

FSOC report on digital asset financial stability risks and regulation – Key takeaways

October 20, 2022 | Client Update | 14-minute read

The FSOC report assesses the financial stability risks of the crypto-asset ecosystem using a framework for vulnerabilities and shocks pioneered by the Federal Reserve, and makes several recommendations for regulatory reform. It reveals a continuing lack of consensus and turf wars among the U.S. financial regulators.

Background

The [report](#) recently issued by the Financial Stability Oversight Council (FSOC) is quite different from the other reports published so far by the U.S. financial regulators in response to [Executive Order 14067](#) on digital assets (FSOC Report). Helpfully, this report included a series of specific policy recommendations about what Congress and the regulators ought to do next. But the FSOC Report reveals a continuing lack of consensus and turf wars among the U.S. financial regulators, making its calls for coordination and cooperation ring hollow and introducing incoherence into some of the recommendations.[1]

Following an exhaustive 60-page discussion of the potential financial stability risks of crypto-asset activities, the FSOC Report identifies three principal gaps in the regulation of those activities – (1) limited direct federal oversight of the spot market for crypto-assets that are not securities, (2) opportunities for regulatory arbitrage and (3) the vertical integration of crypto-asset services – and includes ten not very detailed recommendations for closing those gaps and addressing other identified regulatory considerations.[4][3][2]

Below are six key takeaways from the FSOC Report. We also compare the FSOC Report to other recent statements and reports by members of the FSOC. **Appendix 1** is a chart with more details on the three identified regulatory gaps and the recommendations aimed at closing them.

Appendix 2 compares FSOC's framework for assessing the financial stability risks of the crypto-asset ecosystem with the Federal Reserve's framework for assessing the financial stability risks and resilience of the traditional banking system, which was introduced in the Federal Reserve's inaugural [Financial Stability Report in 2018](#). In applying this framework to vulnerabilities in the form of interconnections between the crypto-asset ecosystem and the traditional financial system, the FSOC Report exaggerates the risks of many of those interconnections. Most of the other vulnerabilities in the crypto-asset ecosystem identified in the FSOC Report are identical to the vulnerabilities in the traditional financial system identified in the Federal Reserve's Financial Stability Reports and can be addressed the same way they are addressed in the traditional financial system.[6][5]

Key takeaways

1. **FSOC is more skeptical than supportive of crypto-asset activities.**

- The FSOC Report focuses almost exclusively on the financial stability risks of crypto-asset activities, but does not try to address the potential financial stability benefits of those activities.
 - The skeptical tone of the FSOC Report mirrors recent statements by various members of FSOC.[8]
 - The Financial Stability Board similarly focused almost exclusively on risks in a [report](#) on crypto-asset activities and markets released just a few days after the FSOC Report was published.
 - In contrast, in his first [speech](#) after the FSOC Report was released, Federal Reserve Vice Chair for Supervision Michael Barr described the promise of financial innovation, including crypto-asset activities, as making “financial products and services better, faster, cheaper, and more available ... [and] disrupt traditional providers by spurring competition, creating products that better meet customer needs, and extending the reach of financial services and products to those typically unserved.”

[7]

- Among other things, the FSOC Report does not consider the risks of continued Congressional and regulatory inaction nor the public benefits of clarifying:
 - Which crypto-asset activities are permissible for the existing nonbank crypto-asset ecosystem; or
 - Which crypto-asset activities are permissible for banking organizations as an incident of the business of banking, closely related to banking, financial in nature, incidental to a financial activity or complementary to a financial activity.
- The FSOC Report similarly expresses skepticism on whether there are persuasive use cases and thus benefits for most crypto-assets, especially non-fungible tokens (NFTs), viewing their value as primarily driven by speculation rather than “fundamental economic use.”[9]
- Finally, the FSOC Report contains several threats of more enforcement of current laws, calling out noncompliance with existing laws.[10]

2. The FSOC’s failure to deal with the SEC’s expansive view of its jurisdiction over crypto-assets weakens many of its other recommendations.

