

President Biden's Working Group on Financial Markets Issues Report on Stablecoins

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On November 1, the President's Working Group on Financial Markets (PWG), along with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency, issued a "Report on Stablecoins" (Report) that provided background on stablecoins, identified regulatory gaps related to such digital assets, and offered recommendations for addressing those gaps. After outlining the risks and deficiencies in the current regulatory landscape as it relates to stablecoins, the Report recommended that Congress enact legislation requiring that stablecoins be governed according to a comprehensive federal framework.

As of October 2021, according to the Report, the market capitalization of stablecoins issued by the largest issuers exceeded \$127 billion — nearly a 500% increase over the previous 12 months. The rapid growth of stablecoins has precipitated an urgent need to establish a federal regulatory framework that provides guidance to consumers and businesses alike. The recommendations in the Report represent an initial step in that process, and we expect more guidance from federal agencies concerning governance relating to these coins and other digital assets. We will continue to track developments in this space and report on future initiatives for stablecoins and other digital assets in the regulatory space.

Existing Risks

Stablecoins are digital assets designed to maintain stable value, unlike other types of cryptocurrency, and are generally benchmarked against a sovereign currency, such as the U.S. dollar.^[1] Stablecoins offer some of the same benefits as other digital assets, such as mobility and accessibility, but are generally intended to be less volatile because they are benchmarked against a fiat currency. As a result, stablecoins have grown in popularity and have the potential to become much more widely used than other more volatile digital assets.

As noted in the Report, stablecoins predominantly are used to facilitate trading, lending, and borrowing of other digital assets. However, stablecoin issuers and others involved in stablecoin projects have expressed their intent to move the asset class into more widespread use. The prospect of rapid growth presents several key risks, including the potential for market destabilization; disruptions in payment systems; a concentration of economic power; and the need to protect consumers, preserve market integrity, and prevent illicit financial behavior. The Report covers each of these risk categories in detail.

First, investor confidence in the value of stablecoins may be undermined by a number of factors, which could result in a valuation decline in stablecoins that could disrupt critical funding markets and potentially upset the

economy and financial system. Second, stablecoin payment systems face a number of basic risks, such as credit risk, liquidity risk, operational risk, risk arising from improper or ineffective system governance, and settlement risk — all of which could make stablecoin payment systems less reliable. Given the decentralized structure of most stablecoin arrangements, there likely are not sufficient risk-management standards in place. Third, the rapid growth of stablecoins raises several policy concerns, including that (1) the failure of one key participant could easily have an adverse effect on a wide scale; (2) certain players could establish a high concentration of economic power; or (3) the growth of one particular stablecoin over another might have an anti-competitive impact in the market. Fourth, regulators, such as the Securities and Exchange Commission (SEC) and the Commodity Future Trading Commission (CFTC), are not fully postured to leverage their authority to monitor potential fraud or misconduct, as the regulatory framework in this space has not been comprehensively established.

Although existing federal agencies have taken steps to examine stablecoins and may have the authority to handle certain aspects of stablecoin arrangements, the Report concludes that there is currently no comprehensive set of regulatory standards to address the risks above.

Current Regulatory Framework and Gaps

Federal regulators have taken steps to create a coherent regulatory framework for stablecoins and other digital assets using their existing authority. For example, the SEC and the CFTC have the authority to address many concerns regarding potential market and investor risks and have, among other things, taken certain actions against the offer and sale of certain digital assets on the grounds that they constitute an improper unregistered offering of securities or that they are frauds. In the near future, the agencies may take such steps as requiring clear and useful disclosures, protecting against fraud, manipulation, and other risks, and making use of existing rulemaking, examination, supervision, and enforcement powers.

The Report also noted that the CFTC and the SEC are actively considering questions around digital asset trading platforms and decentralized finance, although those questions are not the subject of the recommendations in the Report. These issues raise broad questions around market regulation, supervision, and enforcement. In particular, decentralized finance arrangements present higher risks of fraud, misappropriation, and conflicts of interest.

According to the Report, stablecoin arrangements and activities “may implicate” the jurisdiction of the SEC and/or the CFTC for several reasons. First, the stablecoins themselves may be securities, commodities, and/or derivatives subject to regulation. Second, the lending, trading, and borrowing activity surrounding stablecoins may likewise be considered securities and/or derivatives transactions. However, the Report did not draw any conclusions as to whether stablecoins definitively fall under these agencies’ jurisdiction. Instead, the Report suggested that because responsibilities for managing the various risks in the current stablecoin system are spread across various regulators, and may fall outside existing regulatory jurisdictions altogether, other actions are necessary to ensure that an appropriate regulatory framework is in place.

Implications and Recommendations

Ultimately, the Report recommended that Congress draft and pass substantial federal legislation establishing a federal prudential framework for payment stablecoin arrangements to the extent that stablecoin issuers, wallet providers, and other key entities are domiciled in the U.S., offer products to U.S. persons, or otherwise have a

significant U.S. nexus. This legislation could include limiting the issuance of stablecoins to insured depository institutions, maintenance of reserve assets and ensuring that standards can be implemented to promote sound operations and governance for various types of stablecoins. The Report recommended federal oversight not just of stablecoin issuers, but also custodial wallet providers. In addition, the proposed legislation would provide the designated regulatory agency with the authority to require appropriate risk-management structures, as well as examination and enforcement authority. The Report did not provide a recommendation as to which existing federal agency would have oversight over stablecoins.

The Report represents an ongoing endeavor by the PWG and others in the administration to react to a variety of digital assets, including cryptographic currencies such as bitcoin and distributed ledger technology. In the fast-changing landscape of digital assets, current regulators, including the SEC and CFTC, will likely work to ensure that stablecoin issuers comply with existing regulations and will coordinate in their efforts until federal legislation is passed that will clarify the regulatory framework. In the meantime, individuals and organizations that issue or handle stablecoins should closely monitor regulatory developments and begin to prepare for more defined mandates for stablecoins and other digital assets.

[1] The Report focused on stablecoins that are purportedly convertible for an underlying fiat currency, rather than a smaller subset of stablecoins that are convertible for other, less stable assets or that use other means to attempt to stabilize the value (*i.e.*, synthetic or algorithmic stablecoins).

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