PWG Report on Stablecoins—Implications for the Regulatory Environment

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On November 1, 2021, the President's Working Group on Financial Markets (PWG)[1]—along with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC)—published the *Report on Stablecoins* (Report),[2] providing a wish list for future legislation regulating stablecoins used as a means of payment and recommending interim measures until legislation can be adopted. The Report could have an immediate impact on the way both federal and state regulators assess risk management issues, anti-money laundering (AML) and sanctions controls, reserve management, and the financial soundness and stability of stablecoin issuers even without legislative intervention.[3]

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[1] On March 18, 1988, Executive Order 12631 established the PWG, which is chaired by the Secretary of the Treasury, or his or her designee, and includes the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Securities and Exchange Commission (SEC), and the Chairman of the Commodity Futures Trading Commission (CFTC) or their designees. *See* President's Working Group on Financial Markets, "President's Working Group on Financial Markets Statement on Key Regulatory and Supervisory Issues Relevant to Certain Stablecoins," US Department of the Treasury (December 23, 2020), available at https://home.treasury.gov/system/files/136/PWG-Stablecoin-Statement-12-23-2020-CLEAN.pdf at 1 fn. 1.

[2] President's Working Group on Financial Markets, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, "Report on Stablecoins," US Department of the Treasury (November 2021), available at https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

[3] Other governmental or quasi-governmental bodies that have recently issued reports or letters on stablecoin governance include the OCC independently (*see* Office of the Comptroller of the Currency, "OCC Chief Counsel's Interpretation on National Bank and Federal Savings Association Authority to Use Independent Node Verification Networks and Stablecoins for Payment Activities" (January 4, 2021), Interpretive Letter #1174, available at https://www.occ.gov/news-issuances/news-releases/2021/nr-occ-2021-2a.pdf); the Bank for International Settlements (*see* Douglas Arner, Raphael Auer, and Jon Frost, "Stablecoins: Risks, Potential and Regulation," Bank for International Settlements Working Paper No. 905 (November 2020), available at https://www.bis.org/publ/work905.pdf); the G7 Working Group on Stablecoins (*see* G7 Working Group on Stablecoins, "Investigating the Impact of Global Stablecoins" (October 2019), available at https://www.bis.org/cpmi/publ/d187.pdf); and the Financial Stability Board (*see* Financial Stability Board, "Regulation, Supervision and Oversight of 'Global Stablecoin' Arrangements: Final Report and High-Level Recommendations" (October 13, 2020), available at https://www.fsb.org/wp-content/uploads/P131020-3.pdf).

Summary

Stablecoins are blockchain-based cryptocurrencies pegged to an underlying asset (usually, but not always, a fiat currency like the US dollar or the Japanese yen). The Report asserts that today stablecoins are primarily used in the United States to facilitate the trading, lending and borrowing of other digital assets, but proponents believe that stablecoins could become widely used by households and businesses as a means of payment and cross-border remittances without exchange rate risks.[4] While the Report acknowledges that "[i]f well-designed and appropriately regulated, stablecoins could support faster, more efficient, and more inclusive payments options," it also notes a number of risks attendant with that eventuality.[5] These risks include market integrity, investor protection, and illicit finance concerns, as well as a range of prudential concerns related to the increased use of stablecoins as a means of payment (i.e., payment stablecoins). In order to address the prudential risks related to payment stablecoins, the PWG, along with the FDIC and OCC, recommends that Congress act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis.

While the PWG believes that legislation is "**urgently**" needed, it recommends that as Congress considers how to address the risks associated with stablecoin arrangements, agencies should continue to use their existing authorities to address the prudential risks as necessary.[6] In this regard, the Report notes that certain stablecoins or stablecoin activities may be securities, commodities and/or derivatives, and that in these instances the SEC and/or the Commodity Futures Trading Commission (CFTC) would have jurisdiction over them.

