

Crypto bank sues Federal Reserve over delay in master account application

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Custodia Bank has filed suit in federal court against the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Kansas City, seeking to force a decision on its application for a master account after waiting more than 19 months with no answer. The lawsuit raises questions not only about processing of master account applications, but about the Federal Reserve more broadly.

Background

Custodia Bank (Custodia), a Wyoming-based bank with a cryptocurrency-focused business model, has filed suit against the Board of Governors of the Federal Reserve System (the Board) and the Federal Reserve Bank of Kansas City (Kansas City Reserve Bank) for their delay in processing Custodia's application for a master account with the Federal Reserve. Custodia submitted a master account application to the Kansas City Reserve Bank in October 2020. On June 7, 2022, after more than 19 months with "no clear end to Custodia's application saga in sight," Custodia filed a complaint in the U.S. District Court for the District of Wyoming seeking to force a resolution of its application.¹ In addition to criticizing the Federal Reserve's "unaccountable Kafkaesque process" for evaluating applications for master accounts, the complaint challenges the legitimacy of the Federal Reserve Bank structure.

Custodia (formerly Avanti Bank & Trust) is a Wyoming state-chartered special purpose depository institution (SPDI). The Wyoming legislature authorized the issuance of SPDI charters in 2019 to allow for institutions to provide digital asset custody, deposit-taking and payment services.² SPDIs are authorized to take deposits but not to make loans. Wyoming law permits, but does not require, SPDIs to obtain FDIC insurance. Custodia offers institutional investors custody and settlement services for digital assets.³ Custodia describes having a master account at the Federal Reserve as "vital to [its] ability to operate effectively and efficiently in pursuit of its core mission to offer a secure, compliant bridge between digital assets and the United States dollar payment system."

According to its complaint, Custodia submitted the standard form agreement for a master account with the Kansas City Reserve Bank on October 29, 2020. The form stated that "processing may take 5-7 business days." The head of Supervision and Risk Management at the Kansas City Reserve Bank informed Custodia in January 2021 that there were "no showstoppers" with Custodia's application. Custodia claims that it has repeatedly offered to provide additional information about its business and that the Kansas City Reserve Bank confirmed in a January 2022 letter that Custodia meets the legal eligibility requirements for a master account. In March 2022, however, the Kansas City Reserve Bank informed Custodia that it had "not started processing" Custodia's application.

According to Custodia, neither the Kansas City Reserve Bank nor the Board has provided Custodia with a timeline for processing its application or an explanation of their review process. Custodia criticizes both the Board and the Kansas City Reserve Bank for maintaining a "black box" process for reviewing master account applications. According to Custodia, "the [Kansas City Reserve Bank's] consideration and impending approval of Custodia's application was derailed when, in spring 2021, the Board asserted control over the decision-making process." But the Board has told Custodia that "it will be the Kansas City Fed that communicates, if not makes, the decision on Custodia's" application. Custodia describes the entire master account application process as an unaccountable process that "continues to inflict grave, irreparable harm on Custodia."

Claims brought by Custodia

Custodia asserts a number of substantive and procedural claims in its complaint.

Claims for an order compelling a decision on Custodia's application

Custodia seeks a court order requiring the Board and Kansas City Reserve Bank to promptly decide on Custodia's master account application. These claims arise under multiple legal theories, including the Administrative Procedure Act (APA).⁴

Custodia asserts that the Board and Kansas City Reserve Bank have violated their duty as federal agencies under the APA by failing to take action on Custodia's application. Custodia cites the APA, which states that "[w]ithin a reasonable time, each agency shall proceed to conclude a matter presented to it"⁵ and that a "reviewing court shall ... compel agency action unlawfully withheld or unreasonably delayed."⁶ Custodia also cites the statutory deadline contained in 12 U.S.C. § 4807, which requires each federal banking agency (including the Board) to "take final action on any application to the agency before the end of the 1-year period beginning on the date on which a completed application is received by the agency."

