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Skadden

Recent Developments in the Regulation of

Cryptocurrencies and Other Virtual Assets

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This is the third in a series of articles in which we discuss recent efforts by U.S. regulators and other bodies to set expectations and standards with respect to cryptocurrencies and other virtual assets and the impact of these efforts on businesses engaged in virtual asset activities. Read the full series.

Federal Regulators Move to Regulate Stablecoins Through Banking Laws Plus New Legislation

The President's Working Group on Financial Markets (PWG), together with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), released a much-anticipated Report on Stablecoins (Report) on November 1, 2021, that outlines in broad terms various considerations on how to bring stablecoins within the existing regulatory perimeter.

Stablecoins are a type of virtual asset designed to maintain a stable value relative to a national currency or other reference asset or assets.[1] The Report focuses specifically on "payment stablecoins," which are "designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment."

As stablecoins have become more widely used, concerns have been raised about the risks they pose to investors and the stability of the financial system. The Report urges Congress to pass legislation to address the risks posed by payment stablecoins to the broader economy by, in substance, extending the Bank Holding Company Act of 1956 (BHC Act) framework to payment stablecoin arrangements. As discussed below, this would require stablecoin issuers to be insured banks, thus subjecting an issuer and its affiliates to the consolidated supervisory and regulatory framework of the BHC Act and associated U.S. banking laws. In the absence of new legislation, the Report recommends measures by which U.S. federal banking regulators can apply the existing regulatory framework to payment stablecoin arrangements.

Potential Risks Posed by Stablecoins

The Report identifies a number of potential risks that may be associated with payment stablecoins. These include the possibility that one or more stablecoin arrangements may (i) suffer a loss in confidence that causes them to lose value, (ii) experience payment systems outages or slowdowns, and/or (iii) concentrate the economic power of one or

[1] Stablecoin operators may attempt to stabilize the value of a virtual asset by backing such assets with one or more reserve assets or through the use of complex computer algorithms.

more stablecoin players, harming competition and consumer interests. The potential risks are compounded by what the Report notes is a fragmented regulatory landscape that impedes U.S. regulators from effectively addressing these risks.

- **Loss of Value: Risks to Stablecoin Users and Stablecoin Runs.** The Report notes that stablecoins may be subject to risks of a "run" — *i.e.*, mass withdrawals of funds by customers — resulting from loss of confidence that itself is the product of a potential devaluation or liquidity event. The Report notes that runs can be "a self-reinforcing cycle of redemptions and fire sales of reserve assets," and the risk of a run may differ based on the nature and composition of the stablecoin's reserve assets. For example, a stablecoin backed by insured deposits is likely to have lower risks of a run compared to those backed by assets not guaranteed by the government such as commercial paper other digital assets. A run could harm consumers, spread financial contagion to other similarly situated stablecoin issuers or other types of financial instruments believed to have a similar risk profile, the Report notes, and, under strained market conditions, such a run could amplify a shock to the economy and threaten the broader financial system.
- **Payment System Risks.** Stablecoins offer the prospect of highly efficient payment processing, but the Report suggests that payment stablecoins may face many of the same kinds of risks as traditional payment systems. These include credit risk, risk related to improper or ineffective governance, operational risk, settlement risk and liquidity risk. These may arise in unique ways in the stablecoin context, given that certain stablecoin arrangements contemplate decentralized decision-making and complex operations where no single organization is responsible or accountable for risk management or operational resiliency. To the extent that such risks remain unaddressed or are improperly managed, they could impact payment system availability and directly create financial shocks or operate as a channel through which shocks spread.
- **Risks of Scale: Systemic Risk and Concentration of Economic Power**. The Report discusses the potential that a stablecoin arrangement may scale rapidly and highlights several policy concerns.

  The distress or failure of a stablecoin issuer or a key participant in a stablecoin arrangement, such as a custodial wallet provider, could pose systemic risk to the economy, the Report states.[2]

  The Report also warns that the combination of a stablecoin issuer or a custodial wallet provider and a "commercial firm" could lead to a concentration of economic power. While the Report does not define "commercial firm," the authors were likely focused on established technology, retail and social media companies that, when combined with a stablecoin arrangement at scale, could pose risks to the broader economy. Such combinations raise the same competition concerns posed historically by the mixture of banking and commerce under the logic that such combinations may give a commercial firm unfair access to credit and an unfair advantage in cross-selling their goods and services.

