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Legal Sidebar

Stablecoins: Legal Issues and Regulatory Options (Part 1)

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In 2008, the pseudonymous Satoshi Nakamoto released a white paper describing a peer-to-peer system of electronic cash. The product of that paper—Bitcoin—now boasts a market capitalization of roughly $600 billion. Other cryptocurrencies amount to more than $700 billion, bringing the overall crypto ecosystem in line with the GDPs of many large countries.

Despite this meteoric rise, cryptocurrencies have yet to exhibit a defining feature of cash: widespread use as a medium of exchange. One reason for that failure is volatility. Most cryptocurrencies have exhibited wild fluctuations that may make them unattractive instruments for day-to-day purchases of goods and services.

Enter stablecoins—cryptocurrencies whose value is pegged to a reference asset like the U.S. dollar. While stablecoin issuers attempt to maintain these pegs in different ways, most of the regulatory attention has focused on coins that are putatively backed with reserves of assets denominated in fiat currency. Often, those assets underwrite an issuer's commitment to redeem its stablecoins for a fixed value upon demand.

That structure raises familiar risks. Like banks and money market mutual funds (MMFs)—the principal sources of private money—stablecoin issuers are vulnerable to runs if their customers lose faith in the adequacy of the assets backing their demandable liabilities. Unlike banks and MMFs, however, most stablecoin issuers are not subject to federal regulations and protections designed to instill faith in those liabilities, such as deposit insurance and portfolio restrictions.

Policymakers have taken notice. In November 2021, the President's Working Group on Financial Markets recommended that Congress enact legislation limiting stablecoin issuance to insured depository institutions. Other commentators have advocated different regulatory strategies, ranging from a bespoke federal licensing regime to an outright ban on stablecoin issuance.

This Legal Sidebar—the first part of a two-part series—provides an overview of the existing regulatory framework governing stablecoins. The second part discusses proposals for legislative reform of that framework. Both parts focus on stablecoins that are ostensibly backed one-to-one with reserves of fiat-denominated assets. For a discussion of algorithmic stablecoins, which instead aim to maintain their pegs using algorithmically determined supply adjustments or arbitrage mechanisms involving other

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cryptocurrencies, see CRS Insight IN11928, *Algorithmic Stablecoins and the TerraUSD Crash*, by Paul Tierno, Andrew P. Scott, and Eva Su.

Background

Banks and MMFs: The Incumbent Money Issuers

Money is a fluid concept. Today, it plainly encompasses physical currency like the notes and coins produced by the Treasury Department. The bulk of the money supply, however, consists of liabilities issued by private entities. While the precise boundaries of money issuance are contested, the biggest private players are banks and MMFs.

Both types of institution share a similar structure. Banks primarily fund themselves with short-term deposits while investing in longer-term, less liquid loans. Likewise, prime MMFs issue short-term liabilities to shareholders while investing in less liquid debt instruments with slightly longer maturities.

This process of "maturity transformation" can create social value, but also makes banks and MMFs vulnerable to runs. If depositors or investors lose confidence in the value of the assets backing an institution's demandable liabilities, they may rush to redeem their funds. The firm must then sell assets to meet those redemptions, potentially at steep discounts. The resulting losses may drive a bank into insolvency or cause MMFs that promise to redeem their shares at a fixed price to default on that commitment. In both cases, runs on individual institutions can trigger knock-on effects as creditors begin to question the safety of other firms with similar asset portfolios.

This vulnerability raises the question: why are bank deposits and MMF shares regarded as safe assets that function as "good money"? Part of the answer is regulation. Banks are subject to a comprehensive legal regime that includes capital and liquidity requirements, deposit insurance, access to emergency loans, and special resolution procedures. MMFs face fewer regulatory requirements but are likewise subject to portfolio restrictions and liquidity rules. These regulations help bolster the credibility of the monetary liabilities issued by banks and MMFs and limit the destabilizing effects of runs on both classes of institution.

Stablecoin Providers: Aspiring Money Issuers?

