

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

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Recent guidance from the New York State Department of Financial Services (DFS) and a proposed bill in the U.S. Senate portend more regulatory and legislative activity to clarify the status of and requirements for stablecoin issuers. Together with an executive order from the White House earlier this year intended to foster responsible development of the digital asset sector, they signal an emerging consensus on the shape of a potential stablecoin regulatory regime aiming to protect holders while promoting innovation. Recent market events could also accelerate the move toward regulation.

Though the details vary, the DFS guidance and the bipartisan Senate bill show in broad outline what stablecoin regulation may include:

- Traditional banks may play a role in dealing with stablecoins, including issuing and redeeming them.
- There is a clear desire to provide a level regulatory playing field for all stablecoin issuers by allowing nonbank issuers to obtain bank-like charters and be subject to the supervision of traditional bank regulators.
- Regulatory and supervisory attention is focused on three key areas:
 - **Redeemability:** Holders of stablecoins should be able to redeem them either on demand or within a reasonably short period.
 - **Standards for reserve assets:** Stablecoins need to be backed by high-quality liquid assets equal to the nominal value of all outstanding units of the stablecoin of an issuer to facilitate quick redemption.
 - **Verification and disclosure of assets:** The issuer of stablecoins should be subject to some form of ongoing third-party verification, and potentially public disclosure, of the assets backing the stablecoins and their value relative to the outstanding issuance of stablecoins to ensure public confidence and avoid consumer harm.

The DFS guidance applies to U.S. dollar-backed stablecoin issuers regulated in New York State, who are expected to comply beginning in September 2022.

The legislation in the Senate, the Lummis–Gillibrand Responsible Financial Innovation Act (RFIA), was proposed by Sens. Cynthia Lummis (R-Wyo.) and Kirsten Gillibrand (D-N.Y.) on June 7, 2022. It aims to create an encompassing regulatory structure for digital assets that promotes responsible innovation. (See our June 9, 2022, client alert [“Senate Bill Would Create Comprehensive Regulatory Structure for Cryptocurrencies and Other Digital Assets.”](#))

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These actions follow the White House's March 9, 2022, executive order on "Ensuring Responsible Development of Digital Assets" setting forth the Biden administration's policy priorities and various administrative actions intended to foster responsible development of digital assets. It is expected to result in the issuance of additional proposals regarding stablecoins in the months ahead. (See our March 10, 2022, client alert "[Executive Order Aiming To Coordinate Digital Assets Policies May Bring Much-Needed Clarity](#).")

New York DFS Guidance

On June 8, 2022, DFS released guidance that calls for clear redemption policies, specific reserve requirements and regular attestations by independent auditors. U.S. dollar-backed stablecoin issuers subject to DFS supervision are expected to come into compliance with the DFS guidance within three months of June 8, 2022, except for the requirements specific to annual attestation reports by independent certified public accountants (CPAs). DFS will determine the compliance deadline for the annual attestation at a later date. ([Click here for the full text of the guidance.](#))

Redeemability

The DFS guidance requires U.S. dollar-backed stablecoins to be fully backed by reserve assets with a market value at least equal to the nominal value of all outstanding units of the stablecoin at the close of each business day.

Under the DFS guidance, the stablecoin issuer must adopt clear redemption policies — approved in advance and in writing by DFS — that confer a right to redeem units of the stablecoin from the issuer in a timely manner and subject to reasonable conditions. These redemption policies must either clearly disclose the meaning of "redemption" and "timely" or expressly adopt default terms provided by the DFS guidance.

Reserve Requirements

The DFS guidance requires reserve assets to be segregated from proprietary assets of the issuing entity. Reserve assets must be held in custody with state or federally chartered depository institutions whose deposits are insured by the Federal Deposit Insurance Corporation and/or asset custodians approved in advance by DFS.

Subject to certain important limitations and value caps, the reserve assets are limited to U.S. Treasury bills; reverse repurchase agreements fully collateralized by U.S. Treasury bills, notes or bonds; government money-market funds; and deposit

accounts at state or federally chartered depository institutions in the U.S. Issuers must manage the liquidity risk of their reserve assets in accordance with the redemption requirements provided by the DFS guidance.

Attestations

The DFS guidance mandates that reserve assets are subject to an examination of management's assertions at least once per month by an independent CPA approved by DFS and licensed in the U.S., applying the attestation standards of the American Institute of Certified Public Accountants (AICPA).

The CPA must attest to the assets as of the last business day of each monthly period and at least one randomly selected business day during that period. The CPA must attest to management's assertions of: (a) the end-of-day-market value of the reserves in aggregate and broken down by asset class; (b) the end-of-day quantity of outstanding stablecoin units; (c) whether the reserve was adequate to fully back all outstanding stablecoin units; and (d) whether all DFS-imposed conditions on the reserve assets were met. The issuer must make the CPA's monthly attestations publicly available and send a copy to DFS no more than 30 days after the end of each covered period.