  Similarly, the Report expresses concern that the provider of a widely-adopted stablecoin might impose high costs for users to switch to other payment products or services. Finally, the Report argues that the rapid growth of stablecoins could negatively impact traditional depository institutions, who could lose deposits to stablecoin arrangements, impairing the availability of credit and increasing borrowing costs.
- **Regulatory Gaps.** The Report found that stablecoin arrangements are not currently subject to a consistent set of prudential regulatory standards to manage the risks discussed above. Moreover, the sheer number of parties involved in any given arrangement, and the operational complexity of these arrangements, further complicate supervisory oversight. To address these gaps, the report stresses that a consistent and comprehensive regulatory framework is needed.

Other Risks Posed by Stablecoins

Digital asset trading and decentralized finance (DeFi), many of which rely on stablecoins, also pose risks to market integrity, investor protections, efforts to combat money laundering and the finance of terrorism (AML/CFT) and proliferation, the Report notes.

- **Digital Asset Trading Platforms and DeFi.** The Report emphasizes that digital asset trading and DeFi arrangements raise market integrity and investor protection concerns. DeFi broadly refers to a variety of financial products, services, activities, and arrangements supported by smart contracts.[3] The Report states that stablecoins facilitate digital trading and DeFi activities by providing a stable virtual asset to facilitate borrowing, lending and trading against more volatile virtual assets. Digital asset trading and DeFi give rise to operational risks, and risks related to fraud, market manipulation and insider trading, according to the Report. Where these activities involve complex relationships or significant amounts of leverage, the broader financial system may be at risk. The Report stresses that it is essential to address the significant investor and market risks posed by these activities, and notes that the Securities and Exchange Commis-

[2] A digital wallet allows a user to receive, store and transfer virtual assets to another users. A custodial wallet provider is an enterprise that holds and transfers the virtual assets on a user's behalf.

[3] "Smart contracts" are pieces of computer code that automatically execute specified steps when certain events or conditions occur. They are not "contracts" in the legal sense.

sion (SEC) and the Commodity Futures Trading Commission (CFTC) have broad enforcement, rulemaking and oversight authorities that may be employed to that end.

- **Illicit Finance.** The Report also highlights that stablecoins, particularly those that operate at scale and allow for cross-border payments, give rise to illicit finance concerns and risks to financial integrity, including violations of rules governing AML/CFT and proliferation. In the United States, most stablecoins are considered to be "convertible virtual currencies" and are treated as "value that substitutes for currency" under regulations of the U.S. Department of Treasury's Financial Crimes Enforcement Network (FinCEN). Administrators and other participants in stablecoin arrangements typically must register with FinCEN as money services businesses (MSBs) and comply with associated AML program requirements.

U.S. persons, including persons offering services related to stablecoins, also must comply with economic sanctions enforced by Treasury's Office of Foreign Assets Control (OFAC). OFAC has issued guidance on how companies in the virtual currency industry can build risk-based sanctions compliance programs. (See our client alert "US Treasury Provides Detailed Guidance for the Virtual Currency Industry on Sanctions Compliance" (November 10, 2021).)

The Report indicates that Treasury will continue to assess the risks of stablecoins and seek resources to increase supervision in this space. Treasury will also continue to encourage other countries to implement international AML/CFT standards, and it has traditionally been very supportive of intergovernmental Financial Action Task Force (FATF) initiatives. (See our client alert "FATF Updates Its Global Guidelines for the Regulation of Virtual Assets With an Eye to Emerging Technologies" (November 11, 2021).)

Recommendations Related to Payment Stablecoins

To address the potential risks and concerns identified by the PWG, the Report recommends the passage of new legislation and the adoption of a series of interim measures, with a focus on payment stablecoins that have the most potential to operate at scale and pose risks to the broader economy.

