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A Simple Proposal for Regulating Stablecoins

By Norbert J. Michel and Jennifer J. Schulp

A new report from the President's Working Group on Financial Markets explains the Biden administration's vision for federally regulating stablecoins, a type of digital currency whose value is pegged to "stable" reserve assets, such as the U.S. dollar.[1] The report calls for an expansive federal role and it appeals to Congress for new legislation that would prohibit anyone other than federally insured depository institutions from issuing stablecoins.[2] It also proposes that the Financial Stability Oversight Council (FSOC) review whether stablecoins pose a threat to financial stability.[3]

There is nothing inherently problematic about a federal regulatory framework for stablecoins, and a properly structured one would likely spur further innovation to the U.S. payments system, benefiting millions of people. However, the Biden administration is promoting a misguided approach that will discourage innovation and keep beneficial payments innovations—and the companies that create them—out of the United States. This briefing paper proposes a better regulatory framework for the most common types of stablecoins: straightforward rules based on preventing fraud and promoting transparency.

OVERVIEW OF STABLECOINS

Stablecoins are special cryptocurrencies designed to maintain a stable value rather than be subject to the volatile price movements seen with other digital currencies, such as Bitcoin and Ethereum. The general idea behind stablecoins is that their stable value will help promote their use as a widespread medium of exchange, but they have not yet achieved that status. The most common use for