Paul | Weiss

CLIENT MEMORANDUM

NOVEMBER 8, 2021

Federal Regulators' Report Recommends Urgent Legislation to Regulate Stablecoins

On November 1, 2021, the President's Working Group on Financial Markets (comprised of Treasury, Federal Reserve, SEC and CFTC), the FDIC and the OCC (collectively, the "Agencies") issued a "Report on Stablecoins."[1] The Report recommends that Congress pass "urgent" legislation that would regulate stablecoins pegged to fiat currency[2] through a federal prudential framework, which would include limiting stablecoin issuance, redemption and maintenance to insured depository institutions.[3] As such, all entities involved in the issuance, redemption and maintenance of stablecoins pegged to fiat currency—including any holding companies and custodial wallet providers—could be required to obtain banking charters and, therefore, to meet risk-management standards, liquidity and capital requirements and to generally be separated from commercial enterprises.[4] Absent Congressional action, the Report recommends that the interagency Financial Stability Oversight Council ("FSOC") consider "steps available to it to address the risks" identified in the Report, including designating certain stablecoin-related activities as "systemically important payment, clearing, and settlement activities" and thus requiring entities involved in those activities to be subject to increased oversight.[5]

The Report comes as the use of stablecoins continues to grow. According to the Report, the market capitalization of stablecoins issued by the largest issuers exceeded $127 billion as of October 2021 which reflects a 500% increase since last year.[6]

The key takeaways of the Report are as follows:

- **The Report highlights three primary alleged risks associated with stablecoin and stablecoin-related activities**: (1) risks to stablecoin users, including from stablecoin runs,[7] inconsistent redemption rights, issues with preservation of reserve assets and risks related to the collection, storing and safeguarding of user data;[8] (2) concerns about payment system risks, including risks related to credit, liquidity, operation and settlement which can "create financial shock or operate as a channel through which financial shock can spread";[9] and (3) concerns about systematic risks and concentration of economic power, including risks associated with the rapidly increasing use of stablecoins, the potential for "an excessive concentration of economic power" if a stablecoin issuer or wallet provider links with a commercial enterprise or bank and concerns that any such concentration would result in practices associated with the "mixing of banking and commerce" such as the use of transaction data for marketing.[10] Further, the Report expresses concern about the heightened challenge of supervisory oversight of stablecoins due to the number of different parties who can be involved in the various functions of a single "stablecoin arrangement" [11]—which the Report identifies as the creation and redemption of the stablecoin, the transfer of the stablecoin between parties and the storage of the stablecoin.[12]

- **The Report recommends "urgent" Congressional action, which would align the regulation of entities involved in stablecoin arrangements to banking regulations**. After outlining the various alleged risks associated with stablecoin and stablecoin-related activities, the Report calls for Congressional action that could address these risks on a comprehensive and consistent basis and then provides a proposed structure for any potential legislation.[13] Specifically, the Report recommends that any legislation limit the issuance and redemption of stablecoins to entities that are registered as insured depository institutions.[14] These insured depository institutions would then be required to meet certain prudential standards, such as capital and liquidity requirements, which the Report states would address the Agencies' concerns over financial stability of the market.[15] Further, they would be subject to examination by a designated supervising agency as well as the requirements of the Federal Deposit Insurance Act, which would "enable[] the orderly resolution of failed insured depository institutions" to protect consumers and the market at large.[16]

- **The Report also specifically addresses regulations for other entities involved in the stablecoin arrangement—including custodial wallet providers—that would require these entities to comply with "appropriate risk-management, liquidity, and capital requirements."**[17] For custodial wallet providers, the Report recommends that any legislation restrict them from lending stablecoins, while also limiting their affiliation with commercial entities or their use of users' transaction data.[18] Further, the Report recommends that any legislation incorporate flexibility for regulators to respond to technological changes and developments.[19]

- **Absent Congressional action, the Report calls for FSOC to act—though any such action may be limited**. The Report suggests that, absent legislation, FSOC should address the risks in the Report by considering steps available to it, including the potential "designation of certain activities conducted by a stablecoin arrangement as . . . systemically important payment, clearing, and settlement activities."[20] A designation by the FSOC would result in similar requirements on entities involved in stablecoin arrangements as those identified in the proposed legislation; specifically, these entities would be subject to examination, and would need to meet certain risk-management standards, including likely requirements for reserve assets.[21] However, the designation power of the FSOC is not without limit and could potentially be challenged. In March 2016, a district court in the District of Columbia rescinded the FSOC's designation of MetLife, Inc. as a systematically important nonbank financial company, citing failures related to FSOC's finding that MetLife was materially vulnerable to financial distress as well as FSOC's failure to weigh the costs and benefits of the designation.[22] Following the *MetLife* decision, in 2019, FSOC made a number of key changes to their guidelines for designation.[23] Part of this shift included a move towards prioritizing an activities-based approach for designation instead of focusing exclusively on entity-specific determinations.[24] Because this transition is relatively new, FSOC has limited experience in making activities-based designation.

