Avanti Financial Group, Inc.
Cheyenne, WY 82003

July 12, 2021

via agency website and electronic mail

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. OP-1747

Re: Proposed Guidelines for Evaluating Account and Services Requests

Ladies and Gentlemen:

Avanti Financial Group, Inc. ("Avanti") welcomes the opportunity to submit this comment letter for consideration by the Board of Governors (the "Board") of the Federal Reserve System (the "Federal Reserve") with respect to the proposed guidelines (the "Guidelines") for the evaluation of account access and services requests.

Avanti urges the Board to finalize the Guidelines swiftly so that the applications of qualified applicants pending since last year are resolved quickly.[1] Multiple Federal Reserve officials have recently noted the potential build-up of systemic risks arising from the digital asset industry that stem from status quo regulatory arrangements (especially regarding stablecoins).[2] Avanti agrees there is a regulatory void due to unclear laws, rules, and regulations in respect of digital assets generally. The digital asset industry is the most globally mobile financial sector in history, its financial instruments settle far faster than most traditional financial institutions are set

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[1] Avanti generally supports the principles of clarity and predictability for obtaining Federal Reserve payment system access that are implied by the Guidelines. Avanti declines to provide legal comments on the Guidelines at this time, and nothing herein should be construed as such.

[2] *See, inter alia,* comments by Federal Reserve Chair Jerome Powell here: (https://www.federalreserve.gov/newsevents/pressreleases/other20210520b.htm) and comments by Federal Reserve Bank of Boston President Eric Rosengren here: https://www.bostonfed.org/news-and-events/speeches/2021/official-monetary-and-financial-institutions-forum-fed-week-financial-stability-session.aspx;

up to process and settle their books, and it has exhibited a clear preference for U.S. dollars when intermediaries transact with fiat currency systems globally. Taken together, these characteristics mean the digital asset industry's interactions with traditional U.S. dollar intermediaries pose unique risks and regulatory challenges to U.S. payment system regulators, some of which have not yet manifested. The tail-risk scenarios to payment systems are reasonably foreseeable,[3] capable of being properly managed, and should be monitored. Moreover, the status quo separation of U.S. dollar banking from digital asset servicing *creates* risks both to the banks and non-banks involved, which would not exist but for the required separation of the activities between banks and non-banks.[4]

By swiftly adopting the final Guidelines and approving qualified applicants, the Board can address these risks by opening a regulatory-compliant path to bring U.S. dollar banking and digital asset servicing together within a depository institution that is wholly within the Federal Reserve's purview and supervision, and subject to bank-level capital requirements, laws, rules, regulations and related payment system access requirements (i.e., approved payment system integration methods), as well as special provisions to protect the payment system from risks that are unique to its interaction with digital assets. Such a regulatory-compliant path for bringing together U.S. dollar banking and digital asset servicing within a depository institution has not yet been approved by the Federal Reserve. Avanti believes that well-managed, well-capitalized and compliance-oriented digital asset companies would pursue it if such a path were available—thereby voluntarily subjecting themselves to conventional bank supervision instead of the generally less rigorous regulation applicable to trust companies and money transmitters. Activity would naturally migrate to such depository institutions based on the simple value propositions for customers of fewer layers of intermediaries (and therefore fewer fees) and more reliable access to U.S. dollar banking services relative to the status quo. Opening such a path would help the Federal Reserve directly monitor, supervise, manage and protect against the build-up of systemic risks generally and payment system risks specifically.

Ironically, it is often easier for unregulated companies in the digital asset industry to obtain U.S. dollars than it is for regulated, domestic companies to do so. This results from the fact that unregulated companies can obtain U.S. dollars from either (i) offshore ("eurodollar")

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[3] *See infra*, note 33 and accompanying text. A depository institution that is *properly structured* to withstand an extreme scenario poses minimal risk to the payment system.

[4] While this letter focuses on the risks to the banks resulting from the required separation of banking and digital asset servicing, there are risks faced by the non-banks as well. For example, if a consumer buys a digital asset through a service provider and pays for it via ACH, and then the consumer takes delivery of the digital asset from the service provider's custody and reverses the ACH payment, the service provider has a loss equal to the value of *both* sides of the transaction. This is one of many risk issues faced by non-banks in the digital asset industry that is caused by the fundamental mismatch in both the speed and finality of settlement between U.S. dollars and digital assets. Such risk must be properly managed by banks in order to mitigate payment system risk to the Federal Reserve.

banks or (ii) domestic non-bank intermediaries that offer multi-layered, transaction-splitting arrangements to their digital asset intermediary clients in a "rent-a-charter" structure.[5]

While Avanti generally agrees with the principle implied by the Guidelines that not all institutions without Federal Deposit Insurance Corporation ("FDIC") insurance or a federal bank supervisor should be granted payment system access, especially if they do not meet conventional bank-level capital and similar requirements, the remainder of this comment letter focuses on the following comments:

1) the Board should clarify that depository institutions eligible to apply for payment system access include state-chartered banks that are authorized by their state's law to take deposits, that accept deposits in the ordinary course of business, and that are eligible to apply for deposit insurance under the Federal Deposit Insurance Act, as interpreted by the FDIC;

2) if the Board has developed a view that certain types of banks are not facially eligible for payment system access due to a legal interpretation or policy decision, then that should be made clear;

3) the Guidelines should require the Board to take into account the robustness of the regulatory framework developed by state bank supervisors to evaluate the safety and soundness of state-chartered banking entities that are not FDIC-insured;

4) the Guidelines should set forth one or more objective parameters that an applicant institution can use to gauge its level of liquidity requirement; and

5) Avanti believes that there are significant costs to the Federal Reserve System from continuing to prohibit the digital asset industry's direct payment system access.

