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Bank Regulation for Stablecoins – President's Working Group on Financial Markets Issues Stablecoin Report

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On November 1, 2021, the President's Working Group on Financial Markets,[1] joined by the Office of the Comptroller of the Currency (OCC) and Federal Deposit Insurance Corporation (FDIC), issued its expected report (Report) on stablecoins, a type of digital asset that has recently grown significantly in market capitalization and importance to the broader digital asset markets.[2]

Noting gaps in the regulation of stablecoins, the Report makes the following principal recommendations:

- Congress should promptly enact legislation to provide a "consistent and comprehensive" federal prudential framework for stablecoins –
  - Stablecoin issuers should be required to be insured depository institutions
  - Custodial wallet providers that hold stablecoins on behalf of customers should be subject to federal oversight and risk-management standards
  - Stablecoin issuers and wallet providers should be subject to restrictions on affiliations with commercial entities.
- In the absence of Congressional action, the Financial Stability Oversight Council (FSOC) should consider steps to limit stablecoin risk, including designation of certain stablecoin activities as systemically important payment, clearing, and settlement activities.

The Report thus calls for the imposition of bank-like regulation on the world of stablecoins, and it does so with a sense of urgency. Below we summarize the Report's key conclusions and recommendations, and then preview the path forward if the FSOC is to take up the Report's call to action.

Stablecoins

A stablecoin is a digital asset that is created in exchange for fiat currency that a stablecoin issuer receives from a third-party; most stablecoins offer a promise or expectation that the stablecoin can be redeemed at par on request. Although certain stablecoins are advertised as being backed by "reserve assets," there are currently no regulatory standards governing such assets, which can range on the risk spectrum from insured bank deposits and Treasury bills to commercial paper, corporate and municipal bonds, and other digital assets. Indeed, in October, the CFTC took enforcement action against the issuers of US Dollar Tether (USD Tether) for allegedly making untrue or misleading statements about USD Tether's reserves.[3]

The market capitalization of stablecoins has grown extremely rapidly in the last year; according to the Report, the largest stablecoin issuers had, as of October, a market

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capitalization exceeding $127 billion.[4] The Report states that stablecoins are predominantly used in the United States to facilitate the trading, lending, and borrowing of other digital assets – they replace fiat currency for participants in the trading markets for Bitcoin and other digital assets and allow users to store and transfer value associated with digital asset trading, lending, and borrowing within distributed ledger environments.[5] The Report further notes that certain stablecoin issuers believe that stablecoins should be used in the payment system, both for domestic goods and services, and for international remittances.[6] Stablecoins, the Report asserts, are also used as a source of collateral against which participants in the digital assets markets can borrow to fund additional activity, "sometimes using extremely high leverage," as well as to "earn yield," by using stablecoins as collateral for extending loans and engaging in margined transactions.[7]

Perceived Risks of Stablecoins

The Report views the stablecoin market as currently having substantial risks not subject to regulation.

First, the Report asserts that stablecoins have "unique risks" associated with secondary market activity and market participants beyond the stablecoin issuers themselves, because most market participants rely on digital asset trading platforms to exchange stablecoins with national currencies and other stablecoins.[8] In addition, the Report states that the active trading of stablecoins is part of an essential stabilization mechanism to keep the price of the stablecoin close to or at its pegged value.[9] It further asserts that digital asset trading platforms typically hold stablecoins for customers in non-segregated omnibus custodial wallets and reflect trades on internal records only, and that such platforms and their affiliates may also engage in active trading of stablecoins and as market makers.[10]

Second, the Report argues that stablecoins play a central role in Decentralized Finance (DeFi). It gives two examples – first, stablecoins often are one asset in a pair of digital assets used in "automated market maker" arrangements, and second, they are frequently "locked" in DeFi arrangements to garner yield from interest payments made by persons borrowing stablecoins for leveraged transactions.[11]

