

LEGAL UPDATES

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Stablecoin Market Could Gain from Self-Regulatory Efforts

In 2021 the market for and interest in stablecoins—digital assets designed to maintain a stable value relative to a national currency—has skyrocketed, increasing over 500% with a market cap of approximately \$130 billion. The volume of capital entering into stablecoins has caused the Biden administration to release a report on proposing to regulate those holding and issuing stablecoins similar to the manner in which banks are regulated. The report was the result of a collaboration between the President’s Working Group (PWG) on Financial Markets, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) and is intended to provide guidance for those seeking to utilize stablecoins as financial instruments.

This is a positive development for the cryptocurrency industry overall and one of the latest steps to bring cryptocurrency to mainstream financial institutions and the general public; it is clear that if stablecoin adoption continues at its current pace without consumer protection and market integrity rules, systemic risks and even dangers to end-use retail users will persist.

The report’s chief recommendation is for Congress to enact legislation ensuring that stablecoins are subject to a comprehensive federal regulatory scheme to prevent “runs” on stablecoins and manage “systemic risk” and proposes that existing financial regulators implement the report’s measures in the absence of congressional action.

Stablecoins are a key component of the rapidly emerging Decentralized Finance (DeFi) sector and primarily used to facilitate trading, lending, and borrowing of other digital assets, reducing the need for traditional fiat currencies and financial institutions with their ultimate goal to enable retail users to pay for goods and services. Theoretically, stablecoins must be able to be redeemed upon request for the denomination of currency (underlying

assets) it represents. Presently, there are no standards requiring that the reserve assets on hand by the issuer of stablecoins be held on a one-to-one basis. The danger here is that if there is a run by holders of stablecoins to redeem their stablecoins at the same time, the issuer of the stablecoins could become insolvent, harming the consumer and potentially the financial system. Stablecoin issuers claim that their stablecoin issuance is backed one-to-one by US dollars (or dollar equivalents) that are held at insured depository institutions or in treasury bills. Most stablecoin users hold the asset in institutions like BlockFi due to the returns that they receive on their holdings. For example, BlockFi pays holders of USDC 9% APY on their stablecoin holdings. Most savings accounts pay accountholders a mere 0.06%. In addition, depending on the blockchain underpinning the stablecoin, stablecoin users can transfer their stablecoin value without a third-party financial institution.

The innovation inherent in stablecoins and DeFi has placed regulators like the Securities and Exchange Commission and Commodities and Futures Trading Commission in the awkward position of trying to figure out how to protect consumers and the financial system using laws passed almost a century ago. Other than the market disruption caused by COVID-19, stablecoins haven't been in existence long enough to undergo severe liquidity strains and other stresses, such as the kind that forced the net asset value of some money market funds under \$1. There is concern that if this class of assets is unregulated, stablecoin issuers could hold reserve assets that could plummet in value causing illiquidity, fail to safeguard their reserve assets, or fall prey to bad cybersecurity actors and data breaches.

A prudent approach would be to regulate stablecoins to provide a clear framework for retail users and the broader financial market because they are a useful tool for those active in the 24/7 cryptocurrency market. While comprehensive legislation would be optimal to facilitate stablecoin safety and broader adoption, it is unlikely that Congress will adopt this sort of legislation in the near future. As such, in the interim, all parties may be best served with a collaborative approach between the governing bodies and issuers of stable coins to develop some industry-wide standards and best practices. A set of industry best practices will provide direction through industry guidance documents and rulemakings after consulting with established stablecoin issuers. Stablecoin issuers should then work with regulators and other stakeholders and self-certify to purchasers that they meet these industry-best practices, such as holding sufficient reserve assets. They should work with regulators to operate transparently despite the lack of congressional action for the good of the overall market and to protect retail holders of stablecoins.

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