I. Background

Avanti is a Wyoming depository institution chartered by the Wyoming Division of Banking. Avanti's mission is to build a compliant bridge to the U.S. dollar payment system for digital assets by prioritizing oversight, transparency, and risk mitigation and providing custody

[5] Some of the non-bank entities involved in such multi-layered, transaction-splitting arrangements themselves hold U.S. state money-transmitter licenses ("MTLs"), while others hold no licenses and instead "rent" the licenses of a third-party that is licensed, such as a state-chartered trust company or a different MTL that, in turn, sources U.S. dollars from its bank(s). While state trust companies and money transmitters may be subject to infrequent examinations (or, in some cases, no examinations to date), the banks that provide U.S. dollar access to them are subject to annual bank-level examinations by bank regulators. Examination disparities are not unusual for entities involved in digital assets, for which formally-adopted rules and a supervisory examination manual exist in only one place at present (Wyoming). Because such bank-to-fintech-to-tintech "rent-a-charter" arrangements are relatively new to the digital asset industry, not all have yet been covered by their bank's annual examination and it is not clear how they will withstand bank-level supervisory examinations (especially now that such supervisory examination procedures are beginning to include procedures specific to banks that serve digital asset companies).

for digital assets by meeting the strictest levels of institutional compliance and operational standards. Avanti is a strong advocate for a fair and stable financial system. Avanti has made compliance a top priority and has made a deliberate decision to seek applicable regulatory approvals before opening. As such, Avanti supports the Federal Reserve's paramount goal of ensuring the safety and soundness of the U.S. payment system. Avanti's management team consists of people with deep experience in the "plumbing" of both the traditional and digital asset financial systems, as well as expertise in federally regulated banking institutions. This deep experience influences Avanti's comments submitted in this letter.

An example of Avanti's core philosophy regarding compliance is the team's strategy regarding payment system risk. Avanti publicly expressed the view that the proposed Basel III risk-weight of 1250% for bitcoin and other Group 2 digital assets held on-balance sheet by banks is too low because of the elevated risk to the payment system that such holdings would pose.[6] Whereas bitcoin settles (i) in minutes with (ii) irreversibility, traditional banks generally use (x) operational processes and information technology systems that were designed 40 years ago for less frequent settlement (*e.g.*, in most cases, only once a day) and (y) systems of accounting and recall that permit transactions to be withdrawn, rejected, or recalled. Consequently, a bank whose operational and IT systems are not capable of settling and reconciling on the rapid pace of digital assets could find itself accruing an intraday exposure and not detecting or understanding the exposure until reviewing its overnight reconciliation reports on the next day. If that bank happens to have an intraday overdraft in its Federal Reserve account and has exhausted its back-up liquidity, then a payment system loss would occur.[7] By contrast, Avanti's regulatory structure and operational and information technology systems are built to minimize the risk of default even in extreme circumstances and, consequently, to minimize payment system risk.

Specifically, Avanti:

(1) embraces the level of supervision and oversight the Federal Reserve should choose to apply to state-chartered, non-FDIC insured banks that have payment system access, even if that is tantamount to state member bank supervision and oversight. Additionally, Avanti plans to become a member bank as soon as practicable. Such Federal Reserve supervision and oversight would be in addition to that of the Wyoming Division of Banking;

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[6] https://www.forbes.com/sites/caitlinlong/2021/06/24/bis-proposed-capital-requirements-for-digital assets-vital-move-but-theyre-too-low-for-bitcoin/?sh=19fd5cfb2546

[7] This movie has played before. Prior to the financial crisis of 2008, underwriting and investing in so-called "CDO^2" were *de rigueur* for most large banks. Due to the enormous computational requirements of the correlation risks associated with these transactions, most bank models were at least 24 hours behind (and in many cases 48 or more hours behind) in determining the banks' true exposure to any given CDO^2. When markets corrected, banks did not know how deep the hole was for 24 hours or more. The same could be true for banks trading digital assets, owing to the mismatch in bank reconciliation cycles and digital asset settlement cycles, which could find themselves underwater without even knowing so until the next day.

(2) will use no leverage because it will hold 100% reserves against customer deposit liabilities, nor will it rehypothecate digital assets held in custody (which is prohibited by Wyoming law);[8]

(3) will hold digital assets in its own charter;[9]

(4) will take no credit or interest rate risk in its investments, as detailed in its business plan;[10]

(5) will settle transactions second or simultaneously instead of settling first and thereby avoid "back door" leverage caused by a counterparty failing to deliver after the bank has already met its obligations on a transaction;

(6) will permit no collateral substitution or commingling; and

(7) has designed IT and operational processes to handle the fast settlement with irreversibility characteristics of digital assets, complete with minute-by-minute risk monitoring and active reconciliation processes.

These characteristics are integral to Avanti's business model and the prerequisites generally for bank participation in digital asset activities in a safe and sound manner. Any bank, whether it is a specialized charter with a business plan focused on digital assets, or a more diversified, traditional bank that operates a ringfenced entity to mimic a specialized charter, should embrace these characteristics to ensure that digital asset risks do not infect the banking system or the Federal Reserve's payment system.

These concepts are also integral to the laws and regulations underpinning Wyoming's Special Purpose Depository Institution ("SPDI") charter and oversight regime, which Avanti believes sets the high bar for federal and state treatment of depository institutions that wish to enable digital asset services for their customers.

