Gaining Momentum: The First Senate Discussion Draft on Stablecoins

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On April 6, 2022, Ranking Member of the Senate Banking Committee Senator Toomey (R-PA) released the Stablecoin Trust Act of 2022 (Draft Bill), marking a milestone in his continued effort to provide clarity on a regulatory framework for stablecoins.

The Draft Bill provides a thoughtful and streamlined framework for a "payment stablecoin," generally defined as a convertible virtual currency designed to maintain a stable value relative to a fiat currency or currencies.[1] It also introduces the concept of a limited purpose federal stablecoin license, granted by the Office of the Comptroller of the Currency (OCC), which would include access to Federal Reserve accounts and services.

The Draft Bill comes at a critical time given the $180 billion market capitalization of stablecoins (up from roughly $30 billion one year ago); President Biden's Executive Order on Ensuring Responsible Development of Digital Assets from March 9, 2022; recent congressional testimony from the U.S. Treasury; and increased scrutiny from banking and market regulators about the various risks associated with stablecoins. HM Treasury announced earlier this week that stablecoins will be brought within the regulatory perimeter, paving their way for use in the U.K. as a recognized form of payment.

Below are some notable aspects of the Draft Bill, a summary of what is left unanswered, and what could come next.

Three Paths to Stablecoin Issuance

The Draft Bill envisages three groups of stablecoin issuers: (i) money transmitters registered with the Financial Crimes Enforcement Network (FinCEN) or any other state-licensed money transmitter; (ii) insured depository institutions (IDIs); or (iii) a "national limited payment stablecoin issuer" (NLPSI) licensed by the OCC. All groups would be subject to the same standardized disclosure requirements, which would be submitted to the U.S. Treasury and made publicly available. These requirements are:

- Monthly public disclosures describing reserve assets backing the stablecoin;
- Public disclosure of redemption policies (i.e., describing whether conversion of the stablecoin back to U.S. dollars would be met on demand or with a time lag);
- Undergoing quarterly attestations by a registered public accounting firm, including public disclosure of results; and
- An attestation that assets backing the stablecoin do not "materially diverge" from publicly disclosed information.

Money Transmitters

Virtually all of the largest stablecoin issuers today are money transmitting businesses as well as state-licensed money transmitters across multiple states. Under the Draft Bill, this group would remain subject to state-level supervision and oversight, and could issue stablecoins without a bank charter or a NLPSI license.

This aspect of the Draft Bill is in tension with regulators' recommendation to require that stablecoin issuers be IDIs regulated at both the depository institution and the holding company level.[2] At the same time, the money transmitter path provides additional optionality within a stablecoin framework, and is responsive to the views of experts who contend that there has been a federal power grab over stablecoins.

Money transmitters would be subject to the same standardized disclosure requirements listed above, but unlike NLPSIs, would not be subject to capital, liquidity, and tailored governance and risk-management requirements promulgated by the OCC. If the Draft Bill proceeds, money transmitters would need to consider whether the potential benefits of obtaining a NLPSI license—e.g., obtaining a Federal Reserve master account (as described below)—outweigh the additional regulatory requirements and compliance costs associated with federal oversight and supervision.

IDIs

As of January 2022, an increasing number of tech-forward IDIs have been building a network of banks to further the adoption and interoperability of a bank-minted stablecoin. The Draft Bill would clarify IDIs' ability to issue stablecoins, and would provide IDIs an election to segregate into a separate legal entity the issuance of stablecoins and the management of reserve assets from other activities.

Interestingly, the Draft Bill, as noted above, includes entities other than IDIs as stablecoin issuers, despite regulators' IDI-only recommendation.[3] Following the stablecoin report, there were two interesting developments that help contextualize the non-IDI approach adopted in the Draft Bill.

Last January, Acting Comptroller Michael Hsu elaborated on the stablecoin report's recommendation, explaining that:

> Stablecoin issuers subject to bank regulation would give holders of those stablecoins confidence that those coins were as reliable and "money good" as bank deposits. Even if the tide were to go out, the reserves would be there, overseen and examined by bank supervisors, and potentially even backstopped by access to a central bank's discount window to meet short term liquidity needs if warranted. . . . Regulating stablecoin issuers as banks could also enable *more* innovation in crypto and make those innovations more durable. While innovation thrives in uncertain environments, solid foundations can help, especially when it comes to money and trust.

