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Federal Regulators Recommend Bank Regulation for Stablecoins

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On November 1, 2021, the President's Working Group ("PWG") on Financial Markets¹, along with the Office of the Comptroller of the Currency ("OCC") and Federal Deposit Insurance Corporation, issued a report on stablecoins.

The report is focused on stablecoin arrangements that are pegged to a fiat-currency and recommends that:²

- Congress "promptly" pass legislation requiring stablecoin issuers to be insured depository institutions and providing federal agencies with significant regulatory authority over custodial wallet providers and other key participants in stablecoin arrangements.
- in the absence of congressional action, the Financial Stability Oversight Council (the "FSOC") pursue its authority to designate certain activities conducted within stablecoin arrangements as systemically important payment, clearing and settlement ("PCS") activities.

Key takeaways

Below are our observations on the report and what it means for next steps in the legislative and regulatory processes.

- The report in no uncertain terms reflects the view that stablecoin issuers look like banks and, thus, should be regulated like banks. See [here](#) for our analysis as to why some type of prudential framework appears to be an appropriate policy approach.
- Thus, the report envisions that stablecoin issuers generally would be subject to full-scope prudential standards, including consolidated supervision and activities restrictions, and other participants in stablecoin arrangements would be similarly regulated. The idea of a special purpose charter that provides a more limited regulatory framework is not among the report's recommendations.
- To that end, our view is that there almost certainly will be a prudential regulatory framework in place for stablecoins within the next two years or so.
 - This framework either will come from existing authorities or from legislation.
 - To us, the existing authority most likely to impose a comprehensive prudential framework on stablecoin arrangements is the FSOC's authority to designate systemically important PCS activities (see the [Appendix](#) for an overview of those authorities).
- The legislative and regulatory processes are likely to occur at the same time. Moreover, the FSOC process and other agency work may inform legislation or even encourage congressional action.
- Given the report's clear call for "prompt" congressional action, it seems to us highly likely that there will be congressional hearings in the near term. Those

hearings may evaluate the relative merits of congressional action versus agency action under existing authorities and revisit the report’s policy decisions, such as the decision to not include a recommendation for a special purpose bank charter for stablecoin issuers. We expect continued congressional attention to legislation after the hearings, although it is unclear whether any bill would be enacted.

- Further, the report largely avoids resolving jurisdictional issues among the banking regulators and market regulators.
 - The report focuses on prudential risks and recommendations and leaves open the extent to which a stablecoin or parts of a stablecoin arrangement may be subject to the jurisdiction of the SEC and / or the CFTC.
 - Such issues also may be raised in any hearing on Capitol Hill and, ultimately, could be addressed in legislation. See [here](#) for our prior analysis of the potential for the report to reveal whether the agencies are aligned on key issues, including with respect to questions of what issues fall within the jurisdiction of each agency.
- The views of the individual agencies may become clearer in the near term.
 - In particular, the FRB is expected to release a white paper on the “future of money”; the OCC expects to conclude its review of various innovation issues at or near year-end; the federal banking agencies also may release guidance or other work product on various innovation issues resulting from the ongoing interagency “sprint teams”; and the market regulators are likely to continue to take enforcement and regulatory actions that clarify their respective views on jurisdiction.
 - Each of these actions should provide further insight into how existing tools could be used to regulate stablecoins.

Risks identified

The report identifies the following types of prudential risks associated with payment stablecoin arrangements:

- “run” risk, *i.e.*, the risk of large-scale redemptions that cause fire sales of reserve assets;
- payment system risks, *e.g.*, credit, liquidity, operational, governance and settlement risks; and
- competitive and financial stability risks (the report has a particular focus on risks associated with the ability of a stablecoin to scale quickly if offered by a firm, presumably including a technology firm, with an existing user base).

The report further notes various investor protection, illicit finance and other risks that the agencies believe are implicated by stablecoin activities. The report does little to clarify whether a stablecoin arrangement is a security, commodity and / or derivative, as noted above, and makes clear that the report’s recommendations are “not intended to affect any analysis” under the federal securities laws or the Commodity Exchange Act.

Legislative recommendation

The report recommends legislation to:

- limit stablecoin issuance, redemption and maintenance of reserve assets to insured depository institutions.
- subject custodial wallet providers to federal oversight and regulation, such as by providing regulators with authority to restrict these providers from lending customer stablecoins and to require compliance with risk-management, liquidity and capital requirements. The report also recommends that, to address concerns about concentration of economic power, Congress consider other standards, such as limits on affiliation with commercial entities and on use of users’ transaction data.
- provide federal supervisors with authority to require any entity that performs activities critical to the functioning of a stablecoin arrangement to meet appropriate risk-management standards as well as with examination and enforcement authority over such entities.
- provide federal supervisors with authority to implement standards to promote interoperability among stablecoins or between stablecoins and other payment instruments.

