CFA Institute®
Systemic Risk Council

The Honorable Janet L. Yellen
U.S. Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

February 17, 2022

Re: Risks to Financial Stability Posed by Unregulated Stablecoins

Dear Chair Yellen and Members of the Financial Stability Oversight Council:

We write to urge the Financial Stability Oversight Council (FSOC) to address the risks to U.S. financial stability posed by unregulated and underregulated stablecoins.[1] The President's Working Group on Financial Markets, along with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), recently released a report recommending that Congress address these risks by passing new legislation that would impose needed regulations on stablecoin issuers and the stablecoin market.[2] We agree with this report that a legislative response would help mitigate threats posed by unregulated stablecoins. We also believe that such legislation could help address risks posed by other underregulated monetary instruments.[3]

But there is a significant chance that Congress will not act in time. The supply of unregulated stablecoins is growing fast. Total dollar denominated stablecoins are up 500% over the past year and now exceed $140 billion.[4] Today, the balance sheet of the largest unregulated stablecoin issuer—Tether Limited—is larger than the Reserve Primary Fund was when it broke

[1] Stablecoins, or stable value coins, are digital ledger entries designed to maintain a stable value in terms of an official currency like the U.S. dollar. Many stablecoins are used as a means of payment. Although based on novel technology, and often operated by new business entities, stablecoins are one of many types of private money claims currently in circulation.

[2] PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, THE FEDERAL DEPOSIT INSURANCE CORPORATION & THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS (2021).

[3] Stablecoins are a type of "nondeposit deposit" similar to repurchase agreements, eurodollars, money market mutual funds, financial and asset-backed commercial paper, and liabilities maintained by state-chartered money services businesses. *See* Jonathan R. Macey & Geoffrey P. Miller, *Nondeposit Deposits and the Future of Bank Regulation*, 91 MICH. L. REV. 237 (1992). For a discussion of the risks posed by certain money services businesses and how Congress might address them, see Dan Awrey, *Bad Money,* 106 CORNELL L. REV. 1 (2020); James J. McAndrews & Lev Menand, *Shadow Digital Money* (2020).

[4] *Total Stablecoin Supply*, THE BLOCK (November 27, 2021), www.theblockcrypto.com/data/decentralized-finance/stablecoins/total-stablecoin-supply-daily.

the buck in 2008.[5] Given the uncertainties and delays involved in the legislative process, policymakers should simultaneously pursue the other routes.

Fortunately, Congress has provided the FSOC, its member agencies, and other government bodies with a set of tools that—while somewhat cumbersome to employ—can help prevent unregulated stablecoins from threatening the stability of the U.S. financial system.[6] We propose that the FSOC coordinate the use of these tools by creating a working committee on stablecoins[7] and attempting to bring stablecoins within the regulatory perimeter.

We recommend a two-pronged strategy. First, the FSOC should designate all stablecoins as systemically important payment, clearing, and settlement activities. Second, the FSOC should work with its member agencies, including the banking regulators, the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC) and the Consumer Financial Protection Bureau (CFPB), to use their authorities to regulate stablecoins. Regulators' overarching goal should be to limit or eliminate the use of fractional reserve stablecoins—ledger entries that are not backed one-for-one with insured bank deposits or short-term U.S. government debt—and thereby reduce the risk of runs, contagion, and further expansion of the shadow banking sector.

The FSOC should also open an international dialogue with foreign monetary and stability authorities regarding stablecoins. Many stablecoin operators are located overseas, including the largest, Tether Limited. Stablecoins can also be used to facilitate value transfers internationally, which raises policy issues for global payments system design. FSOC and its member agencies ought to work to harmonize standards for all stablecoin issuers worldwide and ensure that efforts by U.S. regulators to address risks posed by stablecoins domestically do not lead destabilizing activities to move offshore.

I. Title VIII Designation

In response to the 2008 financial crisis, Congress mandated, in Title VIII of the Dodd-Frank Act, that the FSOC "designate those financial market utilities or payment, clearing, or settlement activities that [it] determines are, or are likely to become, systemically important."[8] Accordingly, we believe that the FSOC should designate stablecoins, including those that are fully

[5] Like the Reserve Primary Fund, a money market mutual fund, Tether Limited maintains a pool of short-term credit assets that fluctuate in value. Unlike the Reserve Primary Fund, and other money market funds, Tether Limited does not issue equity shares in this pool of assets. It issues a type of general unsecured claim it calls a stablecoin. As of January 31, Tether had issued over $78 billion in stablecoins and purports to have a pool of assets of equal value. When the net asset value of the Reserve Primary Fund fell below $1 on September 16, 2008, it held assets of $62.4 billion. FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT 356 (2011).

[6] In fact, in our view, current law *requires* that the FSOC marshal these tools and carry out the goals of the existing statutory regime.

[7] FSOC may establish special committees "as may be useful in carrying out the functions of the Council." 12 U.S.C. § 5321(d).