Stablecoin issuers resemble banks and MMFs in important ways. Issuers "mint" stablecoins in exchange for fiat currency from investors. Investors can then hold the stablecoins, trade them on the open market, or (in many cases) redeem the stablecoins for fiat currency from the issuer. While the details of specific redemption options differ from coin to coin, many issuers promise or suggest that investors can redeem their stablecoins at par on demand. To instill faith in their ability to meet redemptions, many providers advertise that their stablecoins are backed one-to-one with reserves of fiat-denominated assets.

Like banks and some MMFs, then, many stablecoin issuers promise to return customer funds at a fixed value on demand, while investing those funds in a range of financial assets. Unlike banks and MMFs, however, most stablecoin issuers are not subject to federal regulations governing the composition of those reserve assets. Similarly, federal law does not require stablecoin providers to disclose details concerning their reserves.

The quality of the relevant portfolios varies widely—as does the level of detail that issuers offer their investors. Some stablecoin providers claim to invest primarily or exclusively in U.S. Treasury securities and accounts at insured depository institutions. Others offer less clarity on the composition of their reserves and reportedly invest in riskier instruments like commercial paper, corporate bonds, intra-group debt, and digital assets.

While this opacity raises investor-protection concerns, the extent to which stablecoins pose broader risks to financial stability is disputed. As of yet, stablecoins are not widely used to purchase goods and services. Instead, they are mainly employed to facilitate the trading, lending, and borrowing of other digital assets.

Based on these relatively narrow use cases, some have argued that stablecoins do not currently pose risks to the financial system, even if they may raise dangers within the crypto economy. In this view, stablecoins are tantamount to "the lobby of the casino that is crypto speculation." Some observers have suggested that this "casino" is well-contained and that the metaphorical "gamblers" understand the relevant risks, making it unlikely that the failure of a stablecoin issuer would have significant spillover effects for traditional financial institutions or the real economy.

Others disagree. Stablecoin skeptics have focused on the rapid growth of these novel instruments over the past two years. (In April 2020, the market capitalization of all stablecoins amounted to roughly $8.3 billion; by April 2022, that figure topped $180 billion—an increase of over 2,000 percent.) Some stablecoin providers have also become major players in certain asset classes. For example, in June 2021, the *Financial Times* reported that Tether—the issuer of the largest stablecoin—had amassed the seventh-largest portfolio of commercial paper in the world.

This dramatic expansion raises the prospect that stablecoin providers may ultimately become key participants in short-term funding markets, in which case a large issuer's failure could have systemic consequences. Several providers also have ambitions for their coins to be widely used for retail purchases, supply-chain payments, and international remittances—tasks that would further entangle stablecoins with the broader financial system.

Current Law

The regulations governing a stablecoin issuer depend in part on the issuer's legal form. Some stablecoin providers are chartered as trust companies under state or federal law. Unlike full-service banks, these issuers are typically not required to obtain deposit insurance. Capital requirements for such providers vary among different chartering authorities.

Other stablecoin issuers are regulated as "money services businesses" (MSBs). State MSB regulations include certain prudential rules to minimize the risk of an MSB's failure and protect customers in the event of bankruptcy. Namely, most states require MSBs to abide by net-worth requirements, security requirements, and restrictions on permissible investments.

These regulations are significantly more permissive than the legal regimes governing banks and MMFs. MSB net-worth requirements vary markedly among different states and are typically far more accommodating than bank capital rules. For example, while South Dakota requires MSBs to maintain a net worth of at least $100,000, federally insured banks are subject to a minimum capital requirement of eight percent of their risk-weighted assets.

Security requirements for MSBs—including surety-bond, letter-of-credit, collateral-deposit, and insurance requirements—likewise differ between jurisdictions and can be quite low relative to the value of a firm's liabilities. For example, Maine requires MSBs to obtain a surety bond, letter of credit, or similar security device in an amount of at least $100,000. In contrast, the Federal Deposit Insurance Corporation insures bank deposits up to $250,000 *for each depositor*.

MSB investment restrictions range from rules that approximate MMF regulation to more lenient requirements that permit investments in public equities, subject to certain concentration limits. Twelve states impose no restrictions on an MSB's investments.

