

President's Working Group on Financial Markets and Federal Banking Regulators Issue Report on Stablecoins

November 8, 2021

On November 1, 2021, the President's Working Group on Financial Markets,¹ the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of the Currency (collectively, the "Financial Regulators") jointly published a report (the "Report") outlining the financial risks associated with the use of stablecoins as a means of payment and the need to address current gaps in regulation by subjecting issuers and other key parties in stablecoin arrangements to comprehensive prudential oversight.²

The Report is the first joint publication on stablecoins issued by this set of financial regulators and conveys a sense of urgency around the creation of a comprehensive legal framework for regulating stablecoins. The Report emphasizes the rapid growth of the stablecoin market, noting that market capitalization exceeded \$127 billion as of October 2021, reflecting a nearly 500-percent increase over the preceding 12 months. Calling for prompt action, the Report warns of the prudential, including systemic, risks posed by the potential increased use of stablecoin including runs, payment system disruptions, and rapid scaling and dominance by an individual stablecoin.

The Report recommends that, to address such risks, Congress enact legislation that would limit stablecoin issuance to insured depository institutions that are subject to prudential regulation and supervision at the entity and holding company levels. The Report also recommends, in the absence of legislative action, that the Financial Stability Oversight Council (the "FSOC") consider using its existing authority to designate certain stablecoin activities as systemically important payment, clearing and settlement activities.

¹ The President's Working Group on Financial Markets consists of the Secretary of the Treasury and the respective Chairs of the Federal Reserve Board, Securities and Exchange Commission (the "SEC") and Commodity Futures Trading Commission (the "CFTC") or their designees.

² The Report defines stablecoins as digital assets designed to maintain a stable value relative to a national currency or other reference asset. President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, "Report on Stablecoins" (Nov. 2021), available [here](#).

The Federal Reserve Board is anticipated to release its related paper on the costs and benefits of central bank digital currency in the coming weeks. The Report also notes that other work on digital assets and distributed ledger technology is ongoing in the Biden Administration.

Below we summarize the Report's key takeaways and our observations.

Three Categories of Prudential Risk

The Report organizes its discussion of prudential risks associated with payment stablecoins into three categories: (1) risk of stablecoin runs resulting from undermined confidence in the value of a stablecoin; (2) risk of disruption to the payment system; and (3) systemic risk and concentrated economic power resulting from a rapidly scaled stablecoin market.

- *Run Risk.* The Report contends that stablecoins are susceptible to runs if users lose confidence in their value. Without prudential oversight, users' confidence may be undermined by an issuer's use of reserve assets that can fall in price or become illiquid, the Report notes. Failure to safeguard properly reserve assets, lack of clarity regarding redemption rights and operational (e.g., cyber) risks may induce runs that could spread to other stablecoins and financial institutions.
- *Payment System Risks.* The Report contends that stablecoin-based payment systems face "many of the same basic risks as traditional payment systems," including credit risk, liquidity risk, operational risk, risks arising from improper or ineffective system governance and settlement risk. Without comprehensive management, such payment systems may become "less available and less reliable for users" and "create financial shocks or operate as a channel through which financial shocks spread."
- *Systemic Risk and Concentration of Economic Power.* Citing rapid growth in the stablecoin markets over the past year, the Report cites policy concerns including that: (1) the issuer or another key participant could pose systemic risk; (2) the combination of a stablecoin issuer or wallet provider with a commercial firm could represent a concentration of excessive economic power; and (3) a stablecoin that becomes widely adopted could present anticompetitive effects.

Core Legislative Recommendations

The Report contends that subjecting stablecoin arrangements and key parties, including stablecoin issuers and digital wallet providers, among others, to a consistent set of prudential standards is necessary to address fully the prudential risks and that “legislation is urgently needed.”

- *Insured Depository Institution Requirement.* To mitigate the risk of harm to stablecoin users and run risk, the Report recommends that legislation permit only insured depository institutions to issue stablecoins and engage in the related activities of redemption and maintenance of reserve assets. Such insured depository institutions would be subject to supervision and regulation (including capital and liquidity standards) at both the bank and holding company levels.
- The reference to holding company supervision implies that insured depository institutions not currently subject to consolidated holding company supervision, including industrial banks and limited purpose trust companies, would not be permitted to issue stablecoins.
- The Report also raises the possibility of providing stablecoin issuers access to the federal safety net, which would include the Federal Reserve Discount Window (which is broadly available to depository institutions) and FDIC deposit insurance. However, the Report falls short of categorically describing stablecoins as “deposits”³ eligible for FDIC deposit insurance or otherwise confirming availability of FDIC “pass-through” insurance, which some academic commenters have suggested is necessary to address fully “run risk.”⁴ The Report also fails to discuss the potential downstream regulatory impacts of establishing stablecoins as transferable bank liabilities, including whether doing so could increase the likelihood of their treatment as securities subject to SEC oversight.
- *Oversight of Custodial Wallet Providers and Other Parties.* To address payment system risks, the Report recommends that the legislation subject custodial wallet providers to appropriate federal oversight. Such oversight should include, per the Report, authority to restrict lending of customer stablecoins and impose appropriate risk management, liquidity and capital requirements, which appear similar to those to

³ The difficulty in categorically classifying stablecoins as deposits may arise from the fact that not all stablecoins are structured as debt contracts. To the extent that a stablecoin can be characterized as equity, and its holders as owners (like a money market mutual fund whose shares must be redeemed), the stablecoin may not be considered to be a deposit consistent with a 1979 interpretive letter from the Department of Justice to the SEC regarding the status of money market mutual funds as deposits.

