread means of payment. However, there are currently no standards for reporting or for "reserve assets" tied to stablecoins, and both types of requirements vary widely by asset. Similarly, there is a lack of consistent supervisory or regulatory structure given the variation in products and features.

The President's Working Group on Financial Markets, consisting of representatives from Treasury, FRB, SEC, and CFTC, and in collaboration with the FDIC and OCC, released a report on stablecoins in November 2021. The report's analysis is limited to "payment stablecoins." The report suggests that the use of stablecoins as a means of payment raises a range of prudential concerns and presents recommendations to address them, through both Congressional action and risk mitigation measures utilizing existing regulatory frameworks.

The report affirms that stablecoins are not currently subject to consistent regulatory standards or supervisory frameworks, and therefore present significant risks related to losses of value and asset runs, payment systems, systemic and financial stability risks, and concentrations of economic power. As we discuss, due to their varying structures and participants, they occupy multiple jurisdictions, including SEC and CFTC as market regulators, but also the FRB, OCC, FDIC, DOJ, FinCEN, FTC, and CFPB.

The Treasury Secretary, in testimony to the Senate Banking Committee, reiterated the numerous risks presented by stablecoins, and said it would be "appropriate" for Congress to enact legislation swiftly to address these risks and provide an appropriate regulatory framework to these rapidly growing products.

***The PWG report recommends*:**

— Congress enact legislation to ensure that payment stablecoins and associated arrangements are subject to a consistent and comprehensive federal regulatory framework, which would include:
  — Establishing an appropriate federal prudential framework
  — Limiting stablecoin issuance, redemption, and reserve asset maintenance to insured depository institutions
  — Requiring federal oversight of custodial wallet providers
  — Providing regulators flexibility to address future developments and risks

— Regulatory agencies, in the interim, use their existing authorities to address the prudential risks to the extent possible. This would include:
  — Coordination and collaboration between agencies and regulators
  — Consideration by the FSOC to designate certain stablecoin arrangements as "Systemically Important Payments, Clearing, or Settlement (PCS) Activities"

Appendix: Central Bank Digital Currencies

CBDCs, like stablecoins and other decentralized digital assets, are created in an encrypted data string. They are, however, created by central banks such as the FRB and issued within the central bank's current digital banking network and payment systems. In January 2022, the FRB released a discussion paper on the potential for a U.S. CBDC, which they defined as "a digital liability of the central bank that is widely available to the public", or more simply, a digital form of money.

Like stablecoins, CBDCs have many of the advantages of digital assets such as speed, certainty, and automation, but also enable users to make payments with risk-free assets. CBDCs also have some key advantages over other payment methods, such as not requiring deposit insurance (an advantage of commercial bank money), not having credit or liquidity risk (an advantage over non-bank money), and not deriving their value from another asset (an advantage over stablecoins).

The FRB's paper outlines numerous anticipated benefits that CBDCs could provide, including:

- Acting as a new foundation for the payment system, and a bridge between different payment systems, both legacy and new
- Maintaining centrality of safe and trusted central bank money in a rapidly digitizing economy
- Providing public access to risk-free, digital money, and acting as foundation for private-sector payment systems innovations and competition
- Streamlining cross-border payments by using new technologies, introducing simplified distribution channels, and creating opportunities for cross-jurisdictional collaborations and interoperability
- Supporting the international role of the U.S. dollar in payments and investments, and as the world's reserve currency
- Promoting financial inclusion for economically vulnerable populations

The paper, however, also notes several risks and policy considerations around a potential issuance that the FRB suggests would require further analysis:

- Changes to market structure and investor preferences
- Safety and stability of the financial system, particularly in times of stress
- Efficacy of monetary policy implementation and interest rate controls
- Privacy and data protection and financial crime prevention
- Operational resilience and cybersecurity

Appendix: Abbreviations & Acronyms

AML	Anti-Money Laundering	**FATF**	Financial Action Task Force	**KYC**	Know Your Customer
BCBS	Basel Committee on Banking Supervision	**FDIC**	Federal Deposit Insurance Corporation	**MSB**	Money services business, as defined under the BSA
BSA	Bank Secrecy Act	**FinCEN**	Financial Crimes Enforcement Network within Department of Treasury	**MTL**	Money transmitter license, as defined under the BSA
CBDC	Central bank digital currency	**FRB**	Federal Reserve Board	**NMLS**	Nationwide Multistate Licensing System & Registry
CFPB	Consumer Financial Protection Bureau	**FSB**	Financial Stability Board	**OCC**	Office of the Comptroller of the Currency
CFT	Countering the Financing of Terrorism	**FSOC**	Financial Stability Oversight Council	**OFAC**	Office of Foreign Asset Control within Department of Treasury
CFTC	Commodity Futures Trading Commission	**FTC**	Federal Trade Commission	**PEP**	Politically exposed person
DOJ	Department of Justice	**IASB**	International Accounting Standards Board	**SEC**	Securities and Exchange Commission
FASB	Financial Accounting Standards Board	**IRS**	Internal Revenue Service	**VPN**	Virtual private network

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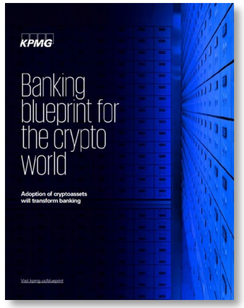

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