Stablecoin issuers are also subject to certain federal regulations. Federal law requires money-transmitting businesses to register with the Treasury Department and comply with anti-money laundering requirements in the Bank Secrecy Act. The Commodity Futures Trading Commission also has authority to police fraud and manipulation in the cash markets for stablecoins, which the agency deployed in 2021 when it settled allegations that Tether had misrepresented the nature of the assets backing its stablecoin.

Other aspects of the federal regulatory framework governing stablecoins remain unsettled. In particular, commentators have explored whether stablecoins might also fall within the purview of federal securities law or banking law. The following subsections discuss each in turn.

Securities Law

The Securities and Exchange Commission (SEC) has not, to date, taken action to regulate stablecoin issuers. SEC Chairman Gary Gensler has said, however, that some stablecoins may qualify as "securities" under federal law—a designation that would subject issuers to registration and reporting requirements. Chairman Gensler has not elaborated on the details of this assessment, but stablecoins would qualify as securities under existing law if they represent "investment contracts." In addition, stablecoins *may* qualify as securities if they represent "notes." Each category has its own legal test.

Howey and *Reves*

To determine whether an instrument is an *investment contract*, courts employ the four-part *Howey* test, which provides that an agreement falls within that category if it involves:

1. an investment of money;
2. in a common enterprise;
3. with an expectation of profit;
4. derived from the efforts of others.

By contrast, the *Reves* test dictates whether a *note*—a promise to pay a specified sum—is a security. Under *Reves*, all notes are presumptively securities. However, that presumption is rebuttable in two ways. First, the seller of a note can establish that a note bears a "family resemblance" to one of the constituents of a judicially created list of notes that are not securities. In determining whether a note bears a family resemblance to a category on that list, courts evaluate:

1. **The motivations of the buyer and seller**. If the seller offers the note to finance a business and the buyer is motivated primarily by an expectation of profit, the note is likely to be a security. By contrast, if the note is exchanged to facilitate the purchase and sale of a consumer good, the note is less likely to be a security.
2. **The plan of distribution**. If a note is commonly traded for speculation or investment, it is more likely to be a security. If it is not frequently traded, it is less likely to be a security.
3. **The reasonable expectations of the investing public**. If the public reasonably believes that a note is a security, courts may deem the note a security even when the economic circumstances might suggest otherwise.
4. **Risk-reducing factors**. If some other factor—like an alternative regulatory scheme, collateral, or insurance—reduces the risk of a note in such a way as to make the application of the securities laws unnecessary, the note is less likely to be a security.

Second, if a note is not sufficiently similar to an item on the relevant list, a court must decide whether to add another category to the list by examining the four factors discussed above. (Some lower courts treat

Reves as involving this two-step process, while others have collapsed the two steps into a single inquiry analyzing the four factors.)

Applying the Doctrine

Both the *Howey* and *Reves* tests are fact-intensive. As a result, the details surrounding specific stablecoin offerings may prove decisive under either inquiry. There is also some ambiguity as to when the tests apply. The Supreme Court has applied the *Howey* test to evaluate agreements that appear to be notes, leading some commentators to wonder whether the standards are mutually exclusive. Accordingly, it is uncertain whether a court would determine that a given stablecoin is (1) a note governed only by the *Reves* test, (2) a note governed by both the *Reves* and *Howey* tests, or (3) another type of instrument governed only by the *Howey* test.

Other difficulties lurk behind that threshold question. *Howey* and *Reves* both evaluate whether the buyer of an instrument is motivated primarily by an expectation of profits. (Under *Howey*, such expectations are necessary for an instrument to qualify as an investment contract. By contrast, *Reves* makes profit expectations one element of a multi-part balancing test.)

This factor arguably cuts against the notion that stablecoins are securities. Stablecoins ordinarily do not pay interest. They are also designed with the explicit goal of maintaining a stable value, making it unlikely that the prospect of capital appreciation is a key factor motivating most stablecoin purchases. The SEC has issued guidance to similar effect. The agency's 2019 *Framework for "Investment Contract" Analysis of Digital Assets* explains that a cryptocurrency is less likely to be a security under *Howey* if its design "provides that its value will remain constant."

