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CLIENT ALERT

President's Working Group Issues Interagency Report on Stablecoins Highlighting Risks and Regulatory Gaps

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On November 1, 2021, the President's Working Group on Financial Markets, joined by the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, issued a Report on Stablecoins (the "Report").[1] The Report provides an overview of the current regulatory landscape for stablecoins, discusses the risks posed by stablecoins and current regulatory gaps and recommends that Congress act promptly to ensure that so-called "payment stablecoins" are subject to comprehensive federal prudential oversight. The Report advocates for legislation that limits stablecoin issuance and related activities of redemption and maintenance of reserve assets to entities that are insured depository institutions subject to prudential supervision.

[1] The President's Working Group is chaired by the Secretary of the Treasury and consists of the chairs of the Board of Governors of the Federal Reserve, the Securities and Exchange Commission (the "SEC") and the Commodity Futures Trading Commission (the "CFTC").

Overview of Stablecoins

Stablecoins are digital assets that are designed to maintain a stable value relative to a designated fiat currency or some other reference asset.[2] Stablecoins typically purport to be backed by "reserve assets."[3] Many stablecoins are offered on the basis of a promise or expectation that they can be redeemed at par upon request.[4]

According to the Report, stablecoins are primarily intended to facilitate trading, lending or borrowing of other digital assets, often for a speculative or an income-producing purpose, on or through digital asset trading platforms.[5] Stablecoins allow holders to move value between digital asset platforms and applications, reducing the need for conversion to and use of fiat currencies and reliance on traditional financial intermediaries.[6]

Stablecoins are typically transferred in one of two ways. In some cases, transfers may be recorded on the books of a particular wallet provider (*e.g.*, a digital asset trading platform) for transactions between users of the same wallet provider (*i.e.*, "off-chain" transactions).[7] Alternatively, transfers may be recorded on the distributed ledger for transactions involving users of different wallets (*i.e.*, "on-chain" transactions).[8]

Regulatory Gaps and Stablecoin Arrangement Variations

The Report notes that many stablecoins are currently underpinned by public blockchains, which, as a general matter, allow anyone to participate in communicating, settling and processing transactions.[9] The "permission-less" nature of public blockchains is seen by the Report as a drawback compared to permissioned (*i.e.*, private) blockchains, which "offer more certainty as to who is responsible for monitoring the network and complying with the rules of the network (*e.g.*, processing only valid transactions) and thus faster and more predictable settlement."[10] In addition, the Report suggests that most stablecoins, unlike traditional retail non-cash payment systems, are not governed by state and federal laws

2 Report at 1, 4. Stablecoins that are purportedly convertible for an underlying fiat currency are distinct 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. The Report focuses on stablecoins that are convertible for fiat currency because of their more widespread adoption. Report at 4 n.5.

3 *Id.* at 4.

4 *Id.*

5 *Id.* at 1, 8.

6 *Id.* at 8.

7 *Id.* at 5.

8 *Id.*

9 Report at 5.

10 *Id.*

regarding risk of fraud or instances of payment error and thus lack transparent rules governing how to allocate loss among participants in the payment network.[11]

The Report highlights that there are "no standards regarding the composition of stablecoin reserve assets, and the information made publicly available regarding the issuer's reserve assets is not consistent across stablecoin arrangements as to either its content or the frequency of its release."[12] The Report also states that "stablecoins differ in the riskiness of their reserve assets, with some stablecoin arrangements reportedly holding virtually all reserve assets in deposits at insured depository institutions or in U.S. Treasury bills, and others reportedly holding riskier reserve assets, including commercial paper, corporate and municipal bonds, and other digital assets."[13] The Report further points out that if reserve assets deposited at an FDIC-insured depository institution do not meet all the requirements for pass-through deposit insurance coverage, the deposit would only be insured to the stablecoin issuer itself up to $250,000.[14]

The Report is also critical of the redemption rights that stablecoins purport to provide and notes that such rights vary considerably among different assets. According to the Report, some stablecoins place no limitations on the amount of stablecoins a holder may redeem, whereas other stablecoins have high minimum redemption amounts, which in some cases, may be considerably greater than the value of stablecoins held by a typical user.[15] The Report emphasizes that the terms of some stablecoins allow the issuer to postpone or suspend redemption payments.[16] Stablecoins also differ in the nature of the claim provided to the holder, with some stablecoins providing a claim on the issuer and others providing no direct redemption rights to holders.[17] Certain creditors of some stablecoin issuers may have a claim on the reserve assets that compete with the rights of holders.[18]

Risks of Stablecoins

The Report argues that stablecoins pose three significant categories of risks.

First, the failure of a stablecoin to perform according to expectations could result in user harm and pose systemic risk in the form of "a 'run' on the stablecoin – *i.e.*, a self-reinforcing cycle of redemptions and fire sales of reserve assets."[19] For

[11] *Id.* at 6.
[12] *Id.* at 4.
[13] *Id.*
[14] Report at 4 n.6.
[15] Report at 4 n.7.
[16] Report at 4 n.8.
[17] Report at 4.
[18] *Id.*
[19] *Id.* at 12.

example, the confidence in a stablecoin may be undermined by a number of factors such as a decrease in value of the reserve assets, a failure to safeguard assets, operational risk, and other factors.[20]

Second, the Report notes that stablecoins used for payment (*i.e.*, "payment stablecoins") are subject to many of the same risks that face traditional payment systems – credit risk, liquidity risk,[21] operational risk,[22] risks arising from improper or ineffective system governance and settlement risk.[23] The Report suggests that stablecoins pose greater risk than traditional payment and settlement systems (in which risk is centrally managed) since some stablecoins feature decentralized decision-making where "no single organization is responsible or accountable for risk-management and resilient operation of the entire arrangement."[24]