One month later, U.S. Treasury Under Secretary for Domestic Finance, Nellie Liang, testified before the Senate Banking Committee noting that the IDI-as-issuer recommendation was a flexible one, and not a one-size-fits-all approach:

> Stablecoin issuers that issue only stablecoins, do not extend credit, should not need to be subject to the full set of banking regulations that relate to credit provision. So flexibility I agree is very important. . . . Staying flexible within an IDI charter — which I believe is flexible — to better match the activities and risks with the regulation. The PWG report did not necessarily recommend deposit insurance, for example, so that would be consistent with a narrow bank.

As described below, these views likely helped shape the Draft Bill's introduction of the NLPSI—a solution designed to address this call for flexibility and provide a viable option for nonbanks.

National Limited Payment Stablecoin Issuers

An NLPSI is a person or entity that receives an OCC license and becomes subject to the OCC's regulatory standards. Entities would apply to the OCC for an NLPSI license, and licenses would generally need to be granted within 90 days after the application is filed. If a license were granted, an NLPSI would be authorized to issue, redeem, make a market in stablecoins, and engage in related activities, such as holding and managing stablecoin reserves.

In an attempt to streamline application determinations, the Draft Bill states that if the OCC fails to either approve or deny an application before expiration of the 90-day period, the application will be deemed granted. While timeliness and certainty are desirable, a 90-day timeframe could prove administratively challenging for the OCC, particularly assuming an influx of NLPSI applications at the inception of the licensing process.

The OCC would maintain discretion to deny an NLPSI license only upon a determination that the activities of the applicant would be unsafe or sound after considering three factors: (i) financial condition and business plan of the applicant; (ii) general character and fitness of management; and (iii) risks presented and potential benefits that could be delivered to consumers. In addition, as noted above, the OCC would be able to establish a limited set of regulations for NLPSIs, which are capital requirements (not to exceed 6 months of operating expenses); liquidity requirements; and tailored governance and risk-management requirements.

Through the creation of an NLPSI, the Draft Bill adopts elements of Under Secretary Liang's "flexible" IDI approach. The NLSPI model seeks to calibrate a regulatory framework that aligns with an issuer's "activities and risks" without imposing the panoply of prudential standards that otherwise apply to IDIs engaging in liquidity or maturity transformation. Aspects of the NLPSI also address many of the key concerns relayed by U.S. Treasury and the federal banking regulators in last year's stablecoin report. As a means of addressing run risk, for example, NLPSIs would be required to back stablecoin with a market value equal to not less than 100 percent of stablecoin outstanding (in either case and cash equivalents, or level 1 high-quality liquid assets).

NLSPIs would also be restricted from engaging in any activities—e.g., making loans or other extensions of credit—other than those incidental to stablecoin issuance or redemption, such as making markets in stablecoin and holding and managing reserve assets. In these respects, the NLSPI could be a workable path towards balancing stablecoin innovation and addressing risk.

National Limited Payment Stablecoin Issuers Would be Eligible for Fed Master Account Access and Services

Another notable aspect of the Draft Bill is that it would settle the question about whether the Federal Reserve will broaden eligibility for master account access for entities like stablecoin issuers, who today remain outside the federal bank regulatory perimeter. The Draft Bill provides a clear Fed master account "on-ramp" for NLPSIs, meaning that each Federal Reserve bank, upon application by an NLPSI, would establish and maintain an account for an NLPSI, and provide to the NLSPI a deposit account along with the following services:

- Currency and coin;
- Check clearing and collection;
- Wire transfer;
- Automated clearinghouse;
- Settlement;
- Securities safekeeping;
- Federal Reserve float; and
- Any new services which the Federal Reserve System offers, including but not limited to payment services to effectuate the electronic transfer of funds.

Payment Stablecoins Would be Exempt from Securities Requirements

As non-interest bearing instruments, the Draft Bill clarifies that payment stablecoins would not be regulated like securities.

Consumer Privacy Protections Would Apply to Stablecoins and "Other Convertible Virtual Currencies"

The Draft Bill clarifies several points related to the applicability of consumer privacy protections to stablecoins and "other virtual currencies." Although "other convertible virtual currencies" is undefined, it is generally understood to include bitcoin, which can be digitally traded between users and be purchased for, or exchanged into, U.S. dollars, Euros, and other real or virtual currencies.