Custodia claims that under case law, failing to meet the "specific, non-discretionary time" for processing applications with a statutory deadline renders the Board and Kansas City Reserve Bank's inaction "unlawfully withheld" under the APA.⁷ Custodia also claims that the Board and Kansas City Reserve Bank have "unreasonably delayed" Custodia's application in violation of the APA. The complaint highlights that the 19 months that Custodia has waited for a response to its application is substantially longer than the five-to-seven-business-day processing time stated on the master account application form. Custodia also argues that the delay has been unreasonable because neither the Board nor the Kansas City Reserve Bank has requested additional information from Custodia or indicated a potential timeline for making a decision. When asked about timing of the application, staff from the Board and Kansas City Reserve Bank have pointed to each other as the cause of the delay. These circumstances, Custodia claims, entitle Custodia to an order under the APA compelling the Board and/or the Kansas City Reserve Bank to promptly issue a decision on Custodia's application.

In raising this claim under the APA, Custodia argues that the Kansas City Reserve Bank is an agency for purposes of the APA. According to the complaint, the Board has asserted to Custodia that it does not consider the Kansas City Reserve Bank to be an agency for purposes of the APA but has "declined to offer any justification or legal support for this view." Custodia argues in its complaint that the Reserve Banks are federal agencies because they wield significant authority "delegated by statute and regulation to contribute to the operations of the United States monetary system, to provide supervision and oversight to financial institutions, to promote a safe and sound payment system ... and to facilitate economic development and financial understanding."

Custodia's position on the APA finds some support in case law. For example, a federal court in Georgia found in 1984 that the actions of the Federal Reserve Bank of Chicago are reviewable as actions of an agency under the APA because the Federal Reserve Bank of Chicago "is an 'authority' of the government of the United States" and "[a]s a member bank of the Federal Reserve System ... performs important governmental functions and exercises powers entrusted to it by the United States government."⁸ Some federal courts have found that Reserve Banks are not federal agencies for the purposes of the Federal Tort Claims Act and the Freedom of Information Act, but those cases do not address the APA.⁹

Challenges to Federal Reserve structure

Custodia also raises alternative claims that raise fundamental questions about the Board's delegation of powers to the Reserve Banks.

If the court agrees with the Board that the Kansas City Reserve Bank is not an agency subject to the APA, then Custodia asserts an alternative claim that the Kansas City Reserve Bank's processing of Custodia's application and any delegation by the Board of final decision-making authority to the Kansas City Reserve Bank violate the Due Process Clause of the U.S. Constitution. Custodia argues that even if the Kansas City Reserve Bank is not an agency for purposes of the APA, it is a "fiscal agent of the United States" and thus "'part of the Government for purposes of' complying with the Constitution." Custodia argues that the members of the Board of Directors of the Kansas City Reserve Bank, who are representatives of stockholding banks, "have particular and heightened competitive incentives to ensure that novel banking institutions like Custodia cannot access master accounts so that stockholding 'traditional' banks can retain a monopoly on access to the Federal Reserve System." Custodia argues that adjudication of its application by "would-be competitors" is an "intolerable and unconstitutional interference with personal liberty and personal property" that violates the Due Process Clause.

Custodia also makes an alternative claim for relief under the Appointments Clause of the U.S. Constitution if the court finds that the Kansas City Reserve Bank has final decision-making authority over Custodia's application. The U.S. Supreme Court has interpreted the Appointments Clause to limit the exercise of "significant authority pursuant to the laws of the United States" to "principal Officers" nominated by the President and confirmed by the Senate.¹⁰ Custodia argues that because the Boards of Directors of the Reserve Banks are not principal Officers, the Kansas City Reserve Bank lacks authority to render final decisions on which institutions can access a Federal Reserve master account and the Board must issue the final decision.

Claims for an order compelling approval of Custodia's application

Custodia also brings claims relating to the merits of its application, not only the process for reviewing its application. In the event that the Board and Kansas City Reserve Bank deny its master account application, Custodia seeks a court order directing the Board and Kansas City Reserve Bank to *approve* its application.¹¹

This claim is based on 12 U.S.C. § 248a(c)(2), which states that specified Federal Reserve bank services "shall be available to nonmember depository institutions." Custodia contends that Section 248a applies to master accounts, since the listed Federal Reserve bank services are only available through master accounts, and requires the Board and Kansas City Reserve Bank to approve all master account applications by eligible depository institutions. Custodia further contends that it is an eligible depository institution under 12 U.S.C. § 461(b)(1)(A)(i), since it is eligible to be insured by the FDIC.