- The FSOC Report recommends that Congress provide new federal regulatory authority over spot markets in crypto-assets and, at the same time, says that “[c]ertain crypto-assets are securities” and thus are subject to regulation under the existing U.S. federal securities laws.
- The FSOC Report does not acknowledge the challenges in deciding whether a particular crypto-asset is a security or the significant gap between blanket statements from SEC leadership asserting that, Bitcoin aside, “almost all digital assets are securities” and more nuanced positions taken by market participants and other regulators – including the CFTC and some state regulators – recognizing that although some crypto-assets may be used in investment capital-raising transactions, it is inappropriate to treat the asset class as a whole as falling under the securities regulatory regime.
- Accordingly, the FSOC Report fails to recommend that Congress enact a definition for crypto-assets that would clarify the jurisdictional line between crypto-assets that are securities and those that are not—something that the current bills being considered in Congress also fail to do. See Davis Polk’s [client update](#) on this issue.
- The FSOC Report fails even to call for the SEC and CFTC to resolve this issue. Instead, the FSOC Report would allow the highly indeterminate *Howey* and *Reves* tests to remain in place, even though these judge-made tests are deliberately broad and subjective catch-alls and therefore unsuited for a new trillion-dollar asset class that can be objectively defined.
- As a result, its recommendations for a comprehensive federal market, consumer, investor and prudential framework cover only those crypto-assets without addressing which assets might fall within the framework. Because the SEC can be counted on to continue issuing broad statements about the crypto-assets that fall under its remit, this means that many of FSOC’s recommendations are unnecessarily limited in their scope.

3. FSOC strongly believes that crypto-asset activities should be subject to a federal regulatory framework created by Congress.

- FSOC is skeptical of the sufficiency of state money services regulation, stating that state regulation focuses on consumer protection and AML/CFT instead of prudential regulation and financial stability—while allowing crypto

platforms to advertise that they are “regulated.”[11]

- The FSOC Report is clearly designed to put pressure on Congress to create a comprehensive regulatory framework for crypto-assets.

4. FSOC recommends that Congress pass legislation that would create a comprehensive federal prudential framework for stablecoins.

- The FSOC Report does not recommend that stablecoin issuers be limited to insured depository institutions (IDIs). This represents a welcome shift from the November 2021 [Report on Stablecoins](#) by the President’s Working Group, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, which recommended such a limitation.
 - Instead, like various Senate bills or discussion drafts, the FSOC Report is consistent with the view that stablecoin issuers could be stand-alone nonbank entities, separately incorporated subsidiaries of IDIs or IDIs.[12]
- The FSOC Report recommends that such legislation reflect the principle of same activity, same risk, same regulatory outcome.
 - This principle implies that if the risk profile of stablecoin issuers is lower than that of traditional banks, the prudential standards, such as capital and liquidity calibrations, should be tailored to reflect this lower risk profile.
- The FSOC Report suggests that if Congress does not implement this recommendation, the FSOC might designate stablecoin issuers as systemically important financial companies or stablecoin activities as systemically important payment, clearing or settlement activities under Title I or VIII of the Dodd-Frank Act.[13]

5. The FSOC Report recommends that Congress pass legislation that subjects crypto-asset companies, their affiliates and subsidiaries to consolidated regulation and supervision by multiple agencies.

- The FSOC Report recommends that Congress pass legislation that would create authority for regulators to regulate and supervise the activities of all of the affiliates and subsidiaries of crypto-asset entities, including by imposing activities and investment restrictions on such entities, their affiliates and subsidiaries.
- This recommendation on comprehensive supervision is not limited to crypto-assets that are not securities.
- While the FSOC Report does not mention the Bank Holding Company Act by name, the recommendation is virtually identical to the consolidated regulatory and supervisory regime in the Bank Holding Company Act, except that it contemplates a group of agencies exercising this authority instead of a single agency.
- A multi-agency structure for exercising consolidated supervision over a group of companies is unprecedented, and we believe, unworkable. It could be more or less stringent than the traditional single-agency consolidated supervision structure, but is likely to lead to a cumbersome supervisory environment for regulated firms.
- It is not clear whether the FSOC would tailor the consolidated supervisory regime to reflect differences between the scope and scale of a group’s activities or its risk profile.

6. FSOC recommends that the federal financial regulators assess the impact of vertical integration on conflicts of interest and market volatility and whether vertical integration can or should be accommodated under existing law.

- FSOC defines vertical integration as “offering retail customers direct access to markets by vertically integrating the services provided by intermediaries such as broker-dealers or futures commission merchants.”
- Since many crypto-asset businesses are structured like universal banks, with most of their activities and services being provided by a single legal entity, FSOC probably means that an assessment of this single-entity model is necessary when it refers to the crypto-asset ecosystem as being vertically integrated.
 - In contrast, traditional U.S. financial services groups are generally subsidiarized, with separate legal entities providing different types of products and services, such as deposit-taking, underwriting and dealing in securities, securities brokerage and derivatives trading.
- There are pros and cons to the universal banking model, which exists in many other parts of the world such as Asia, Canada and Europe.