As a result, the Report describes a range of risks arising from stablecoins, including risks of fraud, misappropriation, and conflicts of interest and market manipulation; the risk that failure of disruption of a digital asset trading platform could threaten stablecoins; the risk that failure or disruption of a stablecoin could threaten digital asset trading platforms; money laundering and terrorist financing risks; risks of excessive leverage on unregulated trading platforms; risks of non-compliance with applicable regulations; risks of co-mingling trading platform funds with funds of customers; risks flowing from information asymmetries and market abuse; risks from unsupervised trading; risks from distributed-ledger based arrangements, including governance, cybersecurity, and other operational risks; and risks from novel custody and settlement processes.[12]

The Report also notes the risk of stablecoin "runs" that could occur upon loss of confidence in a stablecoin and the reserves backing it, as well as risks to the payment system generally if stablecoins became an important part of the payment system. The Report notes that "unlike traditional payment systems where risk is managed centrally by the payment system operator," some stablecoin arrangements feature "complex operations where no single organization is responsible or accountable for risk management and resilient operation of the entire arrangement."[13]

Finally, the Report asserts that the rapid scaling of stablecoins raises three other sets of policy concerns. First is the potential systemic risk of the failure of a significant stablecoin issuer or key participant in a stablecoin arrangement, such as a custodial wallet provider.[14] Second, the Report points to the business combination of a stablecoin issuer or wallet provider with a commercial firm as raising economic concentration concerns traditionally associated with the mixing of banking and commerce.[15] Third, the Report

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states that if a stablecoin became widely accepted as a means of payment, it could raise antitrust concerns.[16]

Recommendations

The Report's key takeaway is that the President's Working Group, the OCC and the FDIC believe that there are currently too many regulatory gaps relating to stablecoins and DeFi. The Report does note that, in addition to existing anti-money laundering and anti-terrorist financing regulations, stablecoin activities may implicate the jurisdiction of the SEC and CFTC, because certain stablecoins may be securities or commodities. Indeed, the CFTC just recently asserted that Bitcoin, Ether, Litecoin and USD Tether are commodities.[17] Nonetheless, the Report states that as stablecoin markets continue to grow, "it is essential to address the significant investor and market risks that could threaten end users and other participants in stablecoin arrangements and secondary market activity."[18]

The Report therefore calls for legislation to close what it sees as the critical gaps. First, it argues that stablecoin issuance, and the related activities of redemption and maintenance of reserve assets, should be limited to entities that are insured depository institutions: state and federally chartered banks and savings associations that are FDIC insured and have access to Federal Reserve services, including emergency liquidity.[19] Legislation should also ensure that supervisors have authority to implement standards to promote interoperability among stablecoins.[20] Given the global nature of stablecoins, the Report contends that legislation should apply to stablecoin issuers, custodial wallet providers, and other key entities "that are domiciled in the United States, offer products that are accessible to U.S. persons, or that otherwise have a significant U.S. nexus."[21]

Second, given the Report's perceived risks of custodial wallet providers, the Report argues that Congress should require those providers to be subject to "appropriate federal oversight," including restricting them from lending customer stablecoins and requiring them to comply with appropriate risk-management, liquidity, and capital requirements.[22]

Third, because other entities may perform activities that are critical to the stablecoin arrangement, the Report argues that legislation should provide the supervisor of a stablecoin issuer with the authority to require any entity that performs activities "critical to the functioning of the stablecoin arrangement" to meet appropriate risk-management standards, and give the appropriate regulatory agencies examination and enforcement authority with respect to such activities.[23]

Finally, the Report advocates that both stablecoin issuers and wallet providers should, like banks, be limited in their ability to affiliate with commercial firms.[24]

Interim Measures

The Report characterizes the need for legislation as "urgent." While legislation is being considered, the Report recommends that the Financial Stability Oversight Council (FSOC) consider taking actions within its jurisdiction, such as designating certain activities conducted within stablecoin arrangements as systemically significant payment, clearing, and settlement activities.[25] The Report states that such designation would permit the appropriate federal regulatory agency to establish risk-management requirements for financial institutions[26] that engage in the designated activities.