Finally, in the absence of congressional action, the Report recommends that the Financial Stability Oversight Council (FSOC)—chaired by Treasury Secretary Janet Yellen—consider steps to address the risks outlined in the Report. Such steps could include designating particular stablecoin transaction activities either as "systemically important payment, clearing, and settlement activities" (PCS activities), thereby allowing the appropriate agency to implement risk management standards, or as "systemically important financial market utilities," subjecting these activities to consolidated supervision.[7]

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[4] The Report notes that in the 12 months prior to October 2021, the use of stablecoins exploded, increasing nearly 500% to a $127 billion market capitalization. Report at 7.

[5] *Id.* at 1.

[6] *Id.* at 3.

[7] *Id.* at 18 fn. 36.

Risks

The Report first draws attention to risks inherent in the present use of stablecoins to facilitate trading, lending and borrowing assets on digital asset platforms and in decentralized finance (DeFi) arrangements. These risks include:

- fraud, misappropriation, and conflicts of interest that could arise due to misleading market disclosures, abuse of inside information, and manipulative trading practices;
- interdependency of stablecoin arrangements and digital asset trading platforms, such that a disruption on one could cause the other to fail;
- lack of governance, interoperability, scalability, and cybersecurity; and
- money laundering and terrorist financing.

The Report emphasizes, however, that stablecoins have the potential to surpass those current uses and become a **widespread payment mechanism**. In this regard, the Report notes the following concerns are associated with payment stablecoins:

- *Runs/Loss of Value* – The Report notes that stablecoins depend on confidence in order to retain their value stability, and that the failure of stablecoins to maintain value stability could expose users to unexpected losses—particularly in cases in which there are “runs” on the reserves that support the value of the tokens. This may, in turn, damage the financial system if runs occur at any significant scale. According to the Report, confidence in a stablecoin can be eroded if (1) the underlying reserves fall in value or become illiquid, (2) a custodian fails to properly safeguard reserve assets, (3) there is a lack of transparency in how to redeem the stablecoin for cash value, and/or (4) there are operational risks related to cybersecurity and collecting, storing, and safeguarding user data.
- *Payment System Risks* – The Report notes that stablecoins encounter many of the same risks as conventional payment systems, such as “credit risk, liquidity risk, operational risk, risks arising from improper or ineffective system governance, and settlement risk.”[8] Though not unique to stablecoins, these risks, if overlooked, could cause the entire payment system to become less reliable for users, and this could result in financial shocks or even operate as a mechanism to spread financial shocks globally as payment stablecoins scale.
- *Systemic Risk and Concentration of Economic Power* – The Report notes that because an individual stablecoin can scale rapidly, unique policy concerns arise, especially when the stablecoin is issued or governed by an actor that already has significant economic power:

[8] *Id.* at 12.

- A stablecoin issuer or other key participant (such as a custodial wallet provider) could pose systemic risk to the economy.[9]
- A stablecoin issuer or wallet provider, if combined with a commercial firm, could create an "excessive concentration of economic power," risking that this highly concentrated entity could take advantage of customers, arbitrarily restricting or granting access to credit.[10]
- A stablecoin that becomes a ubiquitous payment method could cause issues if users "face undue frictions or costs" when switching to another payment service or product.[11] Such anti-competitive effects could easily occur if there is a lack of interoperability standards for stablecoins or stablecoin arrangements.[12]

Finally, the Report specifically touches on gaps in regulation for custodial wallet providers, which is central to the functioning of any stablecoin arrangement (but also to a wide range of other cryptocurrency activity). Transactions recorded on the books of a wallet provider—instead of on the distributed ledger platform—are generally considered "off-chain," as transactions are reflected only on the internal records of those custodial wallet providers.[13] The Report notes that the risk with custodial wallet providers is that they can hold a significant number of stablecoins while they are currently subject to varying levels of supervision from states where they operate. This lack of standardized regulation governing features such as risk management, capital, and liquidity could exacerbate the risk that the failure of a custodial wallet provider could have systemic impacts.

