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WHITE PAPER

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Digital Assets Defined: How Lummis-Gillibrand Will Shore Up Stablecoins

In this latest *White Paper* on our Bill analysis, we underscore headline proposals in the Lummis-Gillibrand Responsible Financial Innovation Act (the "Bill") regarding the issuance and regulation of a "payment stablecoin," which the Bill defines as a digital asset issued by a business entity that is "redeemable on demand" for legal tender, "backed by 1 or more financial assets," and is "intended to be used as a medium of exchange."[1] Stablecoin regulation has received renewed attention after the collapse of the algorithmic stablecoin TerraUSD, which was not fully backed with cash or assets.

We finish this *White Paper* by highlighting unresolved questions that should be the focus of future stakeholder efforts to refine the Bill before aspects of it become law.

FEDERAL PREEMPTION TO ISSUE PAYMENT STABLECOINS

The Bill grants state- and federally chartered depository institutions the right to "issue, redeem, and conduct all incidental activities relating to payment stablecoins," notwithstanding state regulations to the contrary.[2] Federal preemption conveys significant benefits for all depository institutions. The term "incidental activities" is defined broadly to include "management of required payment stablecoin assets," market making, custodial services, settlement and clearing, and post-trade services, and "[a]ll other activities consistent with a safe and sound operation."[3]

Absent these provisions or other sources of federal preemption, depository institutions wishing to issue payment stablecoins would face the prospect of complying with the laws of all 50 states, an onerous and potentially impossible regulatory burden depending on the overlap or conflict among state controls. By extending a federal right to issue payment stablecoins and conduct all "incidental activities" that attend such commercial activity, the Bill nips state protectionist forces in the bud and offers a welcomed and much-needed degree of uniformity. It is notable, though not unprecedented, that the Bill, a federal statute, would preempt state law applicable to state-chartered banks in order to *expand* the powers of those state-chartered banks, underscoring that the Bill is intended to increase uniformity nationwide.

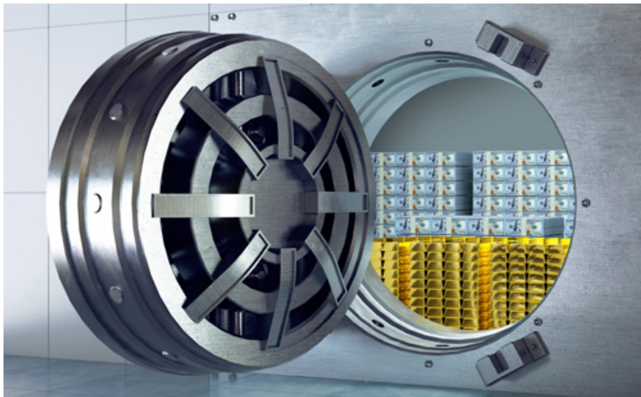
NON-BANKS MAY ISSUE AND REDEEM PAYMENT STABLECOINS AND ACCESS FEDERAL RESERVE SERVICES

The Bill also allows non-depository institutions to issue and redeem payment stablecoins and conduct all "incidental activities," "consistent with a safe and sound operation, as determined by the appropriate regulator of the entity."[4] It also defines a path for payment stablecoin issuers to obtain national charters from the Office of the Comptroller of the Currency if they are exclusively engaged in: issuing payment stablecoins; providing safekeeping, trust, or custodian services; or activities incidental to the foregoing.[5]

Controversially, the Bill also contemplates extending Federal Reserve payment, clearing, and settlement services to these newly chartered stablecoin-only entities.[6] Some have argued that extending Federal Reserve services to entities that do not comply with the same regulatory standards as traditional banks is unfair and exposes the Federal Reserve to unnecessary risks.[7] Others argue that extending Federal Reserve services to all stablecoin issuers fosters competition and lends security and stability to these digital assets, which is one of the Bill's key objectives. Perhaps a compromise can be reached that includes further oversight for all Federal Reserve master account holders.

PAYMENT STABLECOINS MUST BE FULLY BACKED BY RESERVES

The Bill requires payment stablecoin issuers to maintain "high-quality liquid assets . . . equal to not less than 100 percent of the face amount of the . . . payment stablecoins."[8] Such assets include U.S. currency and other legal tender,[9] demand deposits, balances held at the Federal Reserve bank, short-term Treasury securities, or "[a]ny other high-quality, liquid asset determined to be consistent with safe and sound banking practices, as determined by the appropriate Federal banking agency or State bank supervisor."[10]