First, the U.S. Treasury would not be able to collect or mandate collection of nonpublic information about convertible virtual currency transactions except where there is a court-issued search warrant or information that is voluntarily provided by a customer of a financial institution, business, or other third party and held for a legitimate business purpose. The Draft Bill is silent on how this provision relates to the obligations of financial institutions under the Bank Secrecy Act or how this rule would be applied in practice given FinCEN's role in enforcing such compliance.

Second, and limited to stablecoins, NLPSIs would be subject to section V of the Gramm-Leach-Bliley Act, which governs the issuance of regulations ensuring that financial institutions protect the privacy of consumers' personal financial information.

Open Questions

First, the Draft Bill's application is limited to payment stablecoins, consistent with the focus of last November's stablecoin report. How will algorithmic and digital asset-backed stablecoins be regulated? The answer may be addressed as part of the Executive Order's future action items.

Second, the Draft Bill is silent about the potential need for a consumer backstop (e.g., insured deposit protection). This raises a question about the growing retail use of stablecoins, and the potential need for insured deposit protection if a stablecoin issuer were to fail. Given the proliferation and scalability of stablecoins, the potential need for robust consumer protections remains an important question to explore, even if stablecoins are designed to be fully-backed with cash or cash equivalents, or level 1 high quality liquid assets. Likewise, the Draft Bill is silent about any role for the FDIC. If and when the FDIC provides clarity on key questions, such as whether stablecoins could qualify as a deposit and the potential applicability of pass-through insurance, future drafts may address the FDIC's role in a stablecoin framework.

Third, the Draft Bill is silent on a targeted recovery and resolution framework for stablecoin issuers, despite the stablecoin report's recommendation. On the one hand, would such a framework be necessary given a fully-backed, limited purpose stablecoin issuer model coupled with the proposed maintenance of liquidity and capital requirements imposed on NLPSIs? On the other hand, incorporating targeted recovery and resolution planning requirements for NLPSIs—as Wyoming has done[4]—is sensible, particularly given the rapid growth of the stablecoin industry and associated liquidity, operational, and potential systemic risks. This approach would also help level the playing field with the largest potential IDI stablecoin issuers, many of whom are today subject to recovery and resolution requirements under Title

I of the Dodd-Frank Act. Additional policy and data analysis led by the federal banking agencies—in connection with the action items under President Biden's Executive Order—could be instructive on this question.

Lastly, the Draft Bill sidesteps regulatory concerns regarding the risks associated with mixing banking and commerce. The Draft Bill is again silent—perhaps by design—about whether commercial entities (e.g., BigTech) would be eligible to issue stablecoins under any framework. While there is no per se bar to a commercial entity applying for an NLSPI, the OCC would maintain discretion to deny an application if it determined the "activities of the applicant would be unsafe or unsound," including consideration of the risks presented and potential benefits that could be delivered to consumers.

If the Draft Bill proceeds, the bounds of OCC discretion on NLPSI applications is likely to invite additional scrutiny by legislators, the banking industry, nonbanks, and the public.

What's Next?

In addition to the Draft Bill, other bipartisan crypto proposals are expected to be issued soon. It is possible they will also incorporate a regulatory framework for stablecoins, along with additional features that address the open questions above.

As legislative momentum builds, timely and sustained bipartisan agreement is a worthy goal, and hopefully one that brings needed clarity for regulators and innovators.

Endnotes

[1] Other elements of a “payment stablecoin” are that it is convertible directly to fiat currency by the issuer; designed to be widely used as a medium of exchange; issued by a centralized entity; does not inherently pay interest to the holder; and is recorded on a public distributed ledger.

[2] President's Working Group on Financial Matters, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Report on Stablecoins (Nov. 2021), at 2-3, 17(“stablecoin report"), available here.

[3] Id.

[4] 021-002-020 Wyo. Code R. §§ 4, 6; see also Financial Stability Board, Regulation, Supervision and Oversight of “Global Stablecoin” Arrangements: Progress Report on the implementation of the FSB High Level Recommendations (Oct. 7, 2021), at 3 (“Recommendation 7. Authorities should ensure that GSC arrangements have appropriate recovery and resolution plans.”), available here.