Such designations would occur pursuant to Title VIII of the Dodd-Frank Act, and it would be the first time that the FSOC would make them.[27] The procedure that the FSOC must follow is set forth in Title VIII, and, absent an emergency, it appears that it would not be a quick one. First, the FSOC must consult with the relevant federal supervisory agencies and the Federal Reserve.[28] Next, it must provide notice to the financial institutions whose activities are to be designated, and offer those institutions the opportunity for a hearing.[29] The institutions may then choose to appear, personally or through counsel, to

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submit written materials, or, at the sole discretion of FSOC, to present oral testimony or argument.[30] The FSOC must approve the activity designation by a vote of at least two-thirds of its members, including an affirmative vote by the Chair.[31] The FSOC must consider the designation in light of the following factors: (i) the aggregate monetary value of transactions carried out through the activity, (ii) the aggregate exposure of the institutions engaged in the activity to their counterparties, (iii) the relationship, interdependencies, or other interactions of the activity with other payment, clearing, or settlement activities, (iv) the effect that the failure of or a disruption to the activity would have on critical markets, financial institutions, or the broader financial system, and (v) any other factors that the FSOC deems appropriate.[32]

Conclusion

With the Report, Treasury and the relevant federal agencies – the Federal Reserve, the SEC, CFTC, OCC, and FDIC – have made it clear that they believe that the risks of stablecoin activities are not fully mitigated by existing regulation. Their recommendations for legislation look principally to bringing stablecoins within the banking system and to bank regulation as a means of addressing those risks. It is an open question, however, whether Congress will act, much less with the urgency that the Report desires. Action by the FSOC, moreover, will almost certainly take some time, given the statutory designation procedures. In the near term, therefore, it is likely to fall to the existing agencies with some jurisdiction over stablecoins – the CFTC and SEC – to address the gaps with the tools at their disposal.[33]

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[1] The Working Group comprises representatives of the Treasury Department (Treasury), Board of Governors of the Federal Reserve System (Federal Reserve), the Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC).

[2] *See* https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

[3] *See* https://www.gibsondunn.com/digital-asset-developments-us-commodity-futures-trading-commission-asserts-that-tether-is-a-commodity/.

[4] Report, at 7. In addition to USD Tether, the most circulated stablecoins are USD Coin, Binance USD, Dai Stablecoin, and TrueUSD. All are pegged to the U.S. dollar.

[5] *Id.* at 8.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.* at 9.

[12] *Id.* at 10-11.

[13] *Id.* at 12-13.

[14] *Id.* at 14.

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[15] *Id.*

[16] *Id.*

[17] *See* https://www.gibsondunn.com/digital-asset-developments-us-commodity-futures-trading-commission-asserts-that-tether-is-a-commodity/.

[18] Report, at 11.

[19] *Id.* at 16. Unless the insured depository institution in question is an industrial bank, requiring the stablecoin issuer to be an insured depository institution would also be a requirement for the issuer's parent company, if any, to be a bank or thrift holding company supervised and regulated by the Federal Reserve.

[20] *Id.*

[21] *Id.* n. 29.

[22] *Id.* at 17.

[23] *Id.*

[24] *Id.*

[25] *Id.* at 18.

[26] Title VIII defines "financial institution" broadly to reach "any company engaged in activities that are financial in nature or incidental to a financial activity, as described in section 4 of the Bank Holding Company Act," in addition to banks, credit unions, broker-dealers, insurance companies, investment advisers, investment companies, futures commission merchants, commodity pool operators and commodity trading advisers.

[27] The FSOC has previously undertaken designations of systemically significant nonbank financial companies under Title I of the Dodd-Frank Act and systemically significant financial market utilities under Title VIII of the Dodd-Frank Act.

[28] 12 U.S.C. § 5463(c)(1).

[29] *Id.* § 5463(c)(2).

[30] *Id.* § 5463(b)(1).

[31] *Id.* § 5463(c)(3).

[32] *Id.* § 5463(a)(2).

[33] In a press release issued just after the Report, the Director of the Consumer Financial Protection Bureau, Rohit Chopra, stated that "stablecoins may . . . be used for and in connection with consumer deposits, stored value instruments, retail and other consumer payments mechanisms, and in consumer credit arrangements. These use cases and others trigger obligations under federal consumer financial protection laws, including the prohibition on unfair, deceptive, or abusive acts or practices." *See* https://www.consumerfinance.gov/about-us/newsroom/statement-cfpb-director-chopra-stablecoin-report/.

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