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# U.S. regulators speak on stablecoin and crypto regulation

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A recent PWG Report on stablecoins and statements by U.S. financial regulators suggest near-term enforcement focus and longer-term regulatory changes for stablecoin and other cryptocurrency activities. Our client update briefly summarizes the Report's key recommendations and sets out a few key takeaways and one puzzling omission, reflecting on the Report's implications in the context of these statements.

The President's Working Group on Financial Markets (PWG), together with the Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC), issued a joint Report on Stablecoins (the Report) on November 1, 2021. The Report sets out recommendations for the regulation of stablecoin issuers, custodial wallet providers, and others engaged in stablecoin activities. The Report, along with a number of recent statements by regulators, highlight the near-term focus of U.S. financial regulators on enforcing existing laws that apply to stablecoin and cryptocurrency activities, but that, in the longer term, signal that regulatory change is coming. This memorandum briefly summarizes the Report's key recommendations and sets out a few key takeaways and one puzzling omission, reflecting on the Report's implications in the context of the statements by U.S. financial regulators.[1]

## The PWG Report on Stablecoins

The Report addresses three categories of prudential risk posed by those stablecoins described as "payment stablecoins:" the risk of loss of value of stablecoins because of run risk and potential contagion effects; payment system risks, such as potential disruptions in users' ability to make payments with stablecoins; and the risks of scale, including systemic (e.g., contagion) risk, the risk of excessive concentration of economic power and the risk of anti-competitive effects.[3][2]

The Report announces no immediate changes to the federal regulation of stablecoin arrangements. Instead, it recommends that Congress promptly enact new law to regulate stablecoin arrangements, focusing on stablecoin issuers and custodial wallet providers. The Report does not recommend reforms to market integrity and investor protection or anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements. Instead, on those topics, the Report highlights the existing regulatory and enforcement authority of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC) over stablecoins that are securities, commodities or derivatives and of FinCEN over money transmission activities by participants in stablecoin arrangements.

### Congress should require stablecoin issuers to be FDIC-insured banks.

The Report's first recommendation is that Congress should enact legislation to require stablecoin issuers to be insured depository institutions (IDIs) and should prohibit non-IDIs from issuing stablecoins or engaging in the "related activities of redemption and maintenance of reserve assets." The Report does not, however, take a position on whether stablecoin issuance involves deposit-taking for purposes of the various federal banking laws. As IDIs, stablecoin issuers would be subject to consolidated supervision, prudential standards including leverage and risk-based capital requirements, activities restrictions, and limitations on affiliation with commercial entities.

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The Report also recommends that Congress grant the federal supervisor of a stablecoin issuer authority to require critical third-party service providers to the stablecoin arrangement to meet appropriate risk-management standards and to give supervisors examination and enforcement authority over such third-party service providers. This approach is modeled on the existing examination and enforcement authority over third-party service providers to insured banks under the Bank Service Company Act.

The Report recommends that Congress address interoperability among stablecoins, in particular by giving supervisors authority to "implement standards to promote interoperability among stablecoins." It is unclear from the Report whether these interoperability standards would be applicable to stablecoin issuers or other stablecoin arrangement participants such as custodial wallet providers (or both) or what types of interoperability are contemplated.

## Congress should impose federal oversight on custodial wallet providers.

The Report recommends that Congress subject stablecoin custodial wallet providers to federal oversight, without going so far as to say they must be IDIs as well. Indeed, the Report does not specify which regulator Congress should appoint to provide this federal oversight, but does state that the oversight should include authority to restrict custodial wallet providers from lending customer stablecoins and to require custodial wallet providers to comply with appropriate risk management, liquidity, and capital requirements. Given existing U.S. state regulation of custodial wallet providers as money transmitters, this recommendation is sure to generate discussion around the appropriate role of the state regulators and whether there should be a single national regulatory framework.

## FSOC designation of stablecoin activities is an alternative to legislation.

In the absence of congressional action, which we believe to be the most likely scenario, the Report recommends that the Financial Stability Oversight Council (FSOC) consider taking action to address the risks posed by stablecoin arrangements. The primary recommendation is to designate "certain activities conducted within stablecoin arrangements" as, or as likely to become, systemically important payment, clearing, and settlement (PCS) activities under Title VIII of the Dodd-Frank Act.[4]

Any "financial institution" as defined in Title VIII that is engaged in designated PCS activities involving stablecoins would be subject to risk management standards established by the Federal Reserve, the SEC or the CFTC, depending on the entity's primary federal regulator. The Report suggests that the risk management standards could include requirements related to the reserve assets backing a stablecoin and the operation of the stablecoin arrangement, and other prudential standards.