Even so, some commentators have proposed theories to support the proposition that stablecoin purchasers may be motivated by profits for purposes of the *Howey* and *Reves* tests. In brief, the arguments appeal to the role that stablecoins play in facilitating cryptocurrency speculation and the fact that some stablecoins have traded above par during crypto-market turmoil. This issue remains unsettled.

Another wrinkle involves *Reves*' emphasis on risk-reducing factors—in particular, the relevance of an alternative regulatory scheme that would render the securities laws unnecessary. The classic example is banking regulation: the Supreme Court has held that bank-issued certificates of deposit are not securities based in part on the comprehensiveness of federal banking law. The Court has also concluded that interests in federally regulated pension plans do not qualify as securities based on the separate protections afforded by the Employee Retirement Income Security Act.

This element of the *Reves* test suggests that a given stablecoin's status under the securities laws may hinge in part on its current regulatory treatment. The exact contours of this inquiry are not entirely clear, however. Lower courts have not elaborated on the precise level of protection that a regulatory scheme must offer to render the securities laws unnecessary.

Applying this *Reves* factor to stablecoins is thus difficult. As discussed, state laws governing trust companies and MSBs offer stablecoin investors *some* protection against reckless or unscrupulous operators. However, that protection is typically less robust than the assurances offered by federal banking law. Accordingly, if the SEC pursues stablecoin issuers under *Reves*, the sufficiency of extant state regulation may be a key disputed issue.

Banking Law

Stablecoins may also implicate federal banking law. Section 21(a)(2) of the Glass-Steagall Act makes it unlawful for any entity to engage in the business of receiving "deposits" subject to repayment upon request, unless the entity falls within one of three categories.

- ***First***, an institution can accept "deposits" if it is "*authorized*" to do so by federal or state law and is subject to examination and regulation.
- ***Second***, an institution can accept "deposits" if it is "*permitted*" to do so by federal or state law and is subject to examination and regulation.
- ***Third***, an institution can accept "deposits" if it submits to periodic examination by a state banking authority and publishes the same types of periodic reports that the relevant state laws require of banks.

Section 21(a)(2)'s legislative history indicates that it was intended to prohibit "unregulated private banking so far as practicable." The limited case law applying the provision suggests that an entity accepts "deposits" when it takes custody of a client's money subject to repayment upon demand. Persons who accept deposits but do not fall within the exempted categories are subject to criminal sanctions, including fines and imprisonment of up to five years.

Stablecoin issuers arguably accept Glass-Steagall "deposits" insofar as they promise to redeem their coins at par upon request. A November 2021 report from the President's Working Group on Financial Markets gestures toward this possibility, noting that the Department of Justice (DOJ) "may consider whether or how section 21(a)(2) of the Glass-Steagall Act may apply to certain stablecoin arrangements."

The DOJ has confronted related issues in the past. In 1979, the head of the Department's Criminal Division concluded that MMFs do *not* accept "deposits" within the meaning of the Glass-Steagall Act because MMF investors are owners rather than creditors of their funds.

The same may not be true of some stablecoin holders, however. The DOJ based its analysis of MMFs on the premise that MMF investors are exposed to fluctuations in a fund's value. While similar reasoning might apply to stablecoins that are formally structured as pro rata interests in a pool of reserve assets, an issuer's promises or suggestions that investors can redeem their coins at par may result in a different conclusion. In the latter fact patterns, stablecoin investors are arguably more akin to creditors than owners, which could bring a stablecoin issuer within Glass-Steagall's remit.

If a stablecoin issuer indeed accepts Glass-Steagall "deposits," it would need to fall within one of the three exemptions outlined above to avoid running afoul of the statute's prohibition. Whether particular stablecoin providers qualify for those exemptions would turn on the nature of their existing regulatory supervision. Some observers have encouraged federal authorities to clarify the scope of Glass-Steagall's exemptions to provide the industry with greater legal certainty.

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