The President's Working Group on Financial Markets' Report on Stablecoins

Six Things To Know

On Monday, November 1, 2021, the President's Working Group on Financial Markets – comprised of the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission, and the Acting Chair of the Commodity Futures Trading Commission – together with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency (collectively, the "agencies") – issued a much-anticipated report on stablecoins (the "Report"). The Report emphasizes the rapid pace at which stablecoins have developed, the risks that stablecoin arrangements pose and perceived gaps in regulatory authority over stablecoins, and calls for Congressional action to enact comprehensive legislation subjecting stablecoins to a prudential regulatory framework.

1 The Report focuses on "payment stablecoins," defined 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.

The Report observes that stablecoins are primarily used to facilitate trading, lending, or borrowing of other digital assets, predominantly on or through digital asset trading platforms, but can also be used as a means of payment. The Report defines stablecoins generally as digital assets that are designed to maintain a stable value relative to a national currency or other reference assets. The Report, however, focuses its prudential recommendations on payment stablecoins, which it notes are often issued with a promise or expectation that they may be redeemed for fiat currency on a one-for-one basis.

---

2 The Report identifies three key areas of stablecoin risk — loss of value, payment system risk, and risks of scale — and identifies perceived regulatory gaps, including the absence of a consistent set of prudential regulatory standards applicable to stablecoins.

While the Report contains a proportionately brief discussion of the market integrity and investor protection risks posed by stablecoins and stablecoin-related activities, the larger part of the Report's discussion of risks is devoted to three other types of risk: loss of value, payment system risk, and risks of scale. Among the specific types of risks described are:

- *Loss of value and stablecoin runs*. The Report states that the failure of stablecoins to perform according to expectations could harm users of the stablecoin and result in a "run" on the stablecoin — a self-reinforcing cycle of redemptions and fire sales of the stablecoin's reserve assets. It also notes that stablecoin runs can have systemic effects — for example, by spreading from one stablecoin to another, or by amplifying a shock to the economy and financial system where the run occurs under strained market conditions.

- *Payments system risks*. The Report acknowledges that stablecoins' transfer mechanisms provide opportunities for efficient payment processing, but they have many of the same risks as traditional payment systems. According to the Report, if not managed comprehensively, these risks can make payment systems less available and reliable and can create financial shocks or operate as a channel for spreading financial shocks.
- *Risks of scale*. The Report also states that the combination of a stablecoin issuer or custodial wallet provider and a commercial firm could lead to an excessive concentration of economic power. Similarly, a stablecoin that is widely adopted could present concerns at the agencies about anti-competitive effects if, for example, there is friction or costs of switching to a different payment product.

The Report concludes that a major regulatory gap exists because stablecoin arrangements are not subject to a consistent set of prudential regulatory standards that address the above risks.

---

3 The Report recommends that Congress enact legislation requiring stablecoin issuers to be FDIC-insured banks, subjecting custodial wallet providers to federal oversight, and requiring stablecoin issuers to comply with activities restrictions and limits on affiliation with commercial entities.

The Report provides the following three key recommendations for legislation that would establish a federal prudential framework for stablecoin arrangements:

- Stablecoin issuers should be required to be Federal Deposit Insurance Company- ("FDIC-") insured depository institutions, subject to supervision by a federal banking agency at the depository institution level and consolidated supervision and regulation by the Board of Governors of the Federal Reserve System ("Federal Reserve") at the holding company level.
- Custodial wallet providers, a type of wallet provider on which users may rely to hold stablecoins on their behalf, should also be subject to "appropriate federal oversight," including restrictions on service providers' ability to lend customer stablecoins and compliance with appropriate risk management, liquidity, and capital requirements.
- Stablecoin issuers should be required to comply with activities restrictions that limit affiliation with commercial entities. The Report suggests that Congress should "consider" similar standards for custodial wallet providers as well as standards on use of users' transaction data.

Notably, the Report takes no position on which federal banking agency should be responsible for supervising stablecoins issuers and custodial wallet providers. The Report also recommends that legislation give supervisors authority to implement standards to promote interoperability among stablecoins and to impose risk management standards on any entity that performs activities critical to the functioning of a stablecoin arrangement.

---

4 The Report identifies ways that the agencies can use existing authorities to take action to regulate stablecoins in the absence of such legislation, providing a glimpse into the agencies likely approach in the near-term.

The agencies recommend that regulatory authorities use a range of existing authorities to address

the risks of stablecoins, including the following:

- The federal banking agencies should seek to ensure that any applicants for bank charters address the risks outlined in the Report, including risks associated with stablecoin issuance and other related services conducted by the banking organization or the third-party service provider;
- The Consumer Financial Protection Bureau ("CFPB") should apply safeguards under consumer financial protection laws such as the Electronic Fund Transfer Act, the Gramm-Leach-Bliley Act, and the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act");
- The Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC") should apply federal securities and commodities laws to stablecoins that are securities, commodities, and/or derivatives and to the trading, lending and borrowing activity fueled by stablecoins on digital asset trading platforms;
- The U.S. Department of Justice should consider whether section 21(a)(2) of the Glass-Steagall Act (prohibiting deposit-taking by non-bank entities) may apply to certain stablecoin arrangements; and
- The Financial Crimes Enforcement Network ("FinCEN") should exert its existing authority over stablecoin arrangements that constitute "money transmission services" and are subject to federal anti-money laundering and counter-terrorist financing obligations under the U.S. Bank Secrecy Act.

5

The Report recommends that the Financial Stability Oversight Council consider designation of certain activities conducted within stablecoin arrangements as systemically important payment, clearing, and settlement activities.

The Report observes that the Financial Stability Oversight Council ("FSOC") could use its existing authority under the Dodd-Frank Act to designate a stablecoin activity as, or as likely to become, a systemically important payment, clearing, and settlement activity and to subject the activity and financial institutions that engage in the activity to additional risk management standards and to examination and enforcement.

6

The Report highlights the potential for stablecoins to be used to conduct financial crimes, but does not recommend any specific actions in this area.

In a text box that appears after the body of the Report, the Report identifies the possibility that stablecoins are used for money laundering and terrorist financing as another area of risk, but largely defers to ongoing work of the U.S. Department of the Treasury, FinCEN, and the Office of Foreign Assets Control rather than propose any specific actions to address the issue.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services practice:

Randy Benjenk	+1 202 662 5041	rbenjenk@cov.com
Jeremy Newell	+1 212 841 1296	jnewell@cov.com
Michael Nonaka	+1 202 662 5727	mnonaka@cov.com
Karen Solomon	+1 202 662 5489	ksolomon@cov.com
Jane Faulkner	+1 202 662 5757	jfaulkner@cov.com
Jenny Konko	+1 202 662 5025	jkonko@cov.com