Legislation

The Report recommends that Congress pass new laws that essentially would extend the existing BHC Act framework to payment stablecoin arrangements. Under this approach, the issuer of a payment stablecoin (*i.e.*, an entity that issues and redeems stablecoins and maintains the reserve assets) would have to be an FDIC-insured bank. The Report suggests that FDIC insurance would help solve the risk of runs identified by the PWG. Moreover, the parent company of an FDIC insured issuer would be subject to regulation and supervision by the Federal Reserve as a bank holding company, which would potentially address the lack of consolidated supervision identified in the Report. The BHC Act's prohibition of certain nonbank activity would also apply, mitigating concerns associated with mixing banking and commerce. Affiliates of the issuer that are involved in securities and commodities could be functionally regulated by the SEC and CFTC, respectively, as they are today under the existing BHC Act framework.

To further alleviate concerns about payment system risk, the Report argues that custodial wallet providers should be subject to appropriate federal oversight. Legislation should provide the federal supervisor of a stablecoin issuer with the authority to require any entity that performs activities that are critical to the functioning of a stablecoin arrangement, such as custodial wallet providers, meet appropriate risk-management standards.

The Report also expresses concern about systemic risk and concentration of economic power, and urges legislation that would require stablecoin issuers to comply with restrictions limiting affiliation with commercial entities.

Moreover, supervisors should have authority to implement standards that would promote interoperability among stablecoins. The Reports suggests that Congress consider standards applicable to custodial wallet providers, including restrictions on affiliation with commercial entities and on the use of users' payment data.

Interim Measures

In the absence of Congressional action, the Report urges banking and other regulators to take action to address the specific risks related to stablecoins within each agency's jurisdiction and to coordinate and collaborate on issues of common interest. For example, in evaluating a charter application, the Report notes that banking agencies should seek to ensure that applicants address the risks associated with stablecoin issuance and other related services conducted by the banking organization or its third-party service providers.

Where stablecoins qualify as securities, commodities and/or derivatives, application by the SEC and CFTC of federal securities or derivative-related laws can provide important investor and market protections. The Report notes that other authorities, including the Department of Justice, may consider whether or how section 21(a)(2) of the Glass-Steagall Act[4] (requiring that

[4] 12 U.S.C. § 378(a)(2).

persons who accept certain deposits be subject to appropriate examination and regulation) is applicable to stablecoin arrangements, potentially subjecting stablecoin issuers to oversight. In addition, the Report points out that the Consumer Financial Protection Bureau (CFPB), through the application of consumer financial protection laws, can help ensure safeguards in the consumer payments sector.

Finally, the Report recommends that the Financial Stability Oversight Council (FSOC) consider steps available to it to address the risks outlined in the Report, such as the designation of certain activities conducted within stablecoin arrangements as systemically important payment, clearing and settlement (PCS) activities, or likely to become so. This would permit an appropriate agency to establish risk-management standards for financial institutions participating in designated PCS activities. According to the Report, these could include requirements pertaining to the assets backing the stablecoin, the operation of the stablecoin arrangement and other prudential standards. Under such a scheme, financial institutions that engage in designated PCS activities also would be subject to an examination and enforcement framework. The Report notes that any such designation should follow a transparent process.

Outlook

The Report reflects growing concern among U.S. policy makers and regulatory agencies regarding the growing stablecoin market and the influence of the U.S. federal banking regulators in framing the solution outlined in the Report. It is unlikely, though, that Congress will soon act on the Report's recommendations. Similarly, it is unclear how quickly the various U.S. regulatory agencies may seek to implement the recommendations, particularly given the number of vacancies at key leadership positions of these agencies. We expect the individual agencies to continue to act on these issues absent legislation, but with increasing efforts at policy coordination.

Companies involved in stablecoin activity should expect that government agencies will make use of existing authorities, including enforcement authority, to address the risks described in the Report. The Report's emphasis on FDIC insurance suggests that non-deposit-taking companies involved in stablecoins are unlikely to be able to obtain charter approval from the OCC or other federal banking regulators to engage in business with a digital asset focus, including through the existing fintech charter or trust bank charter.

Companies should also pay attention to developments at the state level and look to states as venues for obtaining the relevant license or charter to operate, given that states have considerable regulatory authority over stablecoins by virtue of their money transmission and banking laws. The Conference of State Bank Supervisors (CSBS), which did not participate in the preparation of the Report but is a member of FSOC and influential among the congressional banking committees, has expressed interest in stablecoin regulation. Companies should also expect greater scrutiny at the multi-lateral level, highlighted by FATF efforts to push for a consistent and robust international regulatory response to stablecoins.

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