⁴ See, e.g., Gary B. Gorton and Jeffery Zhang, “Taming Wildcat Stablecoins” (2021), available [here](#).

which traditional financial market utilities are subject. The Report also recommends that the legislation provide a stablecoin issuer's regulator authority to require any entity that performs activities critical to the functioning of any stablecoin arrangement to meet risk management standards, including the CPSS-IOSCO Principles for financial market infrastructures (as adapted to stablecoin). A recent interagency proposal reflects the banking agencies' focus on third-party risk management in light of changing technologies and third parties.⁵

- *Addressing Systemic Risk:* To address potential systemic risk arising from stablecoin activities, the Report recommends that stablecoin issuers be required to comply with activities restrictions that limit affiliation with commercial entities and suggests that custodial wallet providers potentially should be subject to similar limitations (or at least with respect to use of user transaction data), although it is unclear whether these limits would go beyond the limits already in place for bank holding companies and insured depository institutions. In addition, the Report recommends that supervisors should have the authority to implement standards to promote interoperability among stablecoins and between stablecoins and other payment instruments.

Interim Measures

The Report recommends certain interim measures in the absence of congressional action.

- *FSOC:* The Report recommends that the FSOC consider using its authority under Title VIII of the Dodd-Frank Act to designate certain activities conducted within stablecoin arrangements as, or as likely to become, systemically important payment, clearing and settlement activities. The Report observes that such designation would grant the appropriate agency authority to establish risk-management standards for financial institutions engaged in designated activities, including requirements for the assets backing the stablecoin, operational requirements and "other prudential standards." Financial institutions engaging in designated activities also would be subject to examination and enforcement frameworks. The Report recognizes that the FSOC's other authorities may also be available, such as the authority to designate systemically important financial market utilities or nonbank financial institutions. The suggestion of the FSOC as a potential avenue for imposing supervision underscores the Financial Regulators' view of the risk associated with inadequate oversight of payment stablecoins.

⁵ See Debevoise & Plimpton LLP, "Federal Banking Agencies Extend Comment Period for Proposed Third-Party Risk Management Guidance" (Sept. 13, 2021), available [here](#).

- *Agency Actions:* Although some federal financial agencies have expressed that they have insufficient statutory authority to regulate the cryptocurrency industry, the Report endorses action by federal financial agencies.⁶ For example, the Report notes that, in evaluating charter applications, banking agencies will seek to ensure that applicants have addressed the risks outlined in the Report, “including risks associated with stablecoin issuance and other related services conducted by the banking organization or third-party service providers,” which could open the door for agencies to reconsider existing conditional approvals.

The Report also highlights that authorities such as the Department of Justice may consider how section 21(a)(2) of the Glass-Steagall Act could apply to certain stablecoin arrangements. That provision makes it unlawful for a person “to engage...in the business of receiving deposits subject to check or to repayment upon presentation of a pass book, certificate of deposit, or other evidence of debt, or upon request of the depositor” unless the person is subject to some form of regulatory oversight and subjects violators to criminal penalties under section 21(b). The Report also references potential action by other federal financial agencies, including the market regulators, the Financial Crimes Enforcement Network (“FinCEN”) and the Consumer Financial Protection Bureau.

These recommendations come at a time when enforcement against fraudulent and deceptive behavior involving stablecoin is growing; the New York Attorney General’s office settled charges against Bitfinex and Tether for mismanagement of reserves behind the Tether stablecoin in February 2021.⁷

Illicit Finance Risk

The Report addresses illicit finance concerns posed by stablecoins and describes efforts by the U.S. Treasury Department to mitigate illicit finance risks.

- *Illicit Finance Concerns.* The Report notes that stablecoins can be used to transact pseudonymously, without the involvement of financial institutions subject to anti-money laundering and countering the financing of terrorism (“AML/CFT”) obligations, impeding the ability of law enforcement or regulators to identify participants in a transaction. Accordingly, the Report identifies a risk that mass-

⁶ SEC Chairman Gary Gensler noted in a speech that regulators “would benefit from additional plenary authority to write rules for and attach guardrails to crypto trading and lending.” SEC, “Gary Gensler: Remarks Before the Aspen Security Forum,” (Aug. 3, 2021), available [here](#).

⁷ New York Attorney General, “Attorney General James Ends Virtual Currency Trading Platform Bitfinex’s Illegal Activities in New York,” (Feb. 23, 2021), available [here](#).

adopted stablecoins may be used by illicit actors to exploit gaps between countries' AML/CFT regulatory and supervisory frameworks for stablecoins and other digital assets to engage in money laundering, sanctions evasion or other dealings in the proceeds of crime.