Third, the Report highlights the risks of scale or rapid growth of a particular stablecoin.[25] Those risks include systemic risks from the failure or distress of a large stablecoin issuer or custodial wallet provider, anti-competitive effects due to a concentration of economic power and risks arising from affiliations between stablecoin issuers or wallet providers and commercial firms.[26] In addition, the Report notes that if insured depository institutions continue to lose retail deposits to stablecoins, and the reserve assets of stablecoins do not support credit creation, the growth of stablecoins could increase borrowing costs and impair credit availability across the broader economy.[27]

The Report goes on to note that stablecoins present money laundering and terrorist financing risks, given that stablecoins and other digital assets can be used to transfer large amounts across borders quickly and certain stablecoins, like other digital assets, may be used to transact pseudonymously.[28] According to the Report, a well-regulated and supervised stablecoin with strong anti-money laundering and countering the financing of terrorism protections could provide greater

20 *Id.*

21 Liquidity risk is the risk that can "arise in a stablecoin arrangement from misalignment of the settlement timing and processes between stablecoin arrangements and other systems (e.g., if a stablecoin arrangement operates 24/7, but the payment system used for funding stablecoin issuance and returning fiat currency upon stablecoin redemption has regular business hours)." Report at 13.

22 Operational risk is the risk that "deficiencies in information systems or internal processes, human errors, management failures, or disruptions from external events will result in the reduction, deterioration, or breakdown of services." Report at 13. An example of operational risk provided by the Report is that incentives to validate transactions become insufficient to respond to demand for processing transactions. *Id.*

23 Settlement risk is the risk that "settlement in a payment system will not take place as expected" and "[s]tablecoin arrangements that do not clearly define the point at which settlement is final in their rules and procedures can pose heightened uncertainty and create credit and liquidity pressures for arrangement participants." Report at 12–13.

24 *Id.* at 13.

25 *Id.* at 14.

26 *Id.*

27 *Id.*

28 *Id.* at 19. For certain stablecoins, holders and transactions are pseudonymous since holders and transactions are only identified on the public blockchain by a string of characters (which serves as a pseudonym) and not by any personally identifiable information.

transparency into illicit financial activity and could mitigate such risks, especially if the stablecoin takes market share away from riskier alternatives.[29]

Recommendations

To address the concerns highlighted above, the Report recommends that Congress enact legislation to limit stablecoin issuance, and related activities of redemption and maintenance of reserve assets, to entities that are insured depository institutions. Insured depository institutions that issue stablecoins would be subject to supervision and regulation at the depository institution level by a federal banking agency and consolidated supervision and regulation by the Federal Reserve at the holding company level.[30]

The Report also recommends that Congress require custodial wallet providers to be subject to: (i) federal oversight;[31] (ii) restrictions on lending customer stablecoins;[32] (iii) compliance obligations with respect to risk-management, liquidity and capital requirements;[33] and (iv) potentially, limitations on affiliations with commercial entities.[34]

Finally, the Report requests Congress to provide the federal supervisor of stablecoin issuers with authority to require any entity that performs activities critical to the functioning of a stablecoin arrangement to meet risk-management standards.[35] The Report also calls for legislation that provides supervisors with the ability to adopt standards to promote interoperability among stablecoins, or between stablecoins and other payment instruments.[36]

Interim Measures

While legislation is under consideration, the Report notes that the federal agencies will continue to use their existing authority to best address the "significant and growing risks posed by stablecoins."[37] For example, the Report states that "in evaluating a charter application, banking agencies will seek to ensure that applicants address the risks outlined in the Report, including risks associated with stablecoin issuance and other related services conducted by the banking

[29] Report at 19.
[30] *Id.* at 16.
[31] *Id.* at 17.
[32] *Id.*
[33] *Id.*
[34] *Id.*
[35] The Report provides the Principles for Financial Market Infrastructures as adapted to stablecoin arrangements as an example of such a risk-management standard. Report at 17.
[36] *Id.*
[37] *Id.* at 18.

organization or third-party service providers.”[38] The Report also calls on the SEC to apply the federal securities laws to stablecoins that are securities and calls on the CFTC to apply the Commodity Exchange Act for stablecoins that are commodities or commodity derivatives.[39] The Report also calls on the Department of Justice and the Consumer Financial Protection Bureau to intervene and protect the public as necessary.[40]

In the absence of Congressional action, the Report notes that certain stablecoin activity may be deemed systemically important payment, clearing and settlement (“PCS”) activity.[41] As designated PCS activity, a stablecoin arrangement would be subject to the same risk-management standards as financial institutions that engage in PCS activities, including requirements in relation to the assets backing the stablecoin, requirements related to the operation of the stablecoin arrangement, and other prudential standards, as well as being subject to an examination and enforcement framework.[42]

Conclusion

The Report showcases the rapidly evolving and intense regulatory scrutiny of digital assets by federal agencies. The Report increases the likelihood of new legislation addressing the digital asset ecosystem, but also suggests that the CFTC and SEC, which to date have taken the lead in seeking to regulate market participants, may soon share a larger portion of their jurisdictional oversight with federal prudential regulators.

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.*

42 *Id.*

Willkie's Digital Works practice consists of a dedicated team of attorneys with concentrated knowledge and experience in stablecoins, as well as all aspects of digital assets. Willkie also has extensive knowledge and experience in all aspects of the Commodity Exchange Act and the CFTC regulatory regime. We would be pleased to assist on your matters.

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