- **The Report does not take a stance on the applicability of other federal laws to stablecoins, including federal securities laws**. Throughout the Report, the Agencies repeatedly note that certain stablecoins—as well as aspects of digital asset trading platforms and decentralized finance—are currently being considered by the SEC and the CFTC to determine the applicability of federal securities laws and the Commodity Exchange Act.[25] In a statement issued the same day in support of the Report, SEC Chair Gensler emphasized this point, noting that the SEC and the CFTC will be "deploy[ing] the full protection of the federal securities laws and the Commodity Exchange Act" to stablecoins where applicable.[26]

- **The Report suggests that the Biden Administration will be aggressive in its efforts to regulate stablecoins, while continuing to be aggressive in its application of existing regulatory authority in the cryptocurrency industry**. In recent months, multiple federal agencies—including the SEC[27] and the Treasury Department's Office of Foreign Asset Controls[28] — have made statements or issued guidance that confirm an increased focus on the cryptocurrency industry. In response to the Report, other agencies issued statements in support of the Report while confirming that they would continue to harness their existing regulatory authority, where applicable, to monitor and address risks associated with stablecoins. In addition to the statement by SEC Chair Gensler identified above, CFPB Director Rohit Chopra released a statement on the Report, noting that the CFPB will be monitoring for stablecoins that "trigger obligations under federal consumer financial protection laws, including the prohibition on unfair, deceptive, or abusive acts or practices."[29]

The Report represents the starkest example we have seen in the United States of multiple regulators raising the need for urgent legislative action to impose control over part of the cryptocurrency industry. This may pave the way for additional legislative proposals to address other aspects of cryptocurrency. We will continue to monitor these developments.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Jonathan H. Ashtor
+1-212-373-3823
jashtor@paulweiss.com

Jessica S. Carey
+1-212-373-3566
jcarey@paulweiss.com

Manuel S. Frey
+1-212-373-3127
mfrey@paulweiss.com

Michael E. Gertzman
+1-212-373-3281
mgertzman@paulweiss.com

Roberto J. Gonzalez
+1-202-223-7316
rgonzalez@paulweiss.com

David S. Huntington
+1-212-373-3124
dhuntington@paulweiss.com

Brad S. Karp
+1-212-373-3316
bkarp@paulweiss.com

Loretta E. Lynch
+1-212-373-3000

Associate Carly Lagrotteria contributed to this Client Memorandum.

1 President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, *Report on Stablecoins* (Nov 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf; *see also* Treasury Dep't, *Remarks by Under Secretary for Domestic Finance Nellie Lang to the Stanford Graduate School of Business* (Nov. 1, 2021), https://home.treasury.gov/news/press-releases/jy0455; Treasury Dep't, *FACT SHEET: President's Working Group on Financial Markets (PWG), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency* (Nov. 1, 2021), https://home.treasury.gov/news/press-releases/jy0456.

2 Stablecoins can be pegged to other assets, including cryptocurrency or commodities. The Report does not address risks or regulatory gaps around these other types of stablecoins.

3 *Report on Stablecoins*, *supra* note 1, at 7.

4 *Id.* at 2.

5 *Id.* at 3.

6 *Report on Stablecoins*, *supra* note 1, at 7.

7 The Report warns that failure of a stablecoin to perform according to expectations could result in a "run" on that stablecoin – i.e., a self-reinforcing cycle of redemptions and fire sales of reserve assets. The Report goes on to warn that a fire sale of reserve assets could disrupt funding markets and the broader economy. *Id.* at 12.

8 *Id.* at 12.

9 *Id.*

10 *Id.* at 2–3.

11 *Id.* at 14.

12 *Id.* at 6.

13 *Id.* at 16.

14 *Id.*

15 *Id.*

16 *Id.*

---

17 Id. at 17.

18 *Id.*

19 *Id.*

20 *Id.* at 3, 18.

21 *Id.* at 18.

22 *MetLife, Inc.* v. *Financial Stability Oversight Council*, 177 F.Supp.3d 219 (D.D.C. 2016). Though the FSOC filed an appeal of the case, the parties ultimately filed a joint motion to dismiss the appeal.

23 Financial Stability Oversight Counsel, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (2019), https://home.treasury.gov/system/files/261/Interpretive-Guidance-on-Nonbank-Financial-Company-Determinations.pdf.

24 *Id.*

25 *Report on Stablecoins*, *supra* note 1, at 1, 8, 11, 18.

26 SEC, *Statement of Chair Gary Gensler on President's Working Group Report on Stablecoins* (Nov. 1, 2021), https://www.sec.gov/news/statement/gensler-statement-presidents-working-group-report-stablecoins-110121.

27 *See, e.g.,* Paul, Weiss, *Chair Gensler Reaffirms Focus on Crypto Enforcement; SEC Brings Actions Against a DeFi Lender and a Crypto Exchange for Offering Unregistered Securities* (Aug. 11, 2021), https://www.paulweiss.com/practices/litigation/financial-institutions/publications/chair-gensler-reaffirms-focus-on-crypto-enforcement-sec-brings-actions-against-a-defi-lender-and-a-crypto-exchange-for-offering-unregistered-securities?id=40732.

28 *See, e.g.*, Paul, Weiss, *New OFAC Guidance for the Cryptocurrency Industry Highlights Increased Regulatory Focus* (Oct. 25, 2021), https://www.paulweiss.com/practices/litigation/economic-sanctions-aml/publications/new-ofac-guidance-for-the-cryptocurrency-industry-highlights-increased-regulatory-focus?id=41498.

29 CFPB, *Statement of CFPB Director Chopra on Stablecoin Report* (Nov. 1, 2021), https://www.consumerfinance.gov/about-us/newsroom/statement-cfpb-director-chopra-stablecoin-report/.