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These provisions aim to mitigate the systemic risks associated with stablecoins that led to the collapse of TerraUSD. But to the extent the Bill creates payment stablecoins that function like traditional bank deposits but does not deem them to be such for fractional banking purposes, then a 100% backing requirement will all but eliminate any money-multiplier associated with those stablecoins. In other words, as traditional bank deposits migrate into segregated stablecoin reserve accounts held by the central bank, the deposit-backed funding for credit will be reduced.[11]

This 100% backing requirement may eventually relax once lawmakers, regulators, and industry participants better understand stablecoin. The broad definition of "high-quality liquid assets" also leaves a fair amount of discretion and work to be done for federal and state regulators. The Bill does not, for example, adopt the detailed, three-tier definition of "high-quality liquid assets" employed by the federal banking agencies for purposes of the liquidity coverage ratio rule.[12]

ISSUERS MUST REQUEST PERMISSION AND PLAN FOR CONTINGENCIES

A depository institution desiring to issue a payment stablecoin must apply for permission from the appropriate federal or state banking agency not less than six months before the intended stablecoin issuance date.[13] The application must include a tailored recovery and resolution plan, a flow of funds explanation, a robust information technology plan, and operational design of the payment stablecoin, among other things. To prevent bottlenecks, the Bill compels the responsible government entity to make a reasoned decision on each application within four months and limits the grounds for denial to defined criteria.[14]

RECOVERY AND RESOLUTION PLANS FOR STABLECOIN ISSUERS

The Bill requires issuers to have "tailored recovery and resolution plans" in the event of distress, whether by resuming ordinary safe and sound operations or by winding down the issuer, including a plan for the redemption of all outstanding payment stablecoins.[15] The Bill allows the Federal Deposit Insurance Corporation to be appointed as receiver of a covered depository institution, as well as a specially chartered stablecoin entity. If an issuer goes into receivership, stablecoin holders have a priority claim on reserve assets over all other claims on the institution with respect to any required payment stablecoin.[16]

SUPERVISION OF PAYMENT STABLECOIN ISSUER HOLDING COMPANIES

The Bill also adds a new Section 15 to the Bank Holding Company Act ("BHCA") that would establish a "lighter-touch" regulatory framework for entities that control payment stablecoin issuers than the currently existing set of requirements for bank holding companies. The Bill clarifies that such stablecoin issuers are not "banks" for purposes of the BHCA and therefore that entities controlling them are not bank holding

companies,[17] yet commercial firms are prohibited from obtaining controlling interests in payment stablecoin issuers.[18] The "controlling interest" definition is consistent with the existing definition of "control" under the BHCA, and is defined as either the ability to vote 25% or more of any class of voting securities, control of the election of a majority of directors, or the power to exercise a controlling influence over bank management or policies.[19] Those with controlling interests must submit annual audited financial statements and descriptions of all affiliated or parent entities, among other things.

If the appropriate banking supervisor finds that it is in the public interest and has reasonable cause to believe it is necessary to protect customers of a depository institution, then the supervisor may conduct an examination of the controlling entity and force it to divest or sever their relationship with the stablecoin issuer, "if necessary to maintain safety and soundness."[20] Certain other elements of the existing regulatory regime for banks and their affiliates within a bank holding company structure would also apply. For example, existing restrictions on transactions between banks and their affiliates apply to payment stablecoin issuers pursuant to the Bill.[21]

MANY QUESTIONS LEFT UNANSWERED

Although the Lummis-Gillibrand Bill addresses many challenges in the stablecoin sector, it leaves important questions unanswered. Some of these open issues can be addressed through incremental regulation, but many can be addressed now (and probably should).

- Some non-banks that have issued stablecoins already may struggle to amass sufficient cash and other assets to comply with the Bill's 100% backing threshold. Will such entities be grandfathered into the system?

- State and federal definitions and enforcement of the requirement to hold "high-quality liquid assets" may strongly favor capital-rich depository institutions over non-depository entities. If that is the case, the Bill may strongly incentivize non-banks to become depository institutions. This may be undesirable or nonfeasible for many non-banks because it could require fundamental business changes, which could result in significant market exit. The Bill should provide more guidance to regulators regarding what types of assets are sufficiently "high quality" or "liquid." Will cryptocurrencies or other digital assets suffice? If so, under what circumstances? Will the sufficiency of the assets held in reserve to back the stablecoins be evaluated on a case-by-case basis, taking into account the financial strength of the issuer itself?

- The Bill requires stablecoin issuers to comply with the data privacy provisions of the Gramm-Leach-Bliley Act. That law requires covered banks to give customers the ability to opt out of having their nonpublic personal information shared with nonaffiliated companies.[22] But the pseudonymous and yet public nature of blockchains could cause stablecoin issuers to inadvertently violate this aspect of Gramm-Leach-Bliley. For example, an issuer of a stablecoin compatible with public blockchains will have issues complying with Gramm-Leach-Bliley's opt-out requirement because nonaffiliated third parties can easily see a consumer's information whether or not they have opted out. Are there any carveouts to potential liability under these provisions? If preexisting stablecoin issuers apply for charters under Lummis-Gillibrand, will they still be required to comply with Gramm-Leach-Bliley?