Recommendations

Legislation

To address gaps in regulation and mitigate the prudential risks associated with stablecoins becoming a widespread means of payment and cross-border remittance, the Report recommends the following additional legislation:

1. *Runs/Loss of Value* – Legislation should require stablecoin issuers to be insured depository institutions, subjecting them to significantly greater levels of supervision and oversight than the majority of stablecoin issuers face today.[14]

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[9] *Id. at 14.*

[10] The Report notes that these policy concerns are analogous to those traditionally associated with the mixing of banking and commerce, such as advantages in accessing credit or using data to restrict markets or restrict access to products. *Id*.

[11] *Id.*

[12] *Id.*

[13] *Id.* at 5 fn. 9.

[14] Note: This could, depending on how it is structured, require the FDIC to create a framework to insure cryptocurrency assets.

2. *Payment System Risk* – Legislation should provide the federal supervisor of stablecoin issuers the authority to require "any entity that performs activities critical to the functioning of the stablecoin arrangement" to satisfy standards of risk management.[15] Specifically, this would cover custodial institutions (which hold the actual stablecoins), certain types of technology providers that facilitate stablecoin transactions (including those that provide necessary services such as cybersecurity and privacy protection as well as, potentially, the transmission of payment messages),[16] banks that custody the underlying assets backing stablecoins (to the extent they are not already subject to extensive federal regulation), and companies significantly involved in the distribution of stablecoins.
3. *Systemic Risk and Concentration of Economic Power* – Legislation should require stablecoin issuers to limit affiliation with commercial entities in their activities.[17] The federal supervisor of stablecoin issuers should also be permitted to enact standards to increase interoperability among stablecoins, or between stablecoins and other payment instruments.

To address gaps in the regulation of custodial wallet providers, the Report recommends that legislation in this area mandate certain liquidity and capital requirements and restrict custodial wallet providers from lending customer stablecoins. Additionally, it recommends that limits on affiliation with commercial entities be imposed, again applying depository institution-like regulations to this space. Finally, it suggests that Congress implement protections against wallet providers abusing users' transaction data.

Agencies

The Report notes that although executive agencies have requested that Congress act quickly, they understand that comprehensive legislation on this issue will likely take time.[18] In the interim, the agencies are committed to both "address[ing] risks falling within each agency's jurisdiction" and coordinating jointly in pursuit of a common interest in investor and market safety.[19]

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[15] The Report at 17.

[16] Note: These are often entities subject to state regulation.

[17] This is similar to the aims of the Bank Holding Company Act's restrictions on banks controlling nonbanks. *See* 12 US Code § 1843 ("Interests in Nonbanking Organizations"). The Report essentially suggests that bank-like regulations should be applied to stablecoin issuers.

[18] Congress continues to debate issues related to stablecoins and cryptocurrencies in general and has yet to reach an agreement on a regulatory framework.

[19] The Report at 3.

Role of the SEC and CFTC

The Report notes that digital asset trading platforms and DeFi arrangements present risks "most notably to the SEC and CFTC."[20] It emphasizes that the SEC and CFTC "have **broad enforcement, rulemaking, and oversight authorities**…to address…investor protection and market integrity risks" (emphasis added).[21]

The Report notes that stablecoins that qualify as securities are within the SEC's reach at present and could be subject to federal securities laws governing "digital asset offers, sales, and promotions; investment company activities where the stablecoin issuer or platforms holding stablecoins are engaging in the business of investing in securities and meet the definition of 'investment company'; investment adviser activities where entities provide advice on securities (such as in connection with the investment of stablecoin proceeds); and activities of intermediaries and trading platforms."[22] It also notes digital assets that "are, or incorporate, commodity futures, options, and swaps" are subject to the CFTC's jurisdiction, which pursuant to the Commodity Exchange Act governs intermediaries and exchanges offering or engaged in those transactions.[23]

Role of Federal Agencies More Broadly

The Report notes that agencies other than the SEC and CFTC have been playing, and will undoubtedly continue to play, an important role in the regulation of stablecoins. [24] The Department of Justice (DOJ) may, for example, bring civil or criminal charges related to the applicability of various regulations to particular stablecoin arrangements.[25] The Consumer Financial Protection Bureau may also exercise authority to protect customers in the payment sector.[26] Finally, the Financial Crimes Enforcement Network (FinCEN) administers the Bank Secrecy Act and has issued significant guidance on when cryptocurrency companies, including those involved in stablecoin arrangements, are engaged in "money transmission" and are thus subject to the statute.[27]

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[20] *Id.* at 10.