The term "financial institution" is defined in Title VIII to include a laundry list of already federally regulated financial institutions, including IDIs, broker-dealers, futures commission merchants and bank holding companies (BHCs), as well as any other 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 (BHC Act), subject to exclusions for certain already regulated companies including designated contract markets, securities exchanges and clearing agencies. Thus, any existing IDIs or BHCs that engage in designated stablecoin activities would be subject to the special risk management standards for those designated activities. So would monoline stablecoin issuers that do not engage in any activities other than issuing, transferring or buying and selling their stablecoins and maintaining a reserve of cash and cash equivalents to back 100% of their stablecoin liabilities.

By indicating that stablecoin activities by financial institutions are subject to designation under Title VIII, the PWG, FDIC and OCC have effectively determined that issuing, transferring and buying and selling payment stablecoins are activities that are financial in nature or incidental to a financial activity as described in Section 4 of the BHC Act. They have also effectively determined that those activities are permissible for banks when conducted by financial institutions that are IDIs and closely related to banking when conducted by BHCs or their non-bank affiliates.

The Report suggests that FSOC designation of entities that participate in stablecoin arrangements as systemically important financial market utilities under Title VIII of the Dodd-Frank Act or systemically important nonbank financial companies (SIFIs) under Title I of the Dodd-Frank Act would be a secondary alternative to PCS activity designation under Title VIII.[6][5]

# Key takeaways and a puzzling omission

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When read together, the Report and recent statements by U.S. financial regulators reveal likely areas of enforcement and regulatory focus and potential paths forward in the regulation of stablecoin and cryptocurrency activities. Following the release of the Report, several U.S. financial regulators issued statements and spoke about their focus on the regulation of stablecoin arrangements and cryptocurrency activities more broadly. Key among these was a wide-ranging speech by Acting Comptroller of the Currency Michael Hsu that described a possible approach to stablecoin regulation as well as the regulation of "universal crypto firms." Statements by SEC Chair Gary Gensler and Consumer Financial Protection Bureau (CFPB) Director Rohit Chopra forecast near-term enforcement focus on stablecoins by those agencies. And Treasury Under Secretary for Domestic Finance Nellie Liang stated that "[a]dditional work on digital assets and other innovations related to cryptographic and distributed ledger technology is ongoing throughout the [Biden] Administration."

## 1. In the near term, federal agencies will take enforcement action under existing laws.

The Report describes and supports the continuing application of existing laws by federal regulators to stablecoin activities. This includes enforcement actions under the securities, commodities, AML/CFT and consumer protection laws, evaluation of stablecoin-related risks in bank charter applications, and consideration by relevant authorities, including the Department of Justice (DOJ), of whether issuing stablecoins would constitute the taking of deposits for purposes of section 21(a)(2) of the Glass-Steagall Act. The Report discusses in some detail the illicit finance risks raised by stablecoins and how existing FinCEN regulations under the Bank Secrecy Act apply to stablecoin activities.[7]

Given that congressional action or FSOC designation will not progress quickly, we believe that in the near term federal agencies will focus on enforcement against stablecoin issuers and other cryptocurrency market participants under existing law. For example, the Report describes in detail the risks associated with decentralized finance (DeFi) activities that may involve stablecoins and states that the SEC and CFTC will apply the securities and commodities laws to stablecoins that are securities, commodities or derivatives. That prediction was echoed by SEC Chair Gensler, who said in a statement on the Report that "[w]hile Congress and the public evaluate" the Report, the SEC and CFTC will "deploy the full protections of the federal securities laws and the Commodity Exchange Act to [stablecoin] products and arrangements, where applicable." In a separate speech on November 4, Gensler warned crypto and other market participants against pushing the boundaries of securities regulation, declaring: "Make no mistake: regardless of the label or purported mission, we will be looking at the economic realities of a given product or arrangement to determine whether it complies with the securities laws."

Although the CFPB was not among the agencies involved in preparing the Report, CFPB Director Chopra echoed this focus in a statement on the Report in which he highlighted that consumer use cases of stablecoins "trigger obligations under federal consumer financial protection laws, including the prohibition on unfair, deceptive, or abusive acts or practices." And recent statements by Acting Comptroller Hsu, as described further below, indicate that bank regulators' action in this space will not be limited to the review of charter applications.

## 2. The regulatory approach is pro-bank.

The Report's primary recommendation envisions stablecoin issuers being regulated as IDIs, rather than under a new chartering and regulatory regime designed specifically for stablecoin issuers. The Report therefore effectively determines that stablecoin issuance and the related activities of stablecoin transfers, purchases and sales can be conducted by IDIs, meaning that these stablecoin activities are bank-permissible. If they are permissible banking activities, then they must also be closely related to banking and financial in nature or incidental to a financial activity as described in Section 4 of the BHC Act and, therefore, should be permissible for BHCs, financial holding companies and their non-bank affiliates. As noted above, a similar conclusion can be drawn from the FSOC designation recommendation.