Specifically, the framework in Wyoming was methodically developed over a nearly four-year period and involved the input of multiple stakeholders at both the state and federal level (including by the Federal Reserve itself, since 2018). Wyoming SPDIs were constructed to, among other things, comply with federal prudential capital requirements,

[8] In principle, hypothecation of digital assets held in custody is acceptable as long as the trust customer directs the bank to lend its digital assets held in the bank's custody, but the bank would permit no greater than 1:1 leverage.
[9] To achieve the same level of "ringfencing" of digital asset risk to the payment system that Avanti will have, a diversified institution would need to hold digital assets in a bankruptcy-remote entity, isolating them from the estate of the diversified institution in the event of its insolvency.
[10] Fee-based business models, such as that proposed by Avanti, are prevalent and have proven successful in the digital asset industry due to high transaction volume.

ringfence customer assets, avoid the risks associated with maturity transformation and credit risk, ensure commercial law certainty for digital asset transactions, and uphold the same high standards of BSA/AML and OFAC sanctions compliance as traditional banks, but across both fiat and digital assets. In Avanti's view, the Wyoming SPDI is the only currently available charter type in the United States capable of satisfying the Guidelines for applicants doing business in the digital asset sector. Wyoming SPDIs generally, and Avanti specifically, are tailor-made to satisfy the Guidelines and the overall goals of the Board.

Wyoming's process was methodical, as it first built the commercial law foundation (by enacting an interpretive appendix specific to digital assets to its Uniform Commercial Code) before enacting its SPDI charter for digital assets in 2019. Then, it conducted a rulemaking process that has already been through two public comment periods. For its digital asset rulemaking, Wyoming had extensive access to people on the information frontier of digital assets—including Bitcoin Core developers, CTOs of digital asset exchanges, specialist attorneys, and a consumer advocate. Next, Wyoming hired Promontory to help draft a 750-page supervisory examination manual for bank supervisors. Then, Wyoming trained its bank examiners on the specific technology considerations, security implications, and other risks associated with digital assets and has now begun to train judges in its courts using the same guidelines. Again, Avanti believes this framework sets the high bar for federal and state treatment of depository institutions that wish to enable digital asset services for their customers.

II. The Guidelines Will Improve Transparency and Predictability

The central aspect of the Guidelines that Avanti supports is the publication of transparent standards that are predictable for applicants and useful for the Reserve Banks. For a state-chartered bank like Avanti, the master account approval process should be transparent, and applicants should not receive contradictory messages from different parts of the Federal Reserve. While Avanti has some concerns with aspects of the Guidelines, including the level of discretion implied by the proposed Guidelines, Avanti understands that as a practical matter much will depend on how they are implemented. Avanti is confident that if the Guidelines are fairly applied to it, Avanti will be granted payment system access because it satisfies all of the concerns articulated in the proposed Guidelines. For this reason, the transparency, consistency and predictability that could be created by the Guidelines are a welcome development. The Federal Reserve's current practice is not transparent, consistent or predictable.

A. The First Guideline Should Clearly Define What Institutions are Facially Eligible to Apply

The first guideline requires that each institution requesting an account or services must be eligible under the Federal Reserve Act or other federal statute to maintain an account at a Federal Reserve Bank, and "should have a well-founded, clear, transparent and enforceable

legal basis for its operations." While the statutory authority pertaining to eligibility to apply is clear, the latter phrase in the Guideline adds ambiguity and is open to interpretation.

Nonetheless, a Wyoming SPDI does have a "well-founded, clear, transparent and enforceable legal basis for its operations." An SPDI is a "bank" under Wyoming law,[11] the Federal Deposit Insurance Act[12] and other federal laws.[13] Because Wyoming law explicitly authorizes an SPDI to accept deposits, it is also a "depository institution"[14] and, consequently, is eligible to apply.

Section 19 of the Federal Reserve Act defines "depository institution" as including various banking entities that are insured either by the FDIC and any of these entities that is "eligible to make an application to become" insured under section 5 of the Federal Deposit Insurance Act. The Federal Deposit Insurance Act requires that an institution be "engaged in the business of receiving deposits other than trust funds[15]" in order to make an application to become insured. In turn, the FDIC has interpreted this provision as requiring that "a depository institution . . . maintain[] one or more non-trust deposit accounts in the minimum aggregate amount of $500,000."[16] This means that an uninsured institution that accepts and holds at least $500,000 in customer deposits qualifies as a "depository institution" for purposes of obtaining a master account.[17] Because Wyoming SPDIs are authorized by statute to accept deposits, Avanti satisfies the statutory requirement under any reasonable interpretation of the law.

Granting payment system access via a master account has long been considered routine, and the Reserve Banks have historically granted access quickly as a matter of course. Recently that routine has been upended. This is despite the legislative history and longstanding interpretation of 12 U.S.C. 248a(c)(2), which *unambiguously entitles a nonmember depository institution to a master account*. In fact, in 1984, in a set of principles not unlike those which are the subject of this comment letter, the Board stated that "The Monetary Control Act of 1980 . . . has expanded the Federal Reserve's role by requiring the Federal Reserve to provide its services to all depository institutions on an equitable basis. . .".[18]

