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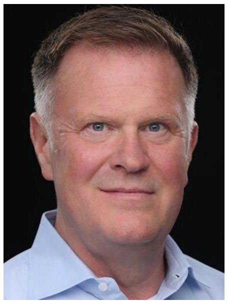
A Closer Look At Competing Stablecoin Legislative Proposals

By **Joseph Hall, David Portilla and Justin Levine** (August 3, 2023, 4:47 PM EDT)



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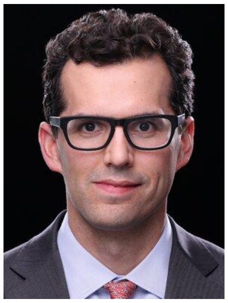

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As Congress picks up its focus on crypto, one area is proving more contentious than previously expected: the regulation of payment stablecoins.

Stablecoins are a type of crypto-asset intended to have a stable value relative to a reference asset — typically $1.

Payment stablecoins represent a subset of stablecoins designed to serve as crypto-native cash equivalents. They are often used as on- and off-ramps between the crypto ecosystem and the traditional banking system, and are typically backed by liquid reserve assets held with traditional financial institutions.

Payment stablecoins today represent one of crypto's most direct connections with the traditional financial sector. Their relatively well-defined nature and implications for the banking system, and financial stability more broadly, make payment stablecoin-focused legislation one of Congress' focus areas.

Reps. Patrick McHenry, R-N.C., and Maxine Waters, D-Calif., the respective chair and ranking member of the powerful House Financial Services Committee, have each released a series of payment stablecoin discussion drafts over the past 15 months.

The latest iterations of competing proposals from McHenry and Waters culminated in a partisan clash during a committee markup on July 27. Although McHenry's bill ultimately advanced out of committee on a 34-16 vote that garnered the support of five Democrats, the effort fell short of expectations.

The vote was preceded by 13 hours of debate that exposed a rift between McHenry, House Republicans and the handful of Democratic supporters on one side, and Waters, the White House and federal financial regulators on the other. At the forefront of the debate were competing views on how to allocate authority between federal and state regulators over payment stablecoin issuers.

Without broader bipartisan agreement on these lingering hurdles, it seems unlikely that McHenry's bill will be taken up in the Democratic-controlled Senate — though perhaps a middle ground could be found in conditioning the level of federal versus state oversight on the size and scale of the payment stablecoin issuer.

What is a payment stablecoin?

The McHenry and Waters bills align on several basic points.

First, a payment stablecoin is a digital asset that is designed to be used as a means of payment or settlement.

Second, the issuer commits to redeem the coins for a fixed amount of monetary value and maintain the coin's price at that fixed value.

And third, a payment stablecoin cannot be a national currency — and so a central bank digital currency, or CBDC, would not be characterized as a payment stablecoin — or a security issued by a registered investment company, such as a money-market fund. Each bill also makes clear that tokenized bank deposits — so-called deposit coins — are not payment stablecoins, and thus not subject to the bills' requirements.

Unlike some other payment stablecoin proposals, neither bill forbids payment stablecoins from paying interest. The McHenry bill, but not the Waters bill, expressly excludes payment stablecoins from the definition of "security" under the federal securities laws.

As a result, under the McHenry bill, a payment stablecoin issuer would be able to pay holders a portion of the interest income generated by the reserve assets without the risk of causing the stablecoin to be classified as a security. This could prove consequential in today's rising interest rate environment.

An interesting implication of the McHenry bill is that a stablecoin issued on a private, permissioned blockchain may not be within the definition of "payment stablecoin," and thus not subject to the bill's requirements or benefits. Payment stablecoins are defined in the McHenry bill as a type of "digital asset," which in turn is defined as an instrument recorded on "a cryptographically-secured distributed ledger." But the definition of "distributed ledger" refers only to "public" ledgers.

Who should be permitted to issue payment stablecoins? And who should regulate them?

Although the President's Working Group on Financial Markets **recommended in 2021** that Congress restrict anyone who is not an insured depository institution, or IDI, from issuing stablecoins, neither bill would do so.

Indeed, the Waters bill would prohibit IDIs themselves from issuing payment stablecoins, instead requiring IDIs interested in issuing payment stablecoins to use a subsidiary to do so. While the McHenry bill contemplates a similar construct for national banks, a state-chartered bank could issue payment stablecoins either directly or out of a subsidiary.

This design leads to a key observation: Even if the current incarnation of one of these bills were to become law, the federal banking agencies still may not permit an IDI, an IDI subsidiary or a federally regulated nonbank issuer to issue payment stablecoins over a public blockchain, such as ethereum, as is today the standard for stablecoins.

This is because the federal banking agencies have been growing increasingly critical of permissionless blockchains. For example:

- In a January 2023 Joint Statement on Crypto-Asset Risks to Banking Organizations, the federal banking agencies stated, "the agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network … is highly likely to be inconsistent with safe and sound banking practices."

