CLIENT ALERT

Stablecoin Regulation Is Coming? President's Working Group Issues Report on Stablecoins Outlining Stablecoin Risks and Requesting Congress Pass Urgent Legislation Regulating Stablecoins

November 15, 2021

On November 1, the President's Working Group on Financial Markets ("PWG"), joined by the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC"), issued its long-awaited Report on Stablecoins ("Report"). The Report comes months after the PWG's July 2021 meeting to discuss interagency work on stablecoins and preparation of the Report. The Report includes (1) a high-level background on stablecoins, (2) a description of potential risks associated with stablecoins, and (3) recommendations to Congress for legislation or, absent such action, descriptions of potential regulatory actions.

The Report recommends that Congress promptly enact stablecoin-related legislation to comprehensively regulate stablecoins and stablecoin arrangements, and to address potential prudential risks related to stablecoin runs, payment system risks, and systemic risk and potential concentration of power by stablecoin issuers. In particular, the Report requests that Congress pass "urgent" legislation that limits "stablecoin issuance, and the related activities of redemption and maintenance of reserve assets to entities that are insured depository institutions," *e.g.*, state- and federally-chartered banks and savings associations that have FDIC insurance and "have access to emergency liquidity and Federal Reserve services." If Congress enacts the requested legislation, stablecoin issuers and other stablecoin participants could be required to obtain banking licenses or charters and to comply with the associated banking regulatory requirements.

The Report notes that the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") may have authority to regulate aspects of stablecoins to the extent that a particular stablecoin is considered a security, commodity, or derivative. Still, the Report highlights that the PWG believes a comprehensive regulatory regime is necessary to address the regulatory gaps identified by the PWG.

PWG's Identified Risks of Stablecoins

We outline below the various risks identified by the PWG and associated recommendations:

PWG Identified Risk	Summary of Risk
Loss of Value: • Risks to Stablecoin Users • Stablecoin Runs	Confidence in stablecoin value may be undermined by factors including: (1) use of reserve assets that could fall in price or become illiquid; (2) a failure to appropriately safeguard reserve assets; (3) a lack of clarity regarding the redemption rights of stablecoin holders; and (4) operational risks related to cybersecurity and the collecting, storing, and

	safeguarding of data. Stablecoin Runs: • Failure of a stablecoin to perform in accordance with expectations (*i.e.,* that it would allow immediate redemption for a pegged amount of fiat currency) could pose system risks and could result in a "run" on that stablecoin. • A "run" is a self-reinforcing cycle of redemptions and fire sales of reserve assets, the occurrence of which could disrupt critical funding markets, and could spread contagiously from one stablecoin to another, or to other types of financial institutions that are believed to have a similar risk profile.
Payment System Risks: • OperationalRisk • Settlement Risk • Liquidity Risk	Operational Risk: • Deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services, which can disrupt the ability of users to make payments, which can in turn disrupt economic activity. If an operational problem results in a payment error or enables fraudulent payments, users could lose their money. Settlement Risk: • Settlement in a payment system will not take place as expected, and lack of clearly stated settlement certainty can pose heightened uncertainty and create credit and liquidity pressures for arrangement participants. Liquidity Risk: • Can arise from misalignment of settlement timing and processes between stablecoin arrangements and other systems (*e.g.,* if a stablecoin arrangement operates 24/7, but the payment system used for stablecoin issuance and fiat redemption has regular business hours) causing temporary shortages in the quantity of stablecoins available to make payments.
Risks of Scale: Systemic Risk and Concentration of Economic Power • Systemic Risk	Systemic Risk: • A stablecoin issuer or a key participant in a stablecoin arrangement (e.g., a custodial wallet provider) could pose systemic risk such that the failure or distress of that entity could adversely affect financial stability and the real

• Concentration of Economic Power • Anti-Competitive Effects	economy. Concentration of Power: • The combination of a stablecoin issuer or wallet provider and a commercial firm could lead to an excessive concentration of economic power. The Report analogizes this to the concerns that arise with the mixing of banking and commerce, such as advantages in accessing credit or using data to market or restrict access to products. Anti-Competitive Effects: • If a stablecoin becomes widely adopted as a means of payment, this could present concerns about anti-competitive effects, for example, if users of that stablecoin face undue frictions or costs in the event they choose to switch to other payment products or services, which concerns are heightened in the absence of interoperability standards among stablecoins and stablecoin arrangements.

PWG's Request for Legislation

The Report's call for urgent Congressional action to create a regulatory framework for stablecoins highlights the U.S. government's recognition of rapid growth in the digital assets sector and the important role stablecoins play in the digital assets ecosystem. To that end, the PWG recognizes that, if regulated, stablecoins could support faster, more efficient, and more inclusive payment options. The Report also recognizes that broad use of stablecoins for payment could occur quickly due to network effects and rapid adoption.