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[11] Wyo. Stat. § 13-1-101(a)(i).
[12] 12 U.S.C. § 1813(a).
[13] 12 U.S.C. § 461(b)(1). *See also* 15 U.S.C. § 78c(a)(6); 15 U.S.C. § 80a-2(c)(5); 15 U.S.C. § 80b-2(a)(2).
[14] Wyo. Stat. § 13-12-103.
[15] "Trust funds" are "funds held by an insured depository institution in a fiduciary capacity and includes, without being limited to, funds held as trustee, executor, administrator, guardian, or agent." 12 U.S.C. § 1813(p).
[16] 12 C.F.R. § 303.14.
[17] Avanti is a traditional, state-chartered depository institution which, pursuant to the laws enabling its creation and its charter, is in the business of accepting customer deposits. Fiat deposits and deposit accounts are the foundational service provided by Wyoming SPDIs and this qualifies Avanti to apply to the FDIC for insurance pursuant to Section 5 of the Federal Deposit Insurance Act. As more fully detailed in Avanti's business plan, Avanti has a well-founded, clear, transparent, and enforceable legal basis for its operations as a depository institution.
[18] *See Policies: Standards Related to Priced-Service Activities of the Federal Reserve Banks*, Bd. Of Governors of the Fed. Reserve. Sys. (1984), available at https://www.federalreserve.gov/paymentsystems/pfs_principles.htm.

We do not believe that setting forth a written standard for this facial eligibility prong removes any authority from the Federal Reserve (and in fact, may relieve it of various administrative burdens, such as responding to standard verification inquiries from a payment services company regarding new applicants for ABA routing numbers).

Avanti understands from the Board Staff Memo to the Board of Governors accompanying the proposed Guidelines that Staff is considering whether it may be useful in the future to clarify the interpretation of eligibility under the Federal Reserve Act. In the case of a Wyoming SPDI, that clarification of facial eligibility would be straightforward. A Wyoming SPDI is a depository institution under any reasonable interpretation of the Federal Reserve Act definition. Consequently, that clarification should be included with the finalization of the Guidelines. If there are other types of institutions that raise different and more complex interpretive questions of facial eligibility then Avanti understands that further guidance may be necessary. But given the clear question presented by a Wyoming SPDI and the simple nature of the legal interpretive issue in Avanti's case, there is no reason why facial eligibility should continue to be a source of delay.

If a goal of the Guidelines is indeed to "promote consistent outcomes across Reserve Banks and to facilitate equitable treatment across institutions," in Avanti's opinion, the level of discretion embedded in the first principle must be eliminated. Otherwise, the entire set of Guidelines is likely to be subsumed by the first principle. If the first principle means that only institutions regulated by federal banking agencies may obtain access to the payment systems, then the principle should plainly say that.[19] As we have communicated to the Federal Reserve, Avanti intends to become a member bank as soon as practicable, and in the meantime would welcome member bank-equivalent safety and soundness and legal compliance supervision by the Federal Reserve from our opening date.

B. The Second and Third Guidelines Should Eliminate Discretion Relating to Liquid Reserves

The second and third Guidelines pertain to credit, operational, settlement, cyber, or other risks to either the Reserve Bank or the overall payment system.

Avanti has a concern that "sufficient liquid resources to meet its obligations to the Reserve Bank under applicable agreements, operating circulars, and Board policies" could create a level of discretion that, while well-intentioned, could enable decisions to deny access to institutions that otherwise qualify for a master account. This is not a concern for Avanti, as

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[19] We note that the Guidelines also purport to permit a Reserve Bank to limit the services provided to an institution that is granted a master account. Avanti believes that, in the normal course (that is, absent an occurrence giving rise to the need for the Reserve Bank to mitigate risks), this level of discretion exceeds statutory authority and could lead to a master account approval in name only.

Avanti will operate a fully reserved, fully liquid business model. However, Avanti has a broader concern about the level of discretion this part of the Guidelines implies.

Rather than proposing a generic and discretionary requirement, Avanti believes that these guidelines should set forth one or more objective parameters that an applicant institution can use to gauge its level of liquidity requirement.

C. Fourth, Fifth, and Sixth Guidelines

Avanti has no policy comment on the fourth, fifth and sixth guidelines. We note, however, that footnote 5 of the Guidelines proposes additional conditions that the Reserve Banks could impose, such as paying a different rate of interest on the balance held in a master account, limiting the balance on which interest is paid, or imposing a cap on the balance of the account. We see no statutory authority for such differential treatment of master account holders. We also note that there are monetary policy implications to the payment of different rates across Reserve Banks and across depository institutions that hold master accounts.

II. Costs to the Federal Reserve from Continuing to Prohibit the Digital Asset Industry's Payment System Access

There has not been an open path for digital asset-native companies to gain direct access to the Federal Reserve payment system. Wyoming SPDIs were designed to provide such a path for depository institutions that specialize in digital asset servicing in a manner consistent with existing banking laws and regulations, but the Federal Reserve has not yet granted payment system access to any SPDIs. Doing so would mitigate the risks associated with traditional banks handling digital assets and would also mitigate the same risks faced by digital asset companies—in both cases caused by mismatches in the speed and finality of settlement of dollars versus digital assets, respectively.

Because digital assets are not going away, not granting direct access to the payment system to digital asset-native companies that meet conventional bank-level requirements is itself a policy decision to keep a significant portion of U.S. dollar activities in the digital asset industry outside the Federal Reserve's direct purview and supervision. The absence of action to open a direct path has pushed much of the U.S. dollar banking of the digital asset industry into the "shadow" banking system, which means risks cannot be readily monitored.

