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Legal Sidebar

Stablecoins: Legal Issues and Regulatory Options (Part 2)

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As discussed in the first part of this two-part Legal Sidebar series, stablecoins are 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), 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.

In November 2021, the President's Working Group on Financial Markets (PWG) 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 second in a two-part series—explores regulatory options for stablecoins. The first part of the Sidebar series provides an overview of the existing legal framework governing stablecoins.

Options for Congress and Regulators

Commentators have proposed a broad range of measures that Congress and federal regulators could take to address the possible risks and benefits of stablecoins.

Bank Regulation

As noted, the PWG has recommended that Congress adopt legislation limiting stablecoin issuance to insured depository institutions. Several lawmakers in the 116th Congress sponsored legislation that would

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have imposed that requirement. H.R. 8827, the Stablecoin Classification and Regulation Act, would have prohibited the issuance of stablecoins by entities other than insured depository institutions that are members of the Federal Reserve System.

Advocates of such measures argue that bank regulation is needed to minimize the risk of runs on stablecoin issuers. Bank regulation would also respond to worries about Big Tech firms and other large companies extending their power into the financial industry via stablecoin issuance. The Bank Holding Company Act (BHCA) generally prohibits companies that own banks from also owning commercial enterprises. Bank regulation may thus help check potentially troublesome concentrations of economic power by bringing stablecoin issuers under the BHCA umbrella.

For their part, critics of the bank-regulation strategy maintain that such regulations would be both unnecessary and unworkable for stablecoin providers. In particular, some commentators have suggested that narrower regulations targeting the composition of stablecoin reserves would be sufficient to obviate run risk. Observers have also argued that existing leverage ratios for banks would make it infeasible for stablecoin issuers to limit their investments to safe reserve assets, which could call into question the viability of their business models. (A stablecoin provider that limited its reserves to cash and cash equivalents without engaging in more profitable lending activities may have difficulty attracting the equity capital needed to comply with bank leverage rules, which treat safe assets as if they have the same risk profile as consumer and business debt.)

Regulation of Stablecoin Reserves

As the above discussion suggests, some lawmakers have proposed prudential regulations and disclosure requirements involving the composition of stablecoin reserves. For example, the Stablecoin Transparency Act (S. 3970 and H.R. 7328) would require covered stablecoin issuers to hold their reserves in short-term U.S. Treasury securities, fully collateralized repurchase agreements, or fiat currency. The bill would also require covered issuers to publish audited reports detailing their reserves every thirty days.

Federal Licensing Regime

While the Stablecoin Transparency Act would impose standalone reserve requirements on stablecoin issuers, other proposals would couple such requirements with a federal licensing regime. Senator Pat Toomey has released a discussion draft to that effect titled the Stablecoin Transparency of Reserves and Uniform Safe Transactions (Stablecoin TRUST) Act. Among other things, the draft proposes:

- Authorizing the Office of the Comptroller of the Currency (OCC) to license firms as "national limited payment stablecoin issuers" (NLPSIs);
- Prohibiting the issuance of stablecoins by any entity other than a NLPSI, state-regulated money-transmitting business, or insured depository institution;
- Requiring all stablecoin issuers to make certain disclosures concerning their reserves and redemption policies, and to undergo quarterly attestations by a registered public accounting firm;
- Authorizing the OCC to adopt capital, liquidity, and governance requirements for NLPSIs;
- Requiring NLPSIs to hold cash, cash equivalents, or level 1 high-quality liquid assets with a market value equal to or greater than the par value of their outstanding stablecoins; and
- Clarifying that covered stablecoins are not securities under federal law.

To address concerns about the compatibility of stablecoin issuance with bank leverage ratios, the draft proposes allowing insured depository institutions to issue stablecoins via separate legal entities that would be subject to the same tailored regulatory standards as NLPSIs.

Representative Josh Gottheimer has also released a discussion draft proposing that stablecoin issuers be allowed to opt into a federal supervisory framework. The draft—titled the Stablecoin Innovation and Protection Act—would allow banks and non-banks to issue "qualified stablecoins," which would fall outside the scope of the securities and commodities laws. Under the draft, non-banks could elect to become "nonbank qualified stablecoin issuers" (NQSIs) subject to OCC supervision. NQSIs would be required to back their stablecoins with U.S. dollars, securities issued by the federal government, or other assets that the OCC determines appropriate. The bill would also empower the OCC to adopt various prudential rules for NQSIs and direct the Federal Deposit Insurance Corporation to establish an insurance fund for such issuers.

The Responsible Financial Innovation Act—a draft version of which Senators Cynthia Lummis and Kirsten Gillibrand released in June 2022—would combine restrictions on stablecoin reserves with an option for stablecoin issuers to submit to federal oversight. Section 601 of the bill would require both bank and non-bank stablecoin issuers to maintain specified types of liquid assets equal to at least one hundred percent of the face value of their stablecoin liabilities. The legislation would also empower the OCC to charter national bank associations for the exclusive purpose of issuing stablecoins and allow the agency to adopt tailored capital requirements for such entities.

Other stablecoin-licensing legislation is drafted in more general terms. Section 311 of H.R. 4741, the Digital Asset Market Structure and Investor Protection Act, would task the Treasury Department with administering a federal licensing regime for stablecoin issuers. The bill would prohibit the issuance of stablecoins by unapproved entities and allow the Treasury Department to grant applications for approval "under such terms and conditions as the [Treasury] Secretary determines necessary and appropriate."

SEC Oversight

Others have suggested that Congress pass legislation giving the SEC a lead role in stablecoin regulation. (For an overview of the ambiguities surrounding the SEC's current legal authority over stablecoins, see the first part of this Sidebar series.) One commentator has proposed amendments to the Investment Company Act of 1940 that would require stablecoin providers to be regulated as "limited purpose investment companies." Those draft amendments include restrictions on the reserve portfolios of such entities.

Some lawmakers have also proposed legislation to clarify the SEC's legal authority over stablecoins. In the 116th Congress, H.R. 5197, the Managed Stablecoins are Securities Act, would have provided that stablecoins qualify as securities under federal law.

FSOC Designation

Finally, regulators may have existing tools to address stablecoins outside of the securities and banking laws. Under the Dodd-Frank Act, the Financial Stability Oversight Council (FSOC)—an interagency group of regulators—can designate certain conduct as a "systemically important" payment, clearing, or settlement activity. That designation allows financial regulators to establish risk-management standards for institutions that engage in the relevant activity.

FSOC also has the authority to designate financial market utilities and nonbank financial companies as "systemically important" and subject designated institutions to heightened regulatory standards.

The PWG's November 2021 report recommends that FSOC consider using these authorities to designate stablecoin activities and issuers if Congress does not enact stablecoin legislation.

Author Information

Jay B. Sykes
Legislative Attorney

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