FSOC recommendation

The report's recommendation to the FSOC focuses on the FSOC's authority to designate systemically important PCS activities under Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.³

- The report states that designation would permit the appropriate agency to establish risk-management standards for “financial institutions” that engage in the designated PCS activities, including requirements regarding reserve assets, the operation of the stablecoin arrangement, and “other prudential standards” (potentially a reference to capital and liquidity standards).
- We describe the FSOC's PCS designation authority, including authorities of the FRB and other agencies resulting from such a designation, in the [Appendix](#).

Other regulatory authorities

The report states that the agencies will seek to address the identified risks to the extent current law allows and will coordinate among themselves on issues of common interest. These actions include seeking to ensure bank charter applications address the risks outlined the report and considering whether or how section 21(a)(2) of the Glass-Steagall Act of 1933 could be used to require stablecoin issuers to become banks (or at least somewhat similarly regulated).⁴ See [this article](#) for background on section 21(a)(2).

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Appendix:

Title VIII Payment, Clearing and Settlement Activities Designation Authority

Below is a brief introduction to the key points of Title VIII that are relevant to designating stablecoin and stablecoin-related activities as systemically important. We note that, although beyond the scope of this introduction, the Title VIII process likely will raise a variety of significant policy and legal issues.

OVERVIEW

- Title VIII provides the FSOC with authority to designate “payment, clearing, or settlement activities” that “are, or are likely to become, systemically important” (the “systemic importance standard”) (emphasis added).⁵
- In contrast to the nonbank financial company or FMU designation standards, the FSOC has not used the PCS activities designation authority to date and has not adopted any rules or guidance about the processes or standards applicable to the use of this authority. As a result, absent the FSOC adopting rules or guidance, the statutory provisions alone (with the overlay of administrative law standards) would guide a designation process.
 - *This is an activities-based designation; unlike nonbank financial company and FMU designations, no particular entity would be designated as systemically important, but rather, designation would result in multiple entities’ PCS activities being regulated.*
- PCS activities are defined as those carried out by one or more “financial institutions” to “facilitate the completion of financial transactions”.⁶ The definition excludes any offer or sale of a security, or any quotation, order entry, negotiation, or other pre-trade activity or execution activity.⁷
 - “Financial institution”
 - Financial institution includes any banking organization; broker-dealer; investment company; insurance company; investment adviser; futures commission merchant; commodity trading advisor; or commodity pool operator.⁸
 - The definition also includes “any company engaged in activities that are financial in nature or incidental to a financial activity, as described in section 4 of the Bank Holding Company Act”.⁹
 - *Companies that are not otherwise regulated, such as a nonbank stablecoin issuer, may be captured by this “catch all” prong of the definition if it engages in any amount of financial activities (whether those are stablecoin activities or other activities).*
 - “Financial transaction”
 - Financial transaction includes funds transfers; securities contracts; commodity futures contracts; forward contracts; repurchase agreements; swaps and security-based swaps; foreign exchange contracts; derivatives contracts; and any similar transaction as determined by the FSOC.¹⁰
 - The statute elaborates that examples of PCS activities include: the calculation and communication of unsettled financial transactions between counterparties; the netting of transactions; provision and maintenance of trade, contract, or instrument information; the management of risks and activities associated with continuing financial transactions; transmittal and storage of payment instructions; the movement of funds; the final settlement of financial transactions; and other similar functions as determined by the FSOC.¹¹
- *How broadly the FSOC is willing to interpret the definitions discussed above to capture stablecoin and stablecoin-related activities and participants will determine how easily the FSOC may (1) designate the activity under consideration as systemically important and (2) authorize the direct regulation of the actors that could pose a risk to financial stability.*

DESIGNATION STANDARD AND PROCESS

- In evaluating whether a PCS activity meets the systemic importance standard, the FSOC must consider the following factors.
 - The aggregate monetary value of transactions carried out through the PCS activity.
 - The aggregate exposure of a financial institution engaged in PCS activities to its counterparties.
 - The relationship, interdependencies or other interactions of the PCS activity with other FMU or PCS activities.
 - The effect that the failure of or a disruption to the PCS activity would have on critical markets, financial institutions or the broader financial system.
 - Any other factors that the FSOC deems appropriate.¹²
- Before designating a PCS activity as systemically important, the FSOC is required to provide advance notice in the *Federal Register*.¹³ Financial institutions engaged in the PCS activity then have the opportunity to provide comments and to request a “hearing” with the FSOC.¹⁴