As a policy matter, Avanti sees three major costs to the Federal Reserve's current policy of inaction:

(1) it has resulted in many digital asset companies obtaining their U.S. dollars from offshore (eurodollar) banks or onshore non-banks that "rent" their own banking access to their digital asset customers, some of whom may not be licensed, thereby putting a significant

portion of U.S. dollar activity in the globally-mobile digital asset industry outside of the Federal Reserve's direct purview;

(2) it means a significant portion of the digital asset industry's U.S. dollar activities fall outside the Federal Reserve's ability to monitor the potential build-up of systemic risks, which not only has implications for regulatory supervision but also for their impact on monetary policy; and

(3) it *creates* latent risks to financial stability that are outside the direct remit of prudential regulators but would be measured and managed if they were inside—namely, the impact of a potential run on a stablecoin or of the inherent settlement risk caused by the significant structural differences in the settlement speed and irreversibility between digital assets and traditional financial instruments.

A. History of the Digital Asset Market's Access to U.S. Dollar Banking Services

The first bitcoin was mined into existence on January 3, 2009, and the first documented exchange of bitcoin for U.S. dollars happened on May 22, 2010,[20] when a 19-year old California student agreed to fulfill a request from a Florida-based Bitcoin developer who posted the following message to the Bitcointalk chat forum: "I'll pay 10,000 bitcoins for a couple of pizzas." The two people worked out a deal whereby the California student paid U.S. dollars to Papa John's in Florida for the pizza delivery to the Bitcoin developer, who in exchange sent the 10,000 bitcoins to the California student peer-to-peer. In its first years, the entire bitcoin-to-dollar market resembled this transaction: it was small in dollar-equivalent value and was peer-to-peer. The market relied on consumers to exchange dollars for bitcoin using their cash, credit cards, and traditional consumer bank accounts as the on/off ramps to exchange the bitcoin and dollars.

Not long after the bitcoin pizza transaction, the first bitcoin payment companies and exchanges were formed in the U.S. (*e.g.*, BitPay in 2011 and Coinbase in 2012, among others). From inception, obtaining and maintaining U.S. dollar banking services for digital asset start-ups became a major challenge. Indeed, uninterrupted access to U.S. dollar banking services has often been *the* determining factor for the outcome of whether a digital asset start-up survived or failed. In the U.S., a business is literally not a business unless it has a bank account due to the fact that the IRS requires businesses to remit withholding taxes electronically via their bank account.

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[20] https://www.news18.com/news/buzz/who-is-infamous-bitcoin-pizza-guy-man-who-blew-365m-haul-says-yet-had-no-regrets-3775664.html

While press reports often disparagingly refer to the "cat and mouse chase" of digital asset start-ups and bank accounts, the reality is that all digital asset start-ups have faced the same risk regardless of whether they ran legitimate businesses or were scams (or even an industry trade association, which only used dollars rather than digital assets in its operations). To this day, it remains standard risk management for digital asset companies to hold multiple bank relationships due to the history and severe consequences of being de-banked. Most other types of fintechs do not need to think about the risk of being de-banked, but all U.S. digital asset companies face this threat. Even industry giant Coinbase, which recently concluded a successful direct listing of its shares, included a risk factor disclosing the possibility of losing its banking relationships as a material risk in its 2021 S-1 filing with the SEC.[21]

The year 2017 was pivotal for U.S. policymakers regarding banking and digital asset start-ups, and the history is not pretty for either supporters or critics of the digital asset industry. A wave of compliance-driven bank account closures started in late fall 2017 involving most U.S. banks, resulting in dozens of legitimate start-ups closing their doors. Most U.S. banks started simultaneously conducting compliance reviews of their account holders in order to close the accounts of people and businesses involved with the digital asset industry. There was never an official policy pronouncement from U.S. bank regulators requiring such compliance reviews, but dozens of entrepreneurs who later testified about losing their bank accounts described conversations with their bankers about why their accounts were being closed. Some were told that the banks' regulators prompted the review. Such testimony happened during the State of Wyoming's legislative hearings in 2018. It did not seem to matter whether the businesses were legitimate or scams—most banks abandoned the digital asset industry entirely.

Only a small number of traditional banks have continuously served the industry since that time (including Silvergate and Signature), and the entrepreneurs who later testified found that these few banks were overwhelmed in late 2017 and could not open new bank accounts fast enough to save their start-ups. Indeed, the digital asset industry in the U.S. owes its current success to the willingness of these few banks to stick with it despite the higher regulatory costs they likely incurred by doing so.

In 2018 the Wyoming Blockchain Task Force heard testimony from many digital asset entrepreneurs who lost their businesses after they lost their bank accounts in late 2017. Wyoming's response was to authorize a new type of bank charter aimed at helping to solve the problem of legitimate digital asset companies retaining access to U.S. dollar banking services: the Wyoming SPDI. Although three SPDIs have been chartered, none are yet operating.

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[21] https://www.sec.gov/Archives/edgar/data/1679788/000162828021003168/coinbaseglobalincs-1.htm#i86a9d9b35e45447ea6eb369e5dcf1e6a_1274

The stablecoin segment of the digital asset industry became material in 2017 and continued to balloon even after the peak and subsequent cycle correction in bitcoin's price started in December 2017. The quantity of U.S. dollar customer funds held by stablecoin issuers ballooned from $9.9 million at the beginning of 2017 to more than $101 billion today. For comparison, PayPal held $35.6 billion of customer funds on its platform as of March 31, 2021.[22] In other words, stablecoins today are nearly three times the size of PayPal and growing much faster.

The largest stablecoin issuer is an offshore entity, accounting for $62 billion of the total, and the second-largest is a domestic entity governed by state money transmitter license ("MTL") requirements, accounting for $26 billion. In other words, non-bank stablecoin issuers have accumulated substantial customer funds in U.S. dollars, the majority of which are offshore. Stablecoin issuers are substantial entities relative to other non-bank payment platforms in the U.S. that hold customer funds and which are also not subject to bank-level regulatory requirements (such as PayPal).

