Cooley

President's Working Group Urges Congress to Take Action on Stablecoins

November 11, 2021

On November 1, 2021, the President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (together, the "Agencies") released a report on stablecoins. The President's Working Group consists of the Secretary of the Treasury and each chairperson of the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission (CFTC). Stablecoins are digital assets that are designed to maintain a stable value relative to a fiat currency and have the potential to be used as a widespread means of payment. According to the report, the market capitalization of stablecoins issued by the largest stablecoin issuers exceeded $127 billion in October 2021.

The Agencies acknowledge that stablecoins could support faster, more efficient and more inclusive payment options. However, the report focuses on the prudential risks presented by the adoption of stablecoins as a means of payment that may result in harm to users and the broader financial system, primarily:

- Potential "runs"
- Disruptions to the payment chain
- Rapid scaling of adoption

This highly anticipated report places the burden on Congress to pass legislation to close existing regulatory gaps without providing any clarity for emerging companies involved in stablecoin arrangements.

Several factors may undermine stablecoins, resulting in harm to the broader financial system

Certain issuers of stablecoins claim to be backed by reserve assets, making them redeemable for par value upon request. However, the Agencies claim there are no regulations governing such reserve assets. The report states that an instrument, like a stablecoin, can serve as a reliable means of payment or store of value only when there is confidence in its value, particularly in periods of stress. Confidence in a stablecoin may be undermined by several factors, including:

- Use of reserve assets that could fall in price or become illiquid.
- Failure to appropriately safeguard reserve assets.
- Lack of clarity regarding the redemption rights of stablecoin holders.
- Operational risks related to cybersecurity and collecting, storing and safeguarding data.

The report maintains that failure of a stablecoin to perform according to expectations may cause a "run" on that stablecoin, which could cause the issuer into a fire sale of reserve assets that might disrupt critical funding markets and also spread contagiously to other types of financial institutions believed to have a similar risk profile. The result could increase risks to the broader financial system.

Since stablecoins are issued by third parties, users rely on the third party to maintain the payment system for the stablecoin (i.e., custody and management of reserve assets, as well as the use, settlement and distribution of the stablecoins themselves). The Agencies claim that without consistent risk-management standards, the risks of failure across operations, settlement and liquidity are inadequately addressed – and can result in users losing their money. For example, network congestion that results in delayed settlement can create uncertainty, which may heighten liquidity pressures.

Lastly, the Agencies also focus on the prudential risks posed by rapid scaling of stablecoins. The report lists three sets of policy concerns that arise from an individual stablecoin rapidly scaling:

- An issuer or key participant in the stablecoin arrangement poses a systemic risk.
- The combination of a stablecoin issuer or wallet provider and a commercial firm could lead to an excessive concentration of economic power.
- A stablecoin that becomes widely adopted as a means of payment could present anticompetitive effects.

Agencies urge Congress to address regulatory gaps

The Agencies believe there are critical regulatory gaps relating to stablecoins, but they mostly punt on the regulatory question of whether stablecoins are securities. The report merely states that certain stablecoins and stablecoin arrangement may be securities, without providing any clarity on when that would be the case. They did, however, recommend that Congress enact the following legislation to address the prudential risks:

- Require stablecoin issuers to be insured depository institutions, as firms that are FDIC-insured have access to services provided by the Federal Reserve, such as emergency liquidity.
- Require custodial wallet providers to be subject to appropriate federal oversight, which would include performing critical activities to meet risk-management standards.
- Require stablecoin issuers to comply with activities restrictions that limit affiliation with commercial entities and promote interoperability among stablecoins.

The Agencies believe that while Congress considers how to address stablecoins, the SEC, the CFTC, the Consumer Financial Protection Bureau and/or the Council of Economic Advisers should coordinate and collaborate on issues of common interest to provide certain consumer protections and safeguards. The report calls on the Financial Stability Oversight Council (FSOC) to take interim actions as well. Collectively, this regulatory “jump ball” may cause even more confusion to industry participants, as it becomes even less clear which regulatory agency has proper jurisdiction over stablecoin arrangements.

Also, the SEC’s position on stablecoins is somewhat at odds with its position – as reflected in Chair Gary Gensler’s testimony before the US Senate Committee on Banking, Housing and Urban Affairs and before the US House of Representatives Committee on Financial Services – that it is the proper regulatory authority to oversee cryptoassets generally, where many of the same operational risks exist.

Report places burden on other parties to act

The report makes clear that the Agencies believe there are significant risks posed by stablecoins that cannot be addressed by current law or by relevant authorities. The Agencies urge Congress to pass legislation that would treat stablecoin issuers similarly to federally charted banks and the FSOC to take interim actions to address the prudential risks of stablecoins. This recommendation, coupled with the mention of undefined future enforcement actions by regulatory agencies, is further evidence that stablecoins are a hot topic within the Agencies.

Key Contacts

Alfred Browne Boston	abrowne@cooley.com +1 617 937 2310
Derek Colla Miami	dcolla@cooley.com +1 305 724 0529