[8] *Id.* at § 5463(a)(1).

reserved, as likely to become systemically important payment, clearing, and settlement activities, subjecting involved parties (including issuers and wallet providers) to enhanced regulatory oversight. This would permit the Federal Reserve to promulgate risk management standards governing capital, liquidity, policies and procedures, and clearing and settlement.[9]

Stablecoins today are already complex payment, clearing, and settlement activities within the meaning of the law, and their rapid growth over the past year supports a determination that they are "likely to become" systemically important.[10] Regulation to ensure operational integrity is essential.[11] New rules are also needed to require stablecoin issuers to fully reserve against their liabilities. Fractional reserve stablecoins pose run risk that could trigger future panics and the possibility of a self-reinforcing cycle of runs and fire sales that spread to other issuers and asset classes. For example, a run on a stablecoin that holds substantial amounts of commercial paper[12] could prompt a self-reinforcing cycle of runs and fire sales that spreads to other issuers and asset classes.[13] Such panics have driven most acute macroeconomic disasters in American history. By tightening credit and shrinking the money supply, they trigger sharp declines in economic activity, layoffs, and bankruptcies.[14] The FSOC must not wait until a run on fractionally reserved stablecoin issuers triggers a repeat of the 2007-08 panic.[15]

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[9] *Id.* at § 5464.

[10] *Id.* at § 5463(a)(1).

[11] Please see, e.g., Neha Narula, The Technology Underlying Stablecoins (September 23, 2021), https://nehanarula.org/2021/09/23/stablecoins.html (describing operational risks stemming from stablecoin technology).

[12] Commercial paper is a type of debt instrument with a short maturity.

[13] We saw something like this in 2008 with money market mutual funds—investment companies that also issue instruments that are redeemable daily, designed to maintain a net asset value of $1, and invest in risky assets like commercial paper. FINANCIAL CRISIS INQUIRY COMMISSION, FINAL REPORT 356–60 (2011). FSOC has a further designation authority (under Title I of the Dodd-Frank Act) that would permit it to "require supervision by the [Board] for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or because of their activities." *Id.* at § 5332(a)(2). FSOC should also use this authority to address stablecoin issuers as appropriate.

[14] For an overview, see MORGAN RICKS, THE MONEY PROBLEM: RETHINKING FINANCIAL REGULATION 102–42 (2016). *See also* Hugh Rockoff, *It Is Always the Shadow Banks: The Regulatory Status of the Banks that Failed and Ignited America's Greatest Financial Panics*, *in* COPING WITH FINANCIAL CRISES (Rockoff & Suto, eds. 2018).

[15] We do not believe that the law imposes a cost-benefit requirement on the FSOC. However, even if it did, *see* MetLife Inc. v. Financial Stability Oversight Council, 177 F.Supp.3d 219 (2016), the benefits to avoiding monetary system breakdowns, which are driven by fractional reserve arrangements like those maintained by some stablecoin issuers, far exceed any costs entailed by designation, *see, e.g.*, Tyler Atkinson et al., *How Bad Was It? The Costs and Consequences of the 2007-09 Financial Crisis*, 20 FED. RES. BANK OF DALLAS STAFF PAPERS 1, 2 (2013) (estimating the cost at $6 to $14 trillion); Andrew Haldane, *The $100 Billion Question*, Remarks at the Institute of Regulation and Risk Conference, Hong Kong (Mar. 30, 2010) (suggesting that the present value of the 2008 crisis may have been between $60 trillion and $200 trillion for the global economy as a whole, with 1-5 times annual GDP lost in the US alone); Ben S. Bernanke, *The Real Effects of the Financial Crisis*, Brookings Papers on Economic Activity

As the regulators' recent report recognizes, Title VIII designation is, in certain respects a second-best solution. Ideally, entry into fractional reserve stablecoins would require a bank charter, and unchartered issuers could be sued by one of the banking agencies in the same way that the SEC routinely prevents evasion of the securities laws by pursuing arrangements that are functionally equivalent to securities.

In 1933, Congress passed landmark legislation designed to do this. The relevant provision, Section 21(a) of the Banking Act, prohibits unauthorized persons from engaging in the business of receiving deposits subject to repayment "upon request of the depositor."[16] Section 21(a) requires that, at the very least, companies engaged in such a business be examined and regulated by a state banking authority. It thus establishes a regulatory perimeter for money and banking. But while other regulatory regimes, like those for securities, empower a single agency to enforce the law, in money and banking there is no one organization with this responsibility. Instead, there are over fifty banking agencies in the states and territories, the FDIC, the OCC, and the Board, not to mention the National Credit Union Administration and the Federal Housing Finance Agency (formerly the Federal Home Loan Bank Board).

Accordingly, in 1933, Congress assigned responsibility for policing the regulatory perimeter for money and banking to the U.S. Department of Justice (DOJ). The problem with this choice is that the DOJ lacks the expertise and incentives to effectively carry out this duty on its own. To our knowledge, the DOJ has never wielded Section 21(a) to prevent financial firms from issuing functional equivalents to deposits.[17] In the one instance where the DOJ considered a functional deposit equivalent, money market mutual funds, it engaged in a formalistic analysis,[18] contrary to the approach taken by leading banking specialists.[19] Moreover, the statute does not explicitly permit civil enforcement actions, including civil remedies and equitable relief, greatly reducing its potential usefulness. Going forward, to avoid further erosion of the banking laws, Congress should revisit the design of federal entry restriction into banking activities.