- Many customers consider the direct access to crypto-asset products and services through a single legal entity to be an advantage of the current crypto-asset ecosystem. It is also more capital and operationally efficient than the subsidiarized structure.
 - But the subsidiarized structure arguably insulates one affiliate from the risks of another affiliate, makes it easier to manage conflicts of interest and may make recovery and resolution easier.
 - The FSOC Report did not seem to seriously assess the specific pros and cons of this model, but instead, given its skeptical positioning, seems to suggest a move toward a subsidiarized model may be warranted.
- The FSOC also seems to have a separate concern about vertical integration when it states that vertically integrated arrangements “are also sometimes known as non-intermediated, in reference to retail customers placing orders directly to an exchange, rather than through an intermediary such as a broker-dealer or an FCM, that performs these functions.”[14]

Appendix 1: Overview of FSOC recommendations

[Click to view Appendix 1](#)

Appendix 2: Framework for assessing financial stability risks

The FSOC Report uses the same framework for assessing the financial stability risks of the crypto-asset ecosystem that the Board of Governors of the Federal Reserve System (Federal Reserve) has used to assess the financial stability risks and resiliency of the traditional financial system in its annual Financial Stability Reports, but without mentioning those reports. The Federal Reserve introduced this analytical framework in its [2018 Financial Stability Report](#).

Like the Federal Reserve’s Financial Stability Reports, the FSOC Report distinguishes between vulnerabilities and shocks, and focuses on vulnerabilities. The FSOC Report identifies two sets of vulnerabilities in the crypto-asset ecosystem: (1) interconnections between the crypto-asset ecosystem and the traditional financial system and (2) vulnerabilities that it describes as “primarily confined to the crypto-asset ecosystem,” including:[15]

- elevated and volatile asset prices with the potential for large drops in asset prices;
- use of leverage; and
- funding mismatches and the risk of runs.[16]

In applying its framework to the first set of vulnerabilities—namely, interconnections between the crypto-asset ecosystem and the traditional financial system—FSOC seems to have exaggerated some of the risks of interconnections. Here are two examples:

- On page 15, the FSOC Report suggests that an interconnection between a stablecoin issuer and a bank custodian of traditional assets backing the stablecoins could result in harm to the traditional financial system if the stablecoin activities were to obtain significant scale and runs on stablecoins resulted in fire sales of the traditional assets held by the bank custodian for the account of the stablecoin issuer.
 - But how likely are fire sales of traditional assets backing stablecoins if the traditional assets are limited to high-quality liquid assets (HQLAs)?
 - Doesn’t the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) rely on a **fractional** reserve of HQLAs to stem runs and fire sales in the traditional financial system?
 - Why, then, would a stablecoin issuer with a 100% reserve of HQLAs, whether a stand-alone nonbank issuer or a separately incorporated subsidiary of an IDI, be vulnerable to runs and forced sales of HQLAs at fire-sale prices?

- Why would a bank that acts as a custodian for a stablecoin issuer’s reserve of HQLAs be subject to any risk based on that interconnection if the stablecoin issuer were forced to sell the HQLAs at fire sale prices?
 - The HQLAs would not belong to the bank custodian and would be held off-balance sheet, and thus a fire sale of such HQLAs would not affect the bank custodian’s financial condition and should not foster runs against or fire sales by the bank custodian.
- On pages 16-17, the FSOC Report indicates that an interconnection between the crypto-asset ecosystem and the traditional financial system arising from the provision of deposit services by a regulated bank to a crypto-asset firm could result in financial stability risks.
 - But how would a financial stability risk arise from such an interconnection if the crypto-asset firm suffered losses or even went bankrupt?
 - The bank would not suffer any losses since it would have an obligation to the troubled or bankrupt crypto-asset firm rather than a claim against it.
 - If the bank relies on income from crypto-asset firms for a large percentage of its income, any financial stability risk that arises from the loss of such income arises from the failure of the bank’s federal or state supervisors to enforce prudential concentration limits and is no different from the bank’s loss of income from any other sector in the economy.