The Report's approach was taken forward in recent statements by Acting Comptroller Hsu, in discussing stablecoin activities and cryptocurrency activities more broadly. In a November 3 speech titled "Leveling Up Banking and Finance," Hsu discussed his support for bringing "synthetic banking providers," including firms that engage in a wide range of wholesale and retail cryptocurrency activities, within the bank regulatory perimeter. Hsu called on these "large, universal crypto firms—especially issuers of highly-circulated stablecoins" to "embrace comprehensive, consolidated supervision" like that for existing IDIs and BHCs. It is not clear whether Hsu's references to comprehensive, consolidated supervision were intended to be understood literally and narrowly, or whether instead it was meant as a more general policy statement in support of the Report's recommendation that stablecoin issuers and their affiliates should be subject to the full array of provisions in the BHC Act, including the activities and investment restrictions in that law. Hsu also called on federal and state banking regulators to "prioritize the development of policies, staff, and supervisory approaches" to bringing such firms within the bank regulatory perimeter. It is unclear whether Hsu believes legislation is necessary for the OCC and Federal Reserve to assert jurisdiction over such firms.

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## 3. Excessive concentration of economic power is a key concern.

A key concern flagged in the Report is the possibility that the combination of a stablecoin issuer or a wallet provider with a commercial firm could lead to an excessive concentration of economic power, especially where the issuer or wallet provider experiences rapid growth. The Report states that such a combination could lead to anti-competitive advantages in accessing credit or using data to market or restrict access to products, potentially resulting in market concentration in sectors of the real economy. The Report views these policy concerns as "analogous to those traditionally associated with the mixing of banking and commerce."

These concerns would, in part, be addressed if stablecoins were required to be issued by IDIs that are banks for purposes of the BHC Act, which imposes limitations on affiliations between banks and their non-bank affiliates, on the one hand, and commercial entities, on the other. The Report further recommends limits on affiliation between custodial wallet providers and commercial entities, limits on the use of stablecoin users' transaction data by custodial wallet providers, and granting supervisors the authority to implement standards to promote interoperability among stablecoins.

This discussion of competition is consistent with other recent activity by the Biden Administration that suggests a potential push for the separation of commercial activities from the provision of financial services. For example, in a statement on the Report, CFPB Director Chopra highlighted the CFPB's recent issuance of orders to certain large technology companies to collect information on their payments products. Acting Comptroller Hsu queried in his November 3 speech whether "the rapid expansion and mixing of wholesale and retail activities at some crypto firms" merits a "separation of activities in the crypto space" like the separation between commercial and investment banking that had been reflected in the Glass-Steagall Act. We expect that competition considerations will continue to be a key area of focus for U.S. financial regulators as they consider enforcement and regulatory action on stablecoins and other cryptocurrency activities.[8]

## 4. A puzzling omission.

By recommending that Congress require all stablecoin issuers to be IDIs, the Report would effectively require all stablecoin issuers to engage in fractional reserve banking and effectively prohibit them from being structured as 100% reserve banks (i.e., narrow banks) that limit their activities to the issuance of stablecoins fully backed by a 100% reserve of cash or cash equivalents.[10][9]

The reason is that IDIs are subject to minimum leverage capital ratios that were calibrated for banks that engage in fractional reserve banking and invest the vast portion of the funds they raise through deposit-taking in commercial loans or other illiquid assets that are riskier but generate higher returns than cash or cash equivalents. Minimum leverage ratios treat cash and cash equivalents as if they had the same risk and return profile as commercial loans, commercial paper and long-term corporate debt, even though they do not. Unless Congress recalibrated the minimum leverage capital ratios to reflect the lower risk and return profile of IDIs that limit their assets to cash and cash equivalents, the minimum leverage capital ratios would make the 100% reserve model for stablecoin issuance uneconomic and therefore effectively prohibited. It is puzzling why the PWG, FDIC and OCC would recommend a regulatory framework that would effectively require stablecoin issuers to invest in riskier assets and rely on FDIC insurance rather than permitting stablecoins backed by a 100% cash and cash equivalent reserve.[11]

This omission is puzzling for another reason. There has long been a debate whether deposit insurance schemes or a regime that required demand deposits to be 100% backed by cash or cash equivalents would be more effective in preventing runs or contagion. Indeed, the Roosevelt Administration, Senator Carter Glass, a number of economists and most well-capitalized banks were initially opposed to the proposal to create a federal deposit insurance scheme in 1933. Among the arguments against deposit insurance are that the benefits of deposit insurance in the form of reduced run and contagion risk are outweighed by the adverse effects in the form of reduced market discipline resulting from the reduced incentive of depositors to monitor the financial health of their banks. This reduced monitoring gives weaker banks more room to engage in risky activities the costs of which are borne by the stronger and more responsible banks in the form of excessive deposit insurance premiums or by taxpayers in the form of government bailouts.[12]