[21] *Id.* at 15.

[22] *Id.* at 11.

[23] *Id.*

[24] *Id.* at 18.

[25] *Id.* In addition, the DOJ recently created a National Cryptocurrency Enforcement Team. This team will tackle complex investigations and prosecutions of criminal misuses of cryptocurrency, particularly crimes committed by virtual currency exchanges, mixing and tumbling services, and money laundering infrastructure actors. *See* "Deputy Attorney General Lisa O. Monaco Announces National Cryptocurrency Enforcement Team," Department of Justice (October 6, 2021), available at https://www.justice.gov/opa/pr/deputy-attorney-general-lisa-o-monaco-announces-national-cryptocurrency-enforcement-team.

[26] The Report at 18.

[27] *Id.; see also* "Prepared Remarks of FinCEN Director Kenneth A. Blanco at Chainalysis Blockchain Symposium," FinCEN (November 15, 2019), available at https://www.fincen.gov/news/speeches/prepared-remarks-fincen-director-kenneth-blanco-chainalysis-blockchain-symposium.

In the absence of congressional action, the Report recommends that the FSOC consider steps available to it to address the risks identified in the Report. These steps include actions such as designating "certain activities conducted within stablecoin arrangements as, or as likely to become, systemically important payment, clearing, and settlement activities."[28] This would enable an appropriate agency to implement risk management standards for financial institutions that engage in designated PCS activities, which include oversight of the underlying assets backing the stablecoin. Financial institutions that participate in these designated PCS activities are also part of a robust examination and enforcement network. The Report notes that the FSOC could also potentially address stablecoin arrangements by designating them as "systemically important financial market utilities," subjecting those to the consolidated supervision of multiple agencies.[29]

Illicit Finance Risks

The Report concludes by discussing the potential money laundering and terrorism-financing aspects of stablecoin arrangements. It affirms that Treasury will continue engaging with the Financial Action Task Force to both encourage other countries to implement international AML/CFT standards and to bolster such standards domestically.

The Report highlights that a majority of stablecoins are considered "convertible virtual currency" (CVC) and are treated as "value that substitutes for currency" under FinCEN's regulations.[30] If CVC financial service providers (i.e., the participants in stablecoin arrangements) are involved in money transmission activities, they must register as money services businesses with FinCEN. The Report also notes that it may be difficult for stablecoin arrangements to adhere to US sanctions compliance requirements because it is generally not possible to obtain information on the identity and location of transactional counterparties based on blockchain data alone (this is, of course, generally true with respect to blockchain transactions). In light of this, the Report confirms that Treasury will gather additional resources that could empower FinCEN, the Internal Revenue Service and other federal regulators to increase supervision of these regulations in the blockchain space.

Looking Forward

While the PWG focused on regulatory gaps in the stablecoin ecosystem, it will be a challenge to adopt and then implement legislation to fill those gaps in the near term. The most immediate, and perhaps unintended, consequence of the Report, therefore, may be to temporarily increase the regulatory uncertainty in the stablecoin market. With over $100 billion of stablecoin value

[28] The Report at 18.

[29] *Id.*

[30] *Id.* at 20.

outstanding, and with that amount growing at a fast clip, stablecoins are an increasingly important component of the cryptocurrency ecosystem. It would be helpful to the industry, therefore, if the community of federal and state regulators issued clear guidance on their expectations of companies operating in the stablecoin ecosystem. WilmerHale will continue to monitor developments in this space closely and is available to assist companies in meeting their regulatory obligations in this fast-paced environment.

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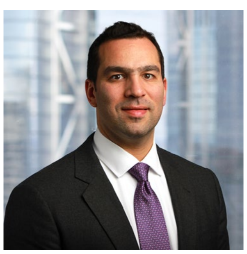

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