This history gives important context for the following discussion of the three costs to the Federal Reserve of waiting to grant payment system access to digital asset-native companies that meet the requirements and to others that would likely follow if the Federal Reserve grants access to qualified applicants.

Cost #1. Digital Asset Companies That Cannot Obtain Dollars Directly Are Readily Obtaining Them Offshore, or from Non-Banks Onshore, Both of Which Put Such Activities Outside the Federal Reserve's Direct Purview

Digital asset companies operating lawfully in the U.S. can currently access U.S. dollar banking services from the few banks described above, as well as from a few more recent entrants. But most of the growth in U.S. dollar banking services in the digital asset industry globally in recent years has happened either offshore or via non-bank "rent-a-charter" arrangements onshore.

(i) Offshore Access to U.S. Dollar Banking by Offshore VASPs

Virtual asset service providers ("VASPs") outside the U.S. can readily gain access to U.S. dollars through offshore (eurodollar) banks. Eurodollars are U.S. dollars deposited at non-U.S. banks and therefore not directly regulated by the Federal Reserve or other onshore bank

[22] *See* PayPal Holdings, Inc. 10-Q, dated March 31, 2021, https://d18rn0p25nwr6d.cloudfront.net/CIK-0001633917/fb83a469-e9cf-4e3c-99cc-cab1ee8baa1e.pdf

regulators.[23] Onshore bank regulators indirectly have the ability to monitor the activity of eurodollar banks via their U.S. correspondent banks, but the eurodollar market is notoriously opaque and difficult to measure—an issue well-known to the Federal Reserve since it was first discussed in minutes of the Federal Open Market Committee as long ago as the early 1960s.[24] Eurodollars originated as trade flows between global non-financial businesses engaging in cross-border trade and settling in U.S. dollars, but they quickly evolved to include the intermediation of financial and investment flows. Milton Friedman famously said of eurodollars in 1969, "their major source is a bookkeeper's pen."[25] Foreign banks create these dollar balances to facilitate transactions that may never involve onshore U.S. businesses or onshore U.S. banks, and therefore would not register in traditional money supply metrics, such as M1.

In this context, it is critical to understand that digital asset markets are (i) global and (ii) transactions settle fast with finality. Digital asset markets are the most global of financial markets that have ever existed, and, aside from their on/off-ramps to fiat currencies, transactions never touch traditional payment rails and are therefore never recorded in official monetary statistics. Transactions settle fast, as digital assets change hands at the speed of light and settle within minutes (when the transactions are updated to public ledgers). There is no analog to traditional financial instruments.

It is not difficult to see how the intersection of digital assets and eurodollars can create policy challenges for the Federal Reserve—namely, offshore eurodollar banks providing U.S. dollar access to offshore VASPs outside of the Federal Reserve's direct purview, and in unlimited size. Specifically, the global nature of digital asset markets makes coordination between the patchwork of country-by-country financial regulators more challenging. But it also opens a whole new source of eurodollar demand, which poses monetary policy implications for the Federal Reserve because the digital asset market already exceeds $1.4 trillion in size[26] and the U.S. dollar stablecoin market, which is predominantly offshore, exceeds $101 billion in size and accounts for $4.6 trillion in on-chain verified payment volume (annualized) and $24.8 trillion in total reported payment volume (annualized) when including exchange-reported transactions that cannot be independently verified.[27]

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[23] As more dollarized countries enable digital asset activities (or, in the case of El Salvador, adopt bitcoin as legal tender), more U.S. dollars can enter global digital asset markets via the eurodollar pathway—presuming that correspondent banking relationships remain open to banks in such countries. Because digital asset markets are global and highly mobile, they do not distinguish whether the U.S. dollars enter them via U.S. or non-U.S. banks, and once inside such dollars continue to circulate within them as eurodollars.

[24] https://www.thelykeion.com/primer-the-eurodollar-market/

[25] https://www.newyorkfed.org/medialibrary/media/research/monthly_review/1970_pdf/01_3_70.pdf

[26] www.coinmarketcap.com as of July 11, 2021.

[27] www.coinmetrics.io for on-chain data and www.messari.io for exchange-reported volume data as of July 8, 2021.

(ii) Onshore Access to U.S. Dollar Banking by Domestic VASPs

Onshore in the U.S., there are two ways for VASPs to obtain U.S. dollar services: some VASPs can transact directly with banks, while others must use "rent-a-charter" arrangements to gain indirect access to banks via a licensed intermediary, such as a state-licensed trust company or money transmitter "renting" its license to the end-user VASP. In the latter arrangement, while the VASP itself must be registered with FinCEN,[28] it may or may not have its own MTLs. In either case, the VASP "rents" the licenses of the intermediary, and transactions may be "split" for compliance with state-by-state MTL licensing requirements. Such arrangements rely on for-the-benefit-of ("FBO") account structures, which are common in the banking industry, but as applied in this case, the structure uses an FBO on top of an FBO (specifically, the structure is VASP-to-intermediary-to-bank, using FBO accounts at both layers).

"Rent-a-charter" business models are ubiquitous in U.S. consumer loan markets, where state-licensed fintechs originate loans for banks under an agreement that the bank will purchase the loans from the fintech days later (and, therefore, the bank is the "true lender"). In such a fintech-to-bank arrangement, fintech lenders face the bank directly. Such "rent-a-charter" models in the digital asset industry differ in a material respect from those in consumer lending markets: In the VASP-to-intermediary-to-bank arrangement, the VASP is one additional step removed from the bank because the VASP uses an additional non-bank intermediary to gain its banking access. As noted previously, such non-bank intermediaries may or may not have already been subject to regulatory examination by state bank regulators.