In a competing proposal that has come to be known as the Chicago Plan, a group of economists led by economists at the University of Chicago argued in favor of a legal regime that required all demand deposits to be 100% backed by a reserve of cash or cash equivalents. Proponents of the Chicago Plan argued that it would be more effective in stemming runs and contagion than the proposed federal deposit insurance scheme, without undermining market discipline or creating moral hazard. The Chicago Plan would have been analogous to the original National Bank Act that required all paper currency issued by national banks to be fully backed 100% by U.S. Treasury securities. The Chicago Plan was ultimately rejected in favor of the federal deposit insurance scheme that was enacted in 1933 not because it would have been less effective than deposit insurance in stemming runs and contagion, but because it was viewed as too radical. Policymakers feared that by prohibiting banks from using deposits to fund commercial loans and invest in other debt

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instruments, the Chicago Plan would have resulted in a further contraction in the already severely contracted supply of credit that was fueling the great contraction in economic output that later became known as the Great Depression.[13]

It is understandable why the Report does not recommend prohibiting IDIs from issuing, transferring or buying and selling stablecoins that represent insured deposit liabilities. What is puzzling in light of this history, however, is why the Report would effectively prohibit stablecoin issuers from structuring themselves as 100% reserve (i.e., narrow) banks that limit their activities to the issuance, transfer and buying and selling stablecoins fully backed by a 100% reserve of cash or cash equivalents.

The PWG's members are the Secretary of the Treasury, the Chair of the Board of Governors of the Federal Reserve System, the Chair of the Securities and Exchange Commission and the Chair of the Commodity Futures Trading Commission. The FDIC and the OCC joined the PWG in issuing the Report. The PWG is authorized to report to the President its views on any recommended legislative changes.[1]

The Report defines "payment stablecoins" as those that are "designed to maintain a stable value relative to fiat currency and, therefore, have the potential to be used as widespread means of payment." The Report distinguishes stablecoins that are convertible for fiat currency from "a smaller subset of stablecoin arrangements that use other means to attempt to stabilize the price of the instrument (sometimes referred to as 'synthetic' or 'algorithmic' stablecoins) or are convertible for other assets."[2]

Treasury Under Secretary for Domestic Finance Nellie Liang described these prudential risks in a speech on the Report. See Remarks by Under Secretary for Domestic Finance Nellie Liang to the Stanford Graduate School of Business (Nov. 1, 2021), https://home.treasury.gov/news/press-releases/jy0455.[3]

12 U.S.C. § 5463.[4]

See 12 U.S.C. § 5463.[5]

See 12 U.S.C. § 5323.[6]

12 U.S.C. § 378(a)(2). The DOJ has previously determined that selling ownership interests in money market mutual funds does not amount to taking deposits for purposes of Section 21 of the Glass-Steagall Act. Letter from Philip B. Heymann, Assistant Attorney General of the DOJ Criminal Division, to Martin Lybecker, Associate Director of the SEC Division of Marketing Management, in response to a letter dated October 19, 1979.[7]

See *CFPB Orders Tech Giants to Turn Over Information on their Payment System Plans* (Oct. 21, 2021), https://www.consumerfinance.gov/about-us/newsroom/cfpb-orders-tech-giants-to-turn-over-information-on-their-payment-system-plans/.[8]

For a discussion of narrow banking, see Michael S. Barr, Howell E. Jackson & Margaret E. Tahyar, *Financial Regulation: Law and Policy*, at 221-224 (3d. ed. 2021)[9]

For a discussion of 100% reserve banks, see *A Program for Monetary Reform* (1939), available at https://monetary.org/pdfs/a_program_for_monetary_reform.pdf, which is an expanded version of the original 1933 Chicago Plan, described below, which was never published.[10]

See Christian Catalini & Jai Massari, *Stablecoins and the Future of Money* (Aug. 10, 2021), https://hbr.org/2021/08/stablecoins-and-the-future-of-money.[11]

See Mark D. Flood, *The Great Deposit Insurance Debate*, Federal Reserve Bank of St. Louis Review, Vol. 74, No. 4, at 51-77 (July/August 1992), https://files.stlouisfed.org/files/htdocs/publications/review/92/07/Deposit_Jul_Aug1992.pdf.[12]

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See Ronnie J. Phillips, *The 'Chicago Plan' and New Deal Banking Reform*, Working Paper No. 76 (June 1992), https://www.levyinstitute.org/pubs/wp/76.pdf; Jaromir Benes & Michael Kumhof, *The Chicago Plan Revisited*, IMF Working Paper (2012), https://www.imf.org/external/pubs/ft/wp/2012/wp12202.pdf. [13]

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