- The Bill contemplates certain "national security threats" as per se "valid reason[s]" for terminating a Federal Reserve account.[23] However, the proposed language is vague, allowing a Federal banking agency to terminate an account if it believes "a specific customer or group of customers is, or [is] acting as a conduit for, an entity which . . . poses a threat to national security."[24] Certain senators have already introduced a bill to prohibit app stores from hosting apps that enable transactions using China's Digital Yuan.[25] The bill's sponsors argue that the Digital Yuan will be used to spy on its users, control and access users' financial lives, and infiltrate the American economy. These arguments are a preview of how stablecoin issuers utilizing foreign central bank digital currencies might be portrayed as threatening national security, regardless of whether the risks pointed to are real or substantial.

- The Bill sets out a 100% reserve requirement for stablecoin issuances and requires banks to make monthly public disclosures that include a summary description of reserve assets, the value of such assets, and the number of total outstanding payment stablecoins.[26] It further provides that the applicable state or federal banking agency must verify

the composition of the assets and the accuracy of the summary description.[27] Several potential issues flow from this requirement. First, it bears consideration whether a bank could have an account terminated if it submits what is deemed to be an inaccurate summary description (perhaps on multiple occasions). Second, if so, the Bill does not provide for any cure period, and it would be an open question as to how this may impact the account termination process. Third, would a depository institution's disclosure of any instances in which it failed to comply with any portion of the reserve requirements—as required by the Bill—be considered an admission for purposes of account termination and perhaps other regulatory actions?

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ENDNOTES

1 § 101(a)(5).
2 *See* § 601 (creating a new 12 U.S.C. 4810(a)).
3 § 601 (creating a new 12 U.S.C. 4810(j)).
4 § 601(l).
5 § 604. While the question of whether the OCC can charter a non-depository fintech on its own authority remains unsettled, there is precedent for Congress to grant authority to the OCC to charter special-purpose national banks, including non-depository entities. *See, e.g.*, 12 U.S.C. §§ 27(b) (bankers' banks); 92a (non-depository trust companies).
6 § 702.
7 *See* Kyle Campbell, "The Lummis-Gillibrand Crypto Bill Provision That Has Banks on Edge," *American Banker* (June 7, 2022).
8 § 601 (creating a new 12 U.S.C. 4810(b)).
9 Section 4810(b)(1) of the Bill includes "any other instrument defined as legal tender (as defined by 31 U.S.C. 5103)" as eligible high-quality liquid assets. Currently, 31 U.S.C. 5103 includes only "coins or currency," but this provision accounts for the Federal Reserve's and Treasury's ongoing consideration of issuing official U.S. digital currencies. The Bill is thus drafted to automatically include such U.S. digital currencies if they eventually come into being.
10 § 601 (creating a new 12 U.S.C. 4810(b)(7)).
11 *See* "Stablecoins: Growth Potential and Impact on Banking" at 12–13, Federal Reserve (Jan. 2022).
12 12 C.F.R. §§ 50.20 (OCC), 249.20 (Federal Reserve), 329.20 (FDIC).
13 § 601 (creating a new 12 U.S.C. 4810(e)).
14 § 601 (creating a new 12 U.S.C. 4810(e)). The Bill does not subject payment stablecoin issuers to existing resolution plan requirements for large banks pursuant to Section 165 of the Dodd-Frank Act; rather, it requires the OCC to establish new, "tailored," resolution plan requirements.
15 § 601 (creating a new 12 U.S.C. 4810(e)).
16 § 601 (creating a new 12 U.S.C. 4810(i)).
17 § 605(2).
18 § 605(2) (amending 12 U.S.C. 1841 with a Section 15(d)).
19 § 605 (amending 12 U.S.C. 1841 with a Section 15(a)(2)).
20 § 605 (amending 12 U.S.C. 1841 with a Section 15(e)).
21 § 604(2); *see* 12 C.F.R. Part 223 (Regulation W).
22 § 601 (creating a new 12 U.S.C. 4810(h)).
23 § 707(c).
24 § 707(c)(1).
25 Defending Americans from Authoritarian Digital Currencies Act, S. 4313, 117th Cong. (2022).
26 § 601 (creating a new 12 U.S.C. 4810(c)).
27 § 601 (creating a new 12 U.S.C. 4810(c)).

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