The Board, by contrast, takes the position that "legal eligibility does not bestow a right to obtain [a master] account."¹² In proposed guidance on its approach to evaluating master account applications,¹³ the Board stated that when evaluating master account applications it not only considers the legal eligibility of the applicant, but also considers its policy goals of ensuring the safety and soundness of the banking system, effectively implementing monetary policy, promoting financial stability, protecting consumers, and promoting a safe, effective, efficient, accessible and innovative payment system.

Legal scholars have supported both sides of the issue. Some contend that Section 248a obligates the Board to provide master accounts to eligible depository institutions because the statute says that Federal Reserve services "shall" be available to nonmember depository institutions, suggesting a congressional mandate.¹⁴ Other scholars argue that Section 248a provides the Board discretion in determining whether to grant a master account to an eligible depository institution, based on the language providing that "nonmembers shall be subject to any other terms ... that the Board may determine are applicable to member banks."¹⁵ Courts have also weighed in on both sides of the debate, but none of these opinions include a majority decision confirming or rejecting the Board's discretionary authority to approve master account applications.¹⁶

The recently introduced Lummis-Gillibrand Responsible Financial Innovation Act, which proposes a new regulatory framework for digital assets, would clarify that the Federal Reserve must provide a master account to any eligible depository institution upon request.¹⁷ The bill's co-sponsor, Senator Cynthia Lummis of Wyoming, has previously criticized the Federal Reserve for its failure to approve Custodia's master account application.¹⁸

Broader implications

The issues raised in Custodia's complaint could affect other non-traditional banks seeking master accounts, the processing of other types of applications submitted to the Federal Reserve, and the structure of the Federal Reserve System more broadly.

- **Interpretation of statutory deadline and "completed application."** Custodia's assertion that the Board and Kansas City Reserve Bank have violated the statutory deadline in 12 U.S.C. § 4807 by not deciding on Custodia's application within one year may prompt the court to interpret the scope of that provision.¹⁹ Section 4807 is clearly not limited to master account applications, given that it requires each federal banking agency to "take final action on *any* application" (emphasis added), but the scope of applications subject to the deadline is not clear. It has also long been unclear, to the frustration of many banks and their lawyers, what makes an application "completed" for purposes of the statute. It is widely known among the banking sector that applications can be delayed by additional questions so that the Board staff can take the position that the application is not "completed." This view has not ever been challenged in court. A judicial interpretation of the meaning of "completed" could impact a variety of applications by financial institutions regulated by the Board, FDIC and OCC. Notably, the Lummis-Gillibrand Responsible Financial Innovation Act would amend Section 4807 to clarify that an application is "completed" for purposes of that provision upon the initial submission of the requisite application form, meaning that agencies cannot extend the statutory deadline by requesting supplemental information from applicants.²⁰ The bill would also expand the application of Section 4807 to include the Reserve Banks.

- **Applications in the bank M&A context.** Some commentators have recently raised concerns about long delays in the processing of bank M&A applications by federal bank regulators.²¹ Custodia’s complaint also follows the recent federal district court decision in *Hurry v. FDIC*,²² where the court ruled that the FDIC improperly delayed acting on a proposed acquisition under the Change in Bank Control Act (CIBCA). In that case, the FDIC argued that the 60-day (or, if extended, up to 180-day) statutory clock for its review of a CIBCA application had not begun to run because the applicant failed to provide sufficient information to be considered proper “notice” to the FDIC. The court rejected this interpretation. Although the standards for review and approval of bank M&A applications are different from those for master account applications, Custodia’s complaint raises many related issues with delays in the application process that could impact the ongoing debate over processing of bank M&A and other applications.
- **Delegation to Federal Reserve Banks.** Any holding on the status of the Kansas City Reserve Bank as an agency under the APA would have implications for the current relationship between the Board and the Reserve Banks. Likewise, any holding on the Appointments Clause claim would raise questions about the authority of the Reserve Banks, whose Boards of Directors are not presidentially-appointed, to continue exercising substantial authority in approving applications for master accounts, M&A transactions and other financial activities, as well as in their supervision of member banks.
- **Effect on other master account applications.** As Custodia described in its complaint, there is currently little clarity on the process for reviewing master account applications by non-traditional banks. The recent reported revocation of the master account of Reserve Trust by the Kansas City Reserve Bank only heightens this climate of uncertainty.²³ In a June 8 letter to Kansas City Reserve Bank President Esther George regarding the revocation of Reserve Trust’s master account, Senate Banking Committee Ranking Member Pat Toomey wrote: “This development heightens the significant concerns already surrounding the fairness, transparency, and consistency of the Federal Reserve System’s approach to master account applications.”²⁴ Any decision in Custodia’s favor, whether ordering prompt action on its application or ordering approval of its application, would likely open the door to master account applications by many other non-traditional banks.