Cost #2: None of the Digital Asset Industry's Activities Currently Fall Within the Federal Reserve's Direct Purview. This Has Implications for Regulatory Supervision and Monetary Policy

Two of the global digital asset ecosystem's sources of U.S. dollars are outside of the Federal Reserve's direct supervision because the activities obtain dollars indirectly via intermediary banks: the offshore (eurodollar) and non-bank onshore sources. But even for onshore bank sources of U.S. dollars, the Federal Reserve has only an indirect view. This is due to the fact that no VASPs in the U.S. currently have direct access to the U.S. dollar payment system. Even VASPs that have direct relationships with banks must access U.S. dollars through intermediary banks rather than directly through the Federal Reserve.

[28] The question whether a VASP is registered with FinCEN as a money services business (MSB) is separate and distinct from the question whether the VASP itself also requires an MTL. The MSB registration vs. MTL license topic is frequently confusing to non-experts. The requirement for VASPs to register with FinCEN as an MSB is clear; the potential grey area is whether a VASP that "rents" an intermediary's trust company or MTL licenses may rely on that third party's licenses or must also itself hold an MTL in any or all the U.S. states in which it operates.

Why does this matter? It means that the Federal Reserve cannot observe the rapidly growing digital asset markets directly. For example, all U.S. dollar stablecoin issuers[29] are either unregulated offshore entities, state-chartered trust companies, or state-registered money transmitters. In other words, no stablecoin issuers are depository institutions that hold Federal Reserve master accounts, into which the Federal Reserve has the ability to monitor minute-by-minute solvency, asset growth, and payment system risk of the stablecoin activity, if the Federal Reserve so desires.[30]

Avanti believes that the technology behind stablecoins will become broadly successful as a payment technology because it offers *straight-through integration*, while legacy payment systems offer (at best) straight-through processing. This alone makes stablecoin technology powerful. Legacy payment rails require U.S. banks to undergo months of tedious integration work with approved banking core providers (which may or may not even offer API capabilities), but fintechs can integrate with stablecoin networks very quickly—limited only by their own internal resources rather than slowed by vendors or other partner organizations. Much is made of the advantages of blockchain networks over legacy systems due to factors such as their programmability, speed, efficiency, and open networks—all of which are true—but Avanti sees the true power of stablecoin technology as its ease of integration for fintechs that need fast-settling, easily-verifiable U.S. dollar payments. Consequently, Avanti believes stablecoin technology will become globally systemically important. The question is whether it will do so inside or outside of the domestic U.S. dollar banking system.

Outside of digital assets, a healthy trend has begun to emerge whereby fintechs are able to obtain depository institution charters, and the Federal Reserve can also make this possible for VASPs via prompt adoption of the Guidelines (in whatever their final form). The Federal Reserve has previously granted master accounts to three such fintechs—Square (via its Utah-chartered industrial loan company), Jiko, and Varo Bank (both chartered by the Office of the Comptroller of the Currency)—as well as to a non-depository trust company (Colorado-based Reserve Trust). We believe the Federal Reserve's approval of the first group of API-based core banking software systems is very likely to encourage this trend whereby more fintechs obtain their own depository institution charters so that they can directly access the payment system and thereby deliver straight-through processing software solutions for payments to their customers, which most banks do not offer today.[31]

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[29] Excluding algorithmic stablecoins, which do not have a traditional issuer.

[30] Facebook's stablecoin, Diem (formerly Libra), is scheduled to be issued via Silvergate Bank later this year. However, it appears from publicly-available information that Diem (not Silvergate) will manage the smart contract. This arrangement appears to separate the "issuer" function into two different legal entities (a bank and non-bank). As stablecoins are structured today, the issuer manages the smart contract as well as the treasury function (including issuance timing and reserve asset management).
See https://www.coindesk.com/facebook-backed-diem-partners-with-silvergate-bank-to-issue-us-dollar-stablecoin

[31] Most banks still ingest payment instructions via flat files or form fills rather than via APIs. Fintechs, by contrast, are heavy users of APIs and, more recently, of blockchains.

Accordingly, Avanti believes this trend of fintechs qualifying to obtain direct payment system access by obtaining depository institution charters is generally favorable to safety and soundness because it brings these activities inside the banking system and the Federal Reserve's direct purview. Avanti also believes clear demarcation between depository institutions and non-depository fintechs is warranted.

Cost #3: It Creates Latent Risks to Financial Stability That Are Outside the Direct Remit of Prudential Regulators

Not granting direct payment system access to VASPs creates latent risks to financial stability in two ways.

First, and already well-known to the Federal Reserve, is the risk created via the growth of stablecoins issued by non-banks, whose reserves could create sudden selling pressure into illiquid short-term credit markets such as commercial paper. Multiple Federal Reserve officials have already articulated this risk.[32]

We would add to their public comments the need for macro risk analysts and correspondent bank supervisors to model the scenario in which an accidental hard fork happens to a blockchain on which substantial stablecoins are issued. What would be the impact to the banks holding the cash reserves and to the asset markets generally (such as commercial paper and T-bills) that could incur sudden selling volume in large size? Is the sudden redemption of stablecoin reserves included in the correspondent banks' stress test scenarios? Such an accidental chain split *could* cause the issuer to need to redeem tens of billions of stablecoins within the span of hours. Unplanned chain forks do occur on public blockchains periodically, one of which happened in November 2020 as the Ethereum blockchain incurred an accidental hard fork that, thankfully, was resolved within a few hours.[33] Again, these risks are manageable for banks that are *properly structured* to handle them. At a minimum, the payment system risk policies of banks that intermediate stablecoin reserve assets today should address such scenarios.