- In a January 2023 order denying Custodia Bank's application to become a member of the Federal Reserve System, the Fed discussed a number of significant concerns related to Custodia's planned issuance over the ethereum blockchain of Avits, an asset the Fed deemed to be the functional equivalent of a stablecoin. These concerns involved safety-and-soundness risks, illicit finance risks, operational risks, cybersecurity risks, run risks, consumer risks and monetary policy risks.

- In June 2023 remarks before the American Bar Association, acting Comptroller of the Currency Michael J. Hsu stated that public blockchains "suffer from a key design flaw," are inefficient, can involve "Ponzi-prone 'tokenomics,'" are "attractive to criminals and others engaged in illicit finance" and make "full compliance with anti-money laundering rules … extremely difficult."

The McHenry bill appears designed to constrain the federal banking agencies' discretion, but it is unclear if it would prevent a federal banking agency from denying an IDI subsidiary's application to issue payment stablecoins based on a general finding that payment stablecoin activities are unsafe or unsound.

Although the Waters bill does not explicitly include safety and soundness as one of the factors a federal banking agency shall consider when reviewing applications, it does include factors involving elastic concepts such as public benefit and financial stability. The Waters bill also grants federal payment stablecoin regulators broad enforcement authority related to any practice deemed unsafe or unsound.

This looming issue aside, each bill follows the model of the U.S. dual-banking system and would establish a framework in which stablecoin issuers could be regulated either directly at the federal level, or primarily at the state level with an overlay of federal oversight.

There are two key differences in how the bills allocate supervisory responsibility:

Federal vs. State Regulation of State Stablecoin Issuers

The McHenry bill grants state regulators primary supervision, examination and enforcement authority over state stablecoin issuers. Unless the Fed and a state regulator enter into a supervisory agreement, the Fed is only provided secondary, backup enforcement authority for "exigent" circumstances.

The Waters bill instead grants the Fed primary authority over state stablecoin issuers. As noted earlier, this thorny issue remains the key item of disagreement between the two sides — and perhaps is exacerbated by our observation above that it's unclear whether the Fed would permit the issuance of payment stablecoins over a public blockchain.

Primary Regulator for Federal Nonbank Stablecoin Issuers

The McHenry bill designates the Office of the Comptroller of the Currency as the primary regulator for some federal nonbank stablecoin issuers — such as national trust banks, which because they are not insured, are nonbanks for purposes of the bill — whereas the Waters bill designates the Fed as the primary regulator of all federal nonbank stablecoin issuers.

STABLECOIN ISSUER	PRIMARY REGULATOR	
Subsidiary of an IDI	Both bills	The IDI's federal banking regulator
Uninsured national trust bank	McHenry	The OCC
	Waters	The Fed
Any other federal nonbank entity	Both bills	The Fed
State entity	McHenry	The appropriate state regulator, with backup enforcement authority to the Fed in "exigent circumstances" unless the state regulator has already entered a supervisory agreement with the Fed deferring authority to the Fed
	Waters	Primarily regulated by the Fed, secondarily regulated by the appropriate state regulator

What requirements apply to reserves?

Each bill would require issuers to hold a reserve of high-quality, liquid assets at least equal to 100% of the aggregate face value of outstanding coins, and to disclose the composition of the reserve on an ongoing basis. Reserve requirements are summarized below.

BILL	RESERVE COMPOSITION	RESERVE DISCLOSURE	REHYPOTHECATION	REDEMPTION
McHenry	• Payment stablecoins must be backed on a 1:1 basis (i.e., the issuer must maintain 100% reserve). • Eligible assets: U.S. currency — including Federal Reserve notes — insured deposits, treasuries with maturities of 90 days or less, repurchase agreements backed by short-term treasuries, central bank reserve deposits, or other assets deemed appropriate by the applicable federal or state payment stablecoin regulator.	• Issuers must publish monthly reports attested to by the CEO or CFO disclosing the state of reserves. • Reports must be examined monthly by a registered public accounting firm.	• Reserves may not be pledged, rehypothecated or reused by payment stablecoin issuers, except that short-term treasuries may be pledged for repurchase agreements with a maturity of 90 days or less for the purpose of creating liquidity to meet reasonable expectations of requests to redeem payment stablecoins.	• Issuers must have procedures to process timely redemptions.
Waters	• Materially similar to McHenry bill, except does not include a catchall for any assets deemed appropriate by the applicable federal or state payment stablecoin regulator.	• Same as McHenry bill, except no requirement for monthly review or annual examination of reports by a registered public accounting firm.	• Same as McHenry bill.	• Issuers must have procedures to process redemptions within one day of request.

Should nonbank payment stablecoin issuers be provided access to the Federal Reserve's payment system or discount window?