The DFS guidance also requires the issuer to obtain an annual attestation report by an independent CPA who must likewise be approved by DFS, licensed in the U.S., and apply the AICPA attestation standards. The annual attestation should audit management's assertions concerning the effectiveness of internal controls and procedures for compliance that the DFS guidance requires. The issuer must produce a copy of the annual attestation to DFS in writing no more than 120 days after the end of the period covered by the report.

U.S. Senate Bill: Responsible Financial Innovation Act

The RFIA is a sweeping legislative initiative that would create comprehensive regulatory oversight of digital assets, including stablecoins. Some of the provisions would be applicable generally to digital assets, while others are focused specifically on stablecoins. ([Click here for the full text of the bill.](#))

Defining Stablecoins

With respect to stablecoin specifically, Title I of the RFIA would define so-called "payment stablecoin" generally to mean a digital asset issued by a business entity that is (a) redeemable, on demand, on a one-to-one basis, for instruments denominated in U.S. dollars and defined as legal tender under U.S. laws or

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as legal tender under the laws of a foreign country (excluding digital assets); (b) accompanied by a statement that the asset is redeemable from the issuer or another identified person; (c) backed by one or more financial assets (excluding other digital assets) that are legal tender under U.S. or foreign law; and (d) intended to be used as a medium of exchange.¹ The bill also requires the Internal Revenue Service to adopt guidance and clarification concerning the legal characterization of payment stablecoins as an indebtedness within one year of the RFIA's enactment.

Issuance of Stablecoins

Notably, the RFIA would permit depository institutions (*i.e.*, insured banks, thrifts and credit unions) to “issue, redeem, and conduct all incidental activities relating to payment stablecoins.” Under the bill, a depository institution that issues “payment stablecoins” would generally need to maintain “high-quality liquid assets” equal to 100 percent of the face value of the outstanding stablecoins. Eligible high-quality liquid assets would include:

- U.S. coins and currency and other legal tender;
- demand deposits at a U.S. depository institution;
- balances held at a Federal Reserve bank;
- foreign withdrawable reserves, securities issued by or guaranteed by the Treasury Department with an original maturity of one-year or less;
- a reserve repurchase agreement relating to an aforementioned security; or
- any other high-quality liquid asset consistent with safe and sound banking practice.

The issuing depository institution must also provide public disclosures regarding the assets backing the stablecoin, including their value and the ability to redeem all outstanding payment stablecoins at par in legal tender.

¹ The bill separates item (a) into two separate elements, “redeemable, on demand, on a 1-to-1 basis for instruments denominated in United States dollars” and “defined as legal tender under section 5103 or under the laws of a foreign country (excluding digital assets),” which would suggest that the payment stablecoins themselves would have to be defined as legal tender. Consistent with an earlier publicly released draft, we expect that these two elements should be read together, such that the legal tender element modifies “instruments denominated in United States dollars,” rather than serving as an independent component of the definition of payment stablecoin.

Importantly, the RFIA is designed to ensure that payment stablecoins issued by a depository institution would not be treated as securities or commodities.² The RFIA would also establish a detailed process that depository institutions could elect to use to issue payment stablecoins.

Moreover, under the RFIA, the Office of the Comptroller of the Currency would be explicitly permitted to charter national banks for the exclusive purpose of issuing payment stablecoins. This would provide another avenue, along with state and national trust charters, for digital asset companies to subject their activities to prudential oversight and provide greater public assurances of the safety and soundness of their operations. The RFIA would also create a tailored supervisory framework under the jurisdiction of the Board of Governors of the Federal Reserve System for holding companies of depository institution issuers of payment stablecoins.

Conclusion

The DFS guidance and the introduction of the RFIA are both important developments as the digital assets industry continues to mature.

DFS has been active in regulating companies that operate in the digital asset space for a number of years. Since 2018, DFS has imposed requirements, standards and controls on stablecoins issued by its regulated entities. DFS also evaluates stablecoin-related aspects of a company's business model as part of its determination of whether to grant a license to engage in virtual currency business activity (a “BitLicense”) or a charter as a limited purpose trust company under the New York Banking Law.

While the RFIA is a broader initiative, and its legislative prospects are uncertain, it signals bipartisan interest in Congress for legislation addressing digital assets, including stablecoins, and practitioners in the fintech sector should follow its development over the months ahead.

Together with the White House's announced policy objectives, these developments suggest a growing convergence in thinking among regulators, legislators and the Biden administration about the broad framework for regulating digital assets, and stablecoins, in particular.

² See [Lummis–Gillibrand Responsible Financial Innovation Act: Section-by-Section Overview](#).

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