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If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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- ¹ Complaint, Custodia Bank, Inc. v. Fed. Reserve Bd. of Governors, Fed. Reserve Bank of Kansas City (D. Wyo. 2022) (Case 1:22-cv-00125-SWS). Custodia is represented by Williams & Connolly, which has a strong record of successfully challenging agency actions.
- ² 2019 Wyo. Sess. Laws 328 (codified as amended in Wyo. Stat. §§ 13-12-101 to 13-12-126).
- ³ *Avanti Financial Group Announces Accelerated Charter Application*, CUSTODIA (July 23, 2020), <https://custodiabank.com/press/bank-charter-application-accepted>; Maria Aspan, *How Caitlin Long Turned Wyoming into Crypto Country*, FORTUNE (July 29, 2021), <https://fortune.com/2021/07/29/caitlin-long-wyoming-crypto/>.
- ⁴ Custodia also claims that it is entitled to a court order compelling the Board and Kansas City Reserve Bank to render a decision on its master account application based on the separation of powers requirement and the Due Process Clause of the U.S. Constitution. Custodia argues that the "black-box process" employed by the Board and the Kansas City Reserve Bank violates "[b]aseline separation of powers and due process principles [that] prohibit agencies from employing decision-making processes devoid of intelligible principles, public scrutiny, or discernable standards." Additionally, Custodia asserts claims for relief under both the Mandamus Act and the Declaratory Judgment Act.
- ⁵ 5 U.S.C. § 555(b).
- ⁶ 5 U.S.C. § 706(1).
- ⁷ *Forest Guardians v. Babbitt*, 174 F.3d 1178, 1191 (10th Cir. 1999).
- ⁸ *Flight Int'l Grp. v. Fed. Reserve Bank of Chi.*, 583 F. Supp. 674, 678 (N.D. Ga. 1984).
- ⁹ *Arney v. United States*, No. 77-3503-NA-CV, 1979 U.S. Dist. LEXIS 8212, at *13-14 (M.D. Tenn. Dec. 4, 1979) ("Under the Federal Reserve Act, the Reserve Banks are so separate from the United States in those areas on which the courts rely in finding federal agency status under the FTCA that the Reserve Banks may not be deemed to be instrumentalities or agencies of the United States for purposes of the FTCA."); *Fox News Network, LLC v. Bd. of Governors of the Fed. Reserve Sys.*, 639 F. Supp. 2d 384, 391 (S.D.N.Y. 2009) ("The Board, in contrast to the FRBs, is a government agency ..."); *Fox News Network, LLC v. Bd. of Governors of the Fed. Rsrv. Sys.*, 601 F.3d 158, 161 (2d Cir. 2010) (citing *Fox News Network, LLC v. Bd. of Governors of the Fed. Reserve Sys.*, 639 F. Supp. 2d 384, 396 (S.D.N.Y. 2009)) ("Congress divided the powers of the

Federal Reserve System between the Board, which is a federal agency, and the [Federal Reserve Banks], which were established as regional banks ... ”).