In response to the risks it identified, PWG specifically asks Congress for authority to:

- **Regulate stablecoins like banks.** Limit the ability to issue stablecoins, engage in stablecoin redemption activities, and maintain reserve assets to entities that are insured depository institutions. Stablecoin issuers would be subject to supervision and regulation at the depository institution level by a federal banking agency and consolidated supervision and regulation by the Federal Reserve at the holding company level, and would be subject to capital and liquidity requirements to address safety and soundness considerations;
- **Regulate custodial wallet providers.** Require compliance with appropriate risk-management, liquidity, and capital requirements, including restricting custodial wallet providers from lending customer stablecoins;
- **Regulate entities performing critical functions for stablecoin arrangements.** Require such entities to meet appropriate risk-management standards, such as the Principles for Financial Market Infrastructures as adapted to stablecoin arrangements. Subject these entities to examination and enforcement authority by regulators with respect to stablecoin activities;
- **Regulate issuers' affiliations with commercial entities**;

- **Regulate use of users' transaction data**;
- **Require stablecoin interoperability.** Provide regulators authority to implement standards to promote interoperability among stablecoins and payment instruments.

Absent urgent Congressional action, the agencies associated with the Report recommend that the Financial Stability Oversight Council ("FSOC") consider measures available to it to address the risks outlined in the Report. Such measures might include potential "designation of certain activities conducted within a stablecoin arrangement as, or as likely to become, systemically important payment, clearing, and settlement activities." A designation by FSOC would likely result in similar requirements on stablecoin-issuers and those involved in stablecoin arrangements, such as establishment of risk-management standards for entities involved in "important payment, clearing, and settlement . . . activities." The FSOC could also impose requirements in relation to the assets backing stablecoin, requirements related to the operation of a stablecoin arrangement, and other prudential standards. Entities with such a "systemically important" designation would also be subject to an examination and enforcement framework. Any designation of an entity as "systemically important" would follow a transparent process.

Although not a principal focus, the Report discusses at some length the PWG's concerns about the use of stablecoins, similar to other digital assets, to facilitate money laundering and terrorist financing. While the Report determines that U.S. regulations are sufficiently broad to cover stablecoin administrators and other stablecoin arrangement participants, the Report asserts that Treasury will pursue additional resources to increase supervision of these regulations as applied to the cryptocurrency industry. The report emphasizes that illicit finance risk mitigation requires worldwide, consistent implementation to be successful. Most countries have not put anti-money laundering and countering the financing of terrorism regulations (AML/CFT) in place for stablecoins or are not supervising their application to stablecoins. On October 28, the Financial Action Task Force released updated guidance on the implementation of FATF AML/CFT standards for virtual assets and virtual asset providers.

Key Takeaways

The regulation of stablecoins may provide clarity, certainty, and greater confidence in stablecoins, including payment use cases and bolstering the key role stablecoins play in the functioning of digital asset markets and DeFi. However, overregulation in the U.S. of stablecoins could stifle innovative growth in the digital assets sector, and could possibly lead stablecoin issuers to prohibit, or "ringfence" U.S. persons from acquiring stablecoins. It remains to be seen what action Congress will take, and what steps regulators might take in the absence of Congressional action.

Although comprehensive, the Report fails to define key terms and authorities that would be essential for regulating stablecoins. The Report fails to clearly define the term "stablecoin issuer." It also fails to identify which entities in the stablecoin arrangement process the PWG believes should be required to become an insured depository institution. Further, the Report does not provide clarity regarding what authorities the SEC and CFTC have over stablecoins generally. Rather, the Report simply notes that these agencies "may" have jurisdiction over certain stablecoin arrangements and activities.

In light of the urgency expressed in the Report and recent regulatory actions in the digital assets space, participants in the digital assets industry and those involved with stablecoins should anticipate further regulatory scrutiny from federal and international regulators and legislative bodies. Crowell & Moring and its public affairs affiliate, C&M International, can support industry participants with regulatory and Congressional engagement, as well as advise on regulatory developments.

The information contained in this publication should not be construed as legal advice.

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[1] Stablecoins are digital assets designed to maintain a stable value relative to a national currency or other reference asset. This is in contrast to digital assets such as Bitcoin, Ethereum, Dogecoin, and numerous others whose unit value is determined on an open market exchange. The Report only addresses "payment stablecoins," which the Report defines as "those stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment." Report at 2. The Report does not address "synthetic" or "algorithmic" stablecoins that use other means to attempt to stabilize the price of the instrument or that are convertible for other assets. *Id.* at 4.

[2] The PWG defines a "stablecoin arrangement" as the "(1) creation and redemption of the stablecoin, (2) its transfer between parties, and (3) storage of the stablecoin by users." Report at 6. This definition is consistent with the Financial Stability Board's ("FSB") explanation of the key functions of a stablecoin arrangement. *See* Financial Stability Board, Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements: Final Report and High-Level Recommendations, at 10 (Oct. 13, 2020) ("FSB Stablecoin Report"), *available at* https://www.fsb.org/wp-content/uploads/P131020-3.pdf.

[3] Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions, Principles for financial market infrastructures, (Bank for International Settlements, April 2012).

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