(Sept. 13-14, 2018) (finding that the unusual severity of the Great Recession was due primarily to the panic in funding markets, which disrupted the supply of credit).

16 Congress exempted from this restriction a variety of incorporated and unincorporated banks and state regulated businesses. 12 U.S.C. § 378 (these include company banks, state and federally chartered banks, and state authorized businesses that are subject to examination and regulation in the same manner as banks).

17 The DOJ has limited its enforcement of Section 21(a) to cases involving other criminal wrongdoing. *See, e.g.*, United States v. Jenkins, 943 F.2d 167 (2d Cir. 1991) (money laundering prosecution).

18 *See* Letter from Assistant Attorney General Philip Heymann, Criminal Division, to Martin Lybecker, Associated Director, SEC Division of Marketing Management (Dec. 18, 1979).

19 *See, e.g.*, Testimony of Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, Federal Reserve Membership, Hearings Before the Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess., at 24-26 (Sept. 26, 1979) (raising concerns about allowing financial firms to create functional deposits like MMFs). *See also* John A. Adams, *Money Market Mutual Funds: Has Glass-Steagall Been Cracked?*, 99 BANKING L.J. 4 (1982).

II. Using Agency Authorities

Congress also empowered the FSOC to recommend that other regulatory agencies apply new or heightened standards and safeguards for financial activities that, due to their nature, size, and scale, could create or increase the risk of significant liquidity, credit, or other problems in the financial system.[20] The FSOC should use this power to work with relevant agencies, including its members, to use their authorities to contain risks to investors and consumers posed by stablecoins and their issuers. Among the agencies with significant ability to act are the Fed, SEC, the CFTC, and the CFPB.[21] Where appropriate, these agencies have the power to regulate stablecoins as securities, commodities, derivatives, and financial products.

Most importantly, the SEC has the authority to impose investor protection and related regulatory requirements on any stablecoins that offer investor returns.[22] The SEC also has the authority to regulate stablecoin issuers that qualify as investment companies under the Investment Company Act of 1940.[23] The CFTC has, among other relevant authorities, the authority to address fraud involving stablecoin transactions in so far as stablecoins qualify as commodities under the Commodity Exchange Act.[24] And the CFPB is responsible for enforcing consumer protection laws in connection with transactions for consumer financial products or services, including the prohibition against unfair, deceptive, or abusive acts or practices.[25]

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[20] 12 U.S.C. § 5330(a).

[21] In addition, to the extent that the OCC, FDIC, or state banking authorities are reviewing applications by stablecoin issuers for bank charters (or deposit insurance), the FSOC should also work with these agencies to ensure that the relevant enterprises are fully reserved with respect to their stablecoin holdings.

[22] Stablecoins that offer interest or other returns to stablecoin holders are "securities" under Section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1), as well as Section 3(a)(10) of the Securities Exchange Act of 1934, *id.* at § 77c(a)(10). This is because such stablecoins are likely "notes" within the meaning of those sections (and notes are securities). *See* Reves v. Ernst & Young, 494 U.S. 56, 66–67 (1990). They are also likely "investment contracts" (and investment contracts are securities). *See* SEC v. Howey, 328 U.S. 293, 299 (1946) (holding that an investment contract includes any investment of money in a common enterprise with the expectation of profits solely from the efforts of others). The securities laws apply even if stablecoins are also deposits, provided they are not issued by insured depository institutions. *See Marine Bank v. Weaver*, 455 U.S. 551 (1982). Stablecoins that do not offer investor returns may not qualify as securities under existing law.

[23] This includes any company that is engaged primarily in the business of investing in securities or is engaged in the business of owning or holding securities and owns or proposes to acquire investment securities having a value exceeding 40 percent of the value of their total assets (exclusive of Government securities and cash items) on an unconsolidated basis. 15 U.S.C. § 80a-3(a)(1). The law excludes Government securities from the definition of securities. *Id.* at § 80a-3(a)(2).

[24] *See* 7 U.S.C. § 9(1) (making it unlawful for a person "directly or indirectly, to use or employ, or attempt to use or employ, in connection with . . . a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate . . ."); *see also* CFTC v. McDonnell, 287 F.Supp.3d 213 (E.D.N.Y. 2018) (concluding that virtual currencies are "commodities" within the meaning of 7 U.S.C. § 9(1)).

[25] *See* 12 U.S.C. § 5531.

III. Conclusion

Unregulated and underregulated stablecoins present a clear threat to U.S. financial stability. Even as policy makers seek revisions to the statutory scheme for money and banking to address this threat, the FSOC must act swiftly to use its existing authorities, and the authorities of its member agencies, to mitigate these threats as best as possible.

Respectfully submitted,

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on behalf of the Systemic Risk Council