STANDARDS FOR DESIGNATED PCS ACTIVITIES

- Once a PCS activity is designated by the FSOC, the FRB, CFTC and SEC are charged with adopting risk management standards for the entities for which each agency is the appropriate financial regulator.¹⁵
- The risk management standards that the agencies may prescribe may address: risk management policies and procedures; margin and collateral requirements; participant or counterparty default policies and procedures; the ability to complete timely clearing and settlement of financial transactions; and other areas that are necessary to achieve the objectives and principles set out in the statute.¹⁶
 - *Although these standards are supposed to only govern financial institutions’ operations and conduct related to the designated PCS activity,¹⁷ the standards could significantly affect certain financial institutions’ business operations or finances.*
- The agencies may establish a threshold as to the level of significance of engagement in the designated PCS activity at which a financial institution will become subject to the standards prescribed with respect to that activity.¹⁸
 - *Establishing a minimum threshold may be important in part because the definition of financial institution has no de minimis threshold. In other words, absent an established threshold, any company that is included within the “catch all” provision of “financial institution” (meaning that it engages in any amount of financial activities) and also engages in the designated PCS activity could be subject to the risk management standards—regardless of how small or insignificant such activities are to the company’s business operations or to financial stability.*

EXAMINATION AND ENFORCEMENT OF DESIGNATED PCS ACTIVITIES

- For federally regulated financial institutions, the primary financial regulatory agency for such an institution is authorized to conduct examinations with respect to designated PCS activities.¹⁹
- If a financial institution does not have a primary financial regulatory agency, the FRB may examine the institution.²⁰
- Each examining agency has the authority to enforce rules and orders against its supervised financial institutions to the same extent that banking regulators have against insured depository institutions supervised under section 8 of the Federal Deposit Insurance Act.²¹
- The FRB also is given a “back-up” examination and enforcement authority.²²

¹ The PWG is chaired by the Secretary of the Treasury and includes the Chairs of the Federal Reserve Board ("FRB"), Securities and Exchange Commission ("SEC") and Commodity Futures Trading Commission ("CFTC").

² The report generally limits its analysis and recommendations to prudential risks associated with "those stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment". The report also refers to these types of stablecoins as "payment stablecoins".

³ The PWG report also notes, in a footnote, that FSOC could address stablecoin arrangements using its authority to designate systemically important financial market utilities ("FMU") under Title VIII,

⁴ See 12 U.S.C. § 378(a)(2).

⁵ 12 U.S.C. § 5463(a)(1).

⁶ 12 U.S.C. § 5462(7)(A).

⁷ *Id.*

⁸ 12 U.S.C. § 5462(5)(A).

⁹ 12 U.S.C. § 5462(5)(A)(x).

¹⁰ 12 U.S.C. § 5462(7)(B).

¹¹ 12 U.S.C. § 5462(7)(C).

¹² 12 U.S.C. § 5463(a)(2).

¹³ 12 U.S.C. § 5463(c)(2).

¹⁴ *Id.* The FSOC also has emergency authority to designate PCS activities without the advance notice process if "necessary to prevent or mitigate an immediate threat to the financial system" posed by the PCS activity. 12 U.S.C. § 5463(c)(3)(A).

¹⁵ 12 U.S.C. §§ 5464(a)(1) and (2)(A). The FRB's standards would apply to all financial institutions, including otherwise unregulated financial institutions, other than those financial institutions to which the SEC's or CFTC's risk management standards apply. *Id.* The SEC's or CFTC's standards would apply to many types of regulated entities, such as broker-dealers, investment companies and futures commission merchants. *Id.*; see also 12 U.S.C. §§ 5301, 5462 (defining the "Supervisory Agency" or "appropriate financial regulator"). However, the market regulators' standard-setting authority would not include, for example, standards for all companies deemed to issue a security under U.S. securities law or offer a commodity under the Commodity Exchange Act. Moreover, as a technical matter, the SEC and CFTC are not required to issue risk management standards under Title VIII.

The FRB is given a "backstop" role. If the FRB determines that the CFTC or SEC standards are "insufficient", the FRB may start a process that ultimately can lead to the FSOC requiring the CFTC or SEC to adopt specified standards. 12 U.S.C. § 5464(a)(2)(B). As a practical matter, it seems more likely the agencies would coordinate in advance to avoid invoking the backstop process.

¹⁶ 12 U.S.C. § 5464(c).

¹⁷ See 12 U.S.C. § 5474(a)(1).

¹⁸ 12 U.S.C. § 5464(e).

¹⁹ 12 U.S.C. § 5462(1); 12 U.S.C. § 5467(a).

²⁰ *Id.*

²¹ 12 U.S.C. § 5467(b).

²² 12 U.S.C. § 5467(e).