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[32] *See supra*, note 2.

[33] *See* https://www.coindesk.com/ethereums-hard-fork-disruption and https://www.cato.org/cato-journal/spring/summer-2021/ten-stablecoin-predictions-their-monetary-policy-implications. Such accidental chain splits are reasonably foreseeable events for blockchains. They can happen, for example, when two or more miners find a block at roughly the same time, when miners do not properly validate a block before mining on top of it, or when two clients of the protocol (*e.g.*, Geth and Parity for Ethereum) are not in sync after a network upgrade. Such unintentional chain splits usually resolve when subsequent blocks are added to one of the chains, making it the longest chain (and then the network abandons blocks that are not in the longest chain, making them so-called "orphaned blocks.") Such a scenario began to play out for a few hours on November 11, 2020 on the Ethereum network, but thankfully resolved before triggering any stablecoin redemptions. Again, a depository institution that is *properly structured* to withstand an extreme scenario of an unintentional, permanent chain split poses minimal risk to the payment system.

Second is the settlement risk caused by the significant structural differences in the settlement speed and reversibility between digital assets and traditional financial payments. Bitcoin settles in minutes with irreversibility, while most banks reconcile their balances at the Federal Reserve only once a day. Due to the relatively fast settlement of bitcoin, a bank could accrue outsized exposure to bitcoin and not discover this until seeing its overnight reconciliation the next day. Moreover, bitcoin has no operational fault tolerance—none of the mechanisms built into traditional financial markets to mitigate settlement problems, such as the discount window, permitted failures to deliver, collateral substitution in securities financing, or ETF market makers authorized to create uncovered short positions, among myriad examples of operational fault tolerance in traditional markets.

Moreover, the structural features that protect against settlement risks in traditional finance don't apply to Bitcoin. Central institutions can serve as lenders of last resort or clearinghouses that allow banks to withstand temporary settlement failures, such as the Federal Reserve (dollars); the DTCC (securities); ICE, CME, and LCH (derivatives); and LBMA member banks (gold). And for these assets, the banking system in aggregate controls nearly all of the underlying collateral. But the banking system will never control most of the bitcoin, ether, or other similar digital assets. Individuals own the vast majority, and it is squirreled away (or lost) and rarely traded, if at all. Only an estimated 22% of the bitcoin supply[34] is free float. During bull markets, that percentage can drop to 12%. Collateral is always scarce, and failure to timely deliver it is a default.

To be clear, none of this is a Bitcoin problem. Rather, the issue is that banks' operational processes and IT systems are not set up to handle bitcoin due to its settlement characteristics.

Consequently, while it may be counterintuitive to traditional financial system experts, granting payment system access to VASPs whose IT and operational processes are designed to handle digital assets is lower-risk than it would be to grant banks that already have payment system access the ability to trade digital assets on-balance sheet. The Bank for International Settlements ("BIS") proposed 1:1 Basel III capital requirement for banks holding bitcoin and similar digital assets on-balance sheet is too low, in Avanti's opinion, because it does not take into account the potential for intraday bank run risk caused by these settlement mismatches.[35]

Again, as discussed above, there is a safe and sound way to integrate digital asset activities into the U.S. dollar payment system.[36]

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[34] https://insights.glassnode.com/bitcoin-liquid-supply/
[35] *See supra*, note 6.
[36] *See supra*, part I, at 4-5 (listing seven characteristics integral to the safe and sound banking of digital assets).

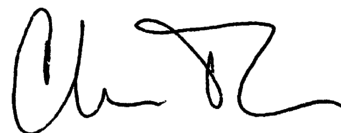
A bank structured according to the principles for safe and sound banking of digital assets should pose minimal risk to the payment system, regardless of the price volatility of digital assets, because the bank is designed to withstand a bank run. But this is not just theoretical. A regulatory banking regime that meets the above requirements already exists in Wyoming, and it is far tougher on banks than the proposed BIS requirements because it prioritizes the settlement risks that the BIS proposal missed. The perception has always been that the states lead a "race to the bottom" in bank regulation, but in this case, the opposite is true—Wyoming's laws are tougher, and they're rightly focused on locking down payment system risk arising from mismatches in settlement speed and finality.

To be clear, banks can and should provide custody services for bitcoin and similar digital assets, just as they do for securities. But the BIS capital rules would allow banks to go much further than custody alone, to hold bitcoin on-balance sheet, thereby taking principal risk (i.e., proprietary trading). None of the states that have enabled digital asset banking (Wyoming, Texas, and Nebraska) goes as far as the BIS proposal goes in terms of acceptable risk levels.

III. Conclusion

Avanti welcomes the favorable resolution of the Guidelines and pending applications of qualified applicants, including SPDIs. By swiftly adopting Guidelines and approving qualified applicants, the Board can address the systemic and payment system risks enumerated in this letter by opening a regulatory-compliant path for banks handling digital assets to obtain direct access to U.S. dollar payment services, and ensuring that such financial intermediaries are subject to bank-level capital requirements, supervision and related payment system access requirements, as well as special provisions to protect the payment system from risks that are unique to digital assets. Avanti looks forward to the favorable resolution of its master account application so that it can start to bring services to its customers that do not exist in the market today and reduce the risks faced today by both the banking system and digital asset companies.

Respectfully submitted,



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