- *Risk Mitigation Efforts.* The Report indicates that Treasury intends to continue leading efforts by the Financial Action Task Force (the "FATF"), an international AML/CFT standard-setting body, to encourage member countries' implementation of international FATF standards for virtual assets and virtual asset providers. The Report also cites the existing U.S. regulatory framework applicable to "convertible virtual currency" ("CVC"). The Report notes that, in the United States, most stablecoins are considered CVCs and that CVC financial services providers engaged in money transmission must register as money services businesses ("MSBs") with FinCEN. As such, they must comply with FinCEN regulations that require that MSBs maintain AML programs, report large cash transactions and file suspicious activity reports on certain suspected illegal activities. In addition, as the Report notes, the Office of Foreign Assets Control ("OFAC") has issued guidance on how the virtual currency industry can build risk-based sanctions compliance programs.⁸

Treasury also intends to pursue additional resources to support domestic supervision of U.S. AML/CFT and sanctions regulations, which the Report warns may involve increased enforcement activity related to stablecoin industry members. Treasury's further assessment of the illicit financing risk landscape for stablecoins and other digital assets will be provided in its upcoming National Illicit Finance Strategy and National Risk Assessments for Money Laundering, Terrorist Financing and Proliferation Financing.

Digital Asset Trading Platforms and DeFi

Although the Report raises broader questions regarding digital asset market regulation, supervision and enforcement, the Report notes both that stablecoins and providers of arrangements that facilitate trading and settlement may fall under the jurisdiction of either the SEC or the CFTC, which are currently considering these issues. The report outlines key characteristics of stablecoin arrangements, including requirements and related risks in mechanisms for distribution and redemption and in facilitation of secondary market activities. The Report draws attention to two such mechanisms: digital asset trading platforms and DeFi.

⁸ OFAC, "Sanctions Compliance Guidance for the Virtual Currency Industry," (October 2021), available [here](#).

- *Digital Asset Trading Platforms.* Digital asset trading platforms typically hold stablecoins for their customers in non-segregated omnibus custodial wallets and reflect trades on internal records. These platforms may hold significant amounts of stablecoins, including on a commingled basis. In addition, these platforms may engage in trading on a principal basis without any disclosure, oversight or other regulatory constraints.
- *DeFi.* The Report describes “DeFi as a variety of financial products, services, activities and arrangements supported by smart contract-enabled distributed ledger technology.” Stablecoins play a central role in many DeFi arrangements to facilitate trading or as collateral for lending and borrowing. The Report notes that despite claims of decentralization, DeFi operations are often administered and/or governed by small groups that provide similar services to incumbent financial service providers and raise similar policy concerns.
- *Risks and Regulatory Gaps.* The Report identifies a variety of risks posed by these mechanisms, including risks of fraud, misappropriation and conflicts of interest; reliance of stablecoin arrangements on continuous and proper operation of these mechanisms (and vice versa); AML/CFT; lack of transparency; and market abuse, among others. In noting that these platforms may be subject to SEC and/or CFTC supervision, the Report also implies that some such arrangements may not fall under the jurisdiction of either of these regulators and underscores the importance of regulatory oversight of both digital asset platforms and DeFi through promotion of investor and market-protection measures.

Comparison of Potential Policy Alternatives

Academic commenters and policymakers have characterized stablecoins as a new form of “private money” and, drawing from historical experience during the Free Banking Era of the 19th century and the rise of money market mutual funds during the 1970s, have proposed to address their attendant risks by transforming this “private money” into “public money” using techniques similar to those implemented during those prior periods.

- One of these proposed responses is to bring stablecoins “within the insured bank regulatory perimeter,” which is ultimately the approach the Report recommends.⁹ This approach was used during the late 19th and early 20th centuries to end the turbulent Free Banking Era by passage of the National Bank Acts in the 1860s,

⁹ See *supra* note 4.

creation of the Federal Reserve System in 1913 and creation of a federal deposit insurance scheme in 1933.

- Another policy approach is to require private money to be backed, one-for-one, with safe assets. Congress adopted this approach during the Free Banking Era through the National Bank Acts, which required that bank notes be backed by U.S Treasury securities. Congress and the SEC adopted a similar approach in response to the rise of money market mutual funds in the 1970s by imposing strict asset quality and NAV requirements. The Report does not suggest that similar measures be taken with respect to stablecoins, although it does suggest that, in the absence of congressional action, the FSOC could consider designating certain activities within stablecoin arrangements as systemically important payment clearing and settlement activities, which would allow the appropriate agency to establish risk-management standards, including that stablecoins be backed one-for-one by high-quality liquid assets.
- A final policy approach would be to establish a central bank digital currency and eliminate all other forms of stablecoin, either through prohibitive tax (as Congress did with the National Bank Acts) or by banning them outright. Although the Report does not propose such an alternative, the Federal Reserve Board has been investigating such an approach.¹⁰ As noted above, we expect the Federal Reserve Board to issue its comprehensive study on central bank digital currency in the near term.

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Please do not hesitate to contact us with any questions.



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¹⁰ Federal Reserve Board, "CBDC: A Solution in Search of a Problem?" (Aug. 5, 2021), available [here](#).



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