- ¹⁰ *Buckley v. Valeo*, 424 U.S. 1, 126 (1976).
- ¹¹ Custodia has asserted these claims under both the Mandamus Act and the Declaratory Judgment Act.
- ¹² Proposed Guidelines for Evaluating Account and Services Requests, 86 Fed. Reg. 25,865, 25,866 (May 11, 2021).
- ¹³ *Id.*; Guidelines for Evaluating Account and Services Requests, 87 Fed. Reg. 12,957 (Mar. 8, 2022). For our analysis of the 2021 proposed guidelines see our client update, *Proposed guidelines: Who can have a Federal Reserve master account?*, Davis Polk (May 11, 2021), https://www.davispolk.com/sites/default/files/2021-06/2021-05-11_proposed_guidelines_who_can_have_a_federal_reserve_master_account.pdf.
- ¹⁴ See, e.g., Peter Conti-Brown, *The Fed Wants to Veto State Banking Authorities. But Is That Legal?*, BROOKINGS (Nov. 14, 2018), <https://www.brookings.edu/research/the-fed-wants-to-veto-state-banking-authorities-but-is-that-legal/>.
- ¹⁵ See, e.g., Julie Andersen Hill, *Bank Access to Federal Reserve Accounts and Payment Systems* (draft of Mar. 30, 2022), U of Alabama Legal Studies Research Paper, Yale Journal on Regulation (forthcoming), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4048081.
- ¹⁶ See *Fourth Corner Credit Union v. Fed. Reserve Bank of Kan. City*, 861 F.3d 1052 (10th Cir. 2017) (remanding without prejudice a suit by a bank with a cannabis-focused business model that was denied a master account; the three-judge panel was divided on the decision, with one judge holding that all depository institutions are entitled to master accounts, one judge holding that plaintiff’s case should be dismissed on ripeness grounds until plaintiff submits a revised master account application to the Federal Reserve reflecting the condition that it would not serve marijuana-related businesses unless it was legal to do so, and one judge upholding the denial of plaintiff’s master account on the grounds that plaintiff was engaged in illegal activity under federal law); *TNB USA Inc. v. Fed. Reserve Bank of N.Y.*, No. 1:18-CV-07978, 2020 WL 1445806 (S.D.N.Y. 2020) (holding that plaintiff lacked standing to pursue its claim against the Federal Reserve Bank of New York for not approving plaintiff’s master account application because the Federal Reserve Bank of New York had not yet made a decision on the application).
- ¹⁷ The Responsible Financial Innovation Act, S. 4356, 117th Cong. § 702 (2022).
- ¹⁸ Senator Cynthia Lummi, *The Fed Battles Wyoming on Cryptocurrency*, Wall Street Journal (Nov. 30, 2021), <https://www.wsj.com/articles/the-fed-battles-wyoming-cryptocurrency-powell-brainard-bitcoin-digital-assets-spdi-fintech-11638308314>.
- ¹⁹ Although Custodia asserts in its complaint that both the Board and Kansas City Reserve Bank have violated Section 4807, as a technical matter Section 4807 only applies to the Board, the FDIC and the OCC, not the Reserve Banks. See 12 U.S.C. § 4801(1) (defining “federal banking agencies” by reference to 12 U.S.C. § 1813).
- ²⁰ The Responsible Financial Innovation Act, S. 4356, 117th Cong. § 704 (2022).
- ²¹ See, e.g., Jim Dobbs, *Long delays for deal approval cast cloud over bank M&A*, American Banker (Dec. 7, 2021); <https://www.americanbanker.com/news/long-delays-for-deal-approval-cast-cloud-over-bank-m-a>; Lauren Seay and Zuhair Gull, *Deal delays dampen U.S. banks’ M&A appetite*, S&P Global (Nov. 22, 2021), <https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/deal-delays-dampen-us-banks-m-a-appetite-67670716>.
- ²² *Hurry v. Fed. Deposit Insur. Corp., et al.*, No. CV 18-2435 (RDM), 2022 WL 670857 (D.D.C. Mar. 7, 2022).
- ²³ Andrew Ackerman, *Kansas City Fed Rescinds Master Account for Payments Firm, GOP Senator Says*, Wall Street Journal (June 9, 2022), <https://www.wsj.com/articles/kansas-city-fed-rescinds-master-account-for-payments-firm-gop-senator-says-11654765201>.
- ²⁴ *Id.*