Cooley

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On June 8, 2022, the New York Department of Financial Services (DFS) released industry guidance regarding US dollar-backed stablecoins issued by virtual currency entities regulated by DFS. The guidance, which applies to entities licensed under the state's virtual currency (BitLicense) regulations[1] or chartered as limited purpose trust companies under the New York Banking Law, sets forth baseline requirements for stablecoins issued under DFS oversight. The requirements are intended to mitigate key regulator concerns related to stablecoins, such as the appropriateness of asset reserves that back stablecoins and the ability of holders to redeem stablecoins for US dollars.

Baseline requirements for stablecoins issuance

The guidance states that DFS will apply the following general conditions to issuances of US dollar-backed stablecoins that are subject to DFS approval.

Backing and redeemability

- A stablecoin must be "fully backed" by reserve assets. DFS will require the market value of reserve assets to – as of the end of each business day – equal or exceed the nominal value of all outstanding units of the stablecoin.
- The issuer's policies on redemption must be "clear" and "conspicuous," and approved by DFS. Under such policies, a lawful holder of a stablecoin must have a right to redeem units of the stablecoin in a "timely" fashion (e.g., not more than two full business days after receipt of an order) at par (i.e., at a 1:1 exchange rate for the US dollar), "net of ordinary, well-disclosed fees." The terms "redemption" and "timely" must be defined in the issuer's policies.

Asset reserves

- Any assets that form the reserve must be segregated from the issuer's proprietary assets and held with a US state or federally chartered depository institution with FDIC-insurance and/or, if approved by DFS in advance, other asset custodians.
- Reserve assets are limited to specified types of assets, such as certain US Treasury bills, reverse repurchase agreements fully collateralized by US Treasury bills, government money-market funds, and deposits at US state or federally chartered depository institutions.

Independent audits

- At least monthly, an independent certified public accountant (CPA) must attest to management's assertions regarding the sufficiency of the reserve assets.
- At least annually, an independent CPA must also attest to management's assertions regarding the effectiveness of internal controls and compliance with the requirements for the monthly attestations.
- The monthly and annual reports must be submitted to DFS and made public.

Other requirements and considerations

The guidance makes clear that DFS believes it has the authority to, and may, impose additional requirements regarding the issuance of stablecoins. DFS may also assess other risks in deciding whether to authorize any particular stablecoins issuance, such as risks related to cybersecurity, Bank Secrecy Act/anti-money laundering and sanctions compliance, consumer protection, safety and soundness, and the stability and integrity of the payment system.

Issuers of stablecoins currently supervised by DFS have three months to come into compliance with the general conditions set forth in the guidance.

Comments and outlook

While numerous state banking departments currently regulate activities involving virtual currencies under their money transmission laws (including through laws that have been expressly amended to address virtual currency activity), there has been limited state-specific guidance regarding stablecoins. Most significantly, outside of New York, the Texas Department of Banking has for several years taken the position that stablecoins backed by sovereign currency are regulated under its state money transmission law because "stablecoins that are pegged to sovereign currency may be considered a claim that can be converted into currency and thus fall within the definition of money or monetary value" under the Texas statute. That is, "the holder has a claim to the sovereign [currency] backing the coin because the issuer has taken on the obligation to provide sovereign currency in exchange for the stablecoin at a later time." In other words, Texas reasoned that issuing a stablecoin with a right of redemption is tantamount to holding money or monetary value on behalf of the holder of the stablecoin, and is therefore subject to money transmission regulation. While many other state money transmission laws have similar definitions of regulated money transmission activity, it appears that no other state has issued similar public guidance.

Based on recent developments, it is possible that other state banking departments could follow New York's lead and expressly address regulation of stablecoins alongside regulation of virtual currency, either under their money transmission laws or perhaps via a standalone virtual currency regime. For example, in California, existing pending legislation (Assembly Bill 2269) proposes to regulate virtual currency activity and, in relevant part, provide an absolute prohibition on licensees from exchanging, transferring, or storing "a stablecoin whose value relative to the United State dollar or another national or state currency is determined primarily by methods **other than** reserve assets" [emphasis added].

If more states conclude that stablecoins are a money transmission product, or expressly affirm that stablecoins issuance is money transmission activity, stablecoins could be more broadly subject to existing prudential requirements for money transmitters, including requirements to hold, at a minimum, equivalent assets in low-risk, highly liquid investments. However, the requirements imposed by New York are more stringent than for traditional money transmission or stored value products, in particular with respect to required **monthly** attestations from an independent CPA regarding the sufficiency of the reserve assets. (Traditional money transmission regulations require licensees to internally manage and confirm the sufficiency of their holdings against outstanding customer obligations, and require only that annual financial statements be audited.)

Although several legislative proposals with respect to stablecoins have been proposed at the federal level, the release of the New York guidance demonstrates that DFS is not waiting for action by Congress to address prudential concerns regarding risks posed by stablecoins. As with some other recent federal proposals, such as the Lummis-Gillibrand bill, the guidance requires issuers to maintain reserves of at least 100% of the nominal value of outstanding stablecoins in low-risk, highly liquid assets. Therefore, algorithmic stablecoins – such as TerraUSD, the algorithmic stablecoin that crashed in May 2022, or Decentralized USD, the algorithmic stablecoin on Tron that launched shortly before the TerraUSD crash – would not be approved for issuance by entities overseen by DFS.[2]

At the federal level, the Lummis-Gillibrand bill would permit non-depository institutions (operating under a state or federal charter or license) to issue stablecoins, and authorize a special depository institution charter under both state law and the National Bank Act for stablecoin issuance, while also permitting banks and credit unions to issue stablecoins.[3] Given the difficult political climate and limited number of days to legislate before the midterm elections, however, it is unlikely that the Lummis-Gillibrand bill (or other federal bills addressing cryptocurrency regulation) will become law this year. The bills could nevertheless serve as the policy foundation for debate that resumes when the next Congress is seated in January 2023.

The DFS stablecoins issuance guidance follows the April 2022 DFS industry letter emphasizing the importance of employing blockchain analytics tools in an effective virtual currency business compliance program. We expect DFS will continue to seek to lead on the regulation of virtual currency business activities.

Notes

1. 23 NYCRR Part 200.
2. DFS, however, states that its regulatory guidance "does not apply to USD-backed stablecoins listed, but not issued, by DFS-regulated entities. DFS does expect regulated entities that list USD-backed stablecoins to consider this guidance when submitting a request for coin issuance or seeking approval for a coin self-certification policy."

3. Sens. John Boozman (R-Arkansas) and Debbie Stabenow (D-Michigan) are reportedly working on another bipartisan bill to address the regulation of cryptocurrency. As of the publication of this alert, the draft text of this bill was not publicly available, so how the bill would address the regulation of stablecoins, if at all, is unknown.

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