The question of who should be entitled to a Fed master account has emerged as a key policy question for the U.S. financial system.

A master account at one of the 12 Federal Reserve Banks is necessary for an institution to have direct access to the Fed's payment systems, as well as to settle transactions in central bank money. A master account is also a necessary, but not sufficient, condition for an institution to have access to the Fed's discount window.

Technological changes in the payments landscape have driven a number of fintech and crypto-asset-based companies to seek access to these services.

In contrast to draft legislation made public by the committee in September 2022 and some other stablecoin legislative proposals, neither bill would grant nonbank issuers access to a Fed master account or the discount window.

What aspects of banklike regulation should apply to issuers?

Each bill would establish banklike regulation and supervision for nonbank issuers, including those issuers that are licensed by a state regulator. Banklike requirements would include capital, liquidity, risk management and activities limits, as well as broad supervision and enforcement authority.

Neither bill explicitly addresses the so-called Collins Amendment to the Dodd-Frank Act, which directed the federal banking agencies to establish minimum — nonrisk sensitive — leverage capital ratios. It is not clear that either bill provides regulators with sufficient authority to reduce the potential negative capital implications on the IDI and its holding company of having a subsidiary that issues payment stablecoins.

The Waters bill would impose additional elements of banklike regulation. For example, any IDI subsidiary stablecoin issuer would be considered a "bank" for purposes of the Bank Holding Company Act, and thus subject to that act's restrictions.

Other elements of the Waters bill include that (1) the Federal Reserve's Regulation W affiliate transaction restrictions would apply to affiliates of federal and state nonbank issuers; (2) acquirers of payment stablecoin issuers would be subject to change-of-control approval requirements; and (3) stablecoin holders' claims against a payment stablecoin issuer would be given priority over all other claims in the issuer's insolvency, much like bank depositors.

How should the broader stablecoin ecosystem be regulated?

The bills differ in allocating regulatory and supervisory authority over payment stablecoin custodians and custodial — but not self-hosted — wallet providers that are not otherwise subject to certain types of regulation.

The Waters bill would grant the Fed this authority exclusively, whereas the McHenry bill would grant a range of federal and state regulators this authority, depending on the entity.

Custodians and wallet providers would be subject to customer protection requirements related to asset segregation and a prohibition on commingling customer property. They also would be required to take appropriate steps to protect customer property from creditor claims.

Each bill would permit payment stablecoins, cash, and other property of multiple customers to be commingled and deposited in an omnibus account at an IDI or trust company.

The McHenry bill also would overturn the U.S. Securities and Exchange Commission's Staff Accounting Bulletin No. 121 for banks, credit unions, trust companies and their affiliates, regardless of whether they issue payment stablecoins, but — in contrast to prior iterations of the McHenry bill — not for other custodians.

SAB 121 was published by the SEC staff in 2022 and directs any public reporting company that safeguards crypto-assets to record a liability on its balance sheet in the amount of the fair value of such crypto-asset, as well as a corresponding asset. The Waters bill does not address SAB 121.

Similar to the Bank Service Company Act, the Waters bill would permit the federal regulator of a payment stablecoin issuer to supervise any payment stablecoin service company engaged by that issuer to perform activities authorized under the Waters bill or that are necessary to the functioning of a payment stablecoin. The McHenry bill does not include a similar provision.

Each bill would provide federal payment stablecoin regulators with the authority to prescribe interoperability and compatibility standards for issuers. Each bill would also impose a two-year moratorium on "endogenously collateralized" — i.e., algorithmic — stablecoins not in existence on the date of enactment of the bill.

What about broader crypto-asset legislation?

Efforts to establish a comprehensive regulatory framework for the broader crypto-asset markets — previously viewed as a more daunting task — have also started gradually progressing through Congress.

On July 26 and July 27, the House Financial Services Committee and the House Committee on Agriculture advanced the Financial Innovation and Technology for the 21st Century Act. Led by Reps. McHenry and Glenn Thompson, R-Pa., chairman of the Agriculture Committee, the bill has thus far attracted more bipartisan support than expected — albeit not from Rep. Waters.

In the other chamber, on July 12, Sens. Cynthia Lummis, R-Wyo., and Kirsten Gillibrand, D-N.Y., published an updated draft of the Lummis-Gillibrand Responsible Financial Innovation Act.

Each of these bills would establish a comprehensive regime for the regulation of crypto-asset trading activities. Of the two, the Senate bill is broader in scope, also covering matters such as payment stablecoins, tax and banking laws.

Any broader crypto legislation will need to address one of the most fundamental issues holding back a broad-based investment in and adoption of crypto technology: the legal classification of crypto-assets — are they securities or not? The developments in the House suggest that the Ripple ruling on July 13, which rejects the categorical approach favored by the SEC, may have prompted a greater sense of urgency for legislative intervention.

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