Although FSOC described the second set of vulnerabilities as being “primarily confined to the crypto-asset ecosystem,” they are virtually identical to the vulnerabilities identified by the Federal Reserve in the traditional financial system. All of the Federal Reserve’s Financial Stability Reports since the framework was introduced in 2018 have described the vulnerabilities of the traditional financial system as follows:

- elevated asset prices that imply a greater possibility of unexpected outsized drops in asset prices;
- excessive borrowing by businesses and households;
- excessive leverage within the financial sector; and
- funding risks arising from liquidity and maturity transformation, giving rise to the risk of runs and the sale of assets at fire-sale prices.

While asset prices in the crypto-asset ecosystem may be more volatile and prone to larger price drops than traditional assets (although, of course, the stock market sometimes experiences large drops as well), the vulnerability in the crypto-asset ecosystem can be addressed the same way it is addressed in the traditional financial system – by requiring strong risk management and controls, including concentration limits, and appropriate capital and liquidity requirements.

If the use of leverage by the crypto-asset firms is excessive, it can be addressed by appropriate capital and liquidity requirements just as excessive leverage is addressed in the traditional financial system.

Finally, funding mismatches and the risk of runs within the crypto-asset ecosystem can be addressed the same way they are addressed in the traditional financial system – by appropriate liquidity requirements. In the case of stablecoin issuers, those requirements would be satisfied by a reserve of HQLAs equal to at least 100% of the aggregate face value of all outstanding stablecoin liabilities.

FSOC was directed to “produce a report outlining the specific financial stability risks and regulatory gaps posed by various types of digital assets and providing recommendations to address such risks.” Executive Order 14067, §6(b) (Mar. 9, 2022). The FSOC Report defines digital assets as consisting of central bank digital currencies (CBDCs) and crypto-assets, but focuses on crypto-assets. It defines crypto-assets as “private sector digital assets that depend primarily on cryptography and distributed ledger or similar technology.” It also distinguishes crypto-assets from other digital representations of value, such as “an equity security placed at a central securities depository [that] may involve a digital representation of value,” but does not rely on digital ledger or similar technology. See *FSOC Report*, Box A, at 7, for more details on how the FSOC defines digital assets and crypto-assets.[1]

FSOC Report, at 14-74.[2]

Id., at 15-6.[3]

Id., at 111-119.[4]

Board of Governors of the Federal Reserve System, *Financial Stability Report*, at 3-5 (Nov. 2018) available [here](#).[5]

See, e.g., *id.*, available [here](#); Board of Governors of the Federal Reserve System, *Financial Stability Report*, at 3-4 (Nov. 2021), available [here](#).[6]

FSOC Report, at 14-74.[7]

See, e.g., SEC Chair Gary Gensler, Statement on Financial Stability Oversight Council's Report on Digital Asset Financial Stability Risks and Regulation Before the Financial Stability Oversight Council Open Meeting (Oct. 3, 2022), available [here](#); Acting Comptroller of the Currency Michael J. Hsu, *Identifying Crypto Risks* (Oct. 11, 2022), available [here](#); Acting Comptroller of the Currency Michael J. Hsu, *Don't Chase*, Remarks to the Harvard Law School and Program on International Financial Systems Roundtable on Institutional Investors and Crypto Assets (Oct. 11, 2022), available [here](#). But see Michael Barr, *Managing the Promise and Risk of Financial Innovation*, at D.C. Fintech Week (Oct. 12, 2022), available [here](#).[8]

Id., at 26.[9]

Id., Box H, at 115-116.[10]

That is, anti-money laundering and combatting the financing of terrorism.[11]

See Stablecoin TRUST Act of 2022 (discussion draft released by Sen. Toomey on April 6, 2022), available [here](#); Lummis-Gillibrand Responsible Financial Innovation Act (bill introduced by Sens. Lummis and Gillibrand on June 7, 2022), especially Title VI, available [here](#); PoliticoPro, Crypto bill from Maxine Waters faces bipartisan resistance (Sept. 26, 2022), available [here](#) (containing link, behind paywall, to a discussion draft bill reportedly under development by Rep. Waters).[12]

FSOC Report at 117.[13]

FSOC Report, Box I at 118.[14]

See, e.g., Board of Governors of the Federal Reserve System, *Financial Stability Report*, at 3-4 (Nov. 2018), available [here](#); Board of Governors of the Federal Reserve System, *Financial Stability Report*, at 3-4 (Nov. 2021), available [here](#). [15]

The FSOC Report also correctly identified two additional vulnerabilities in the crypto-asset ecosystem: (1) financial exposures via interconnections inside the crypto-asset ecosystem; and (2) operational vulnerabilities.[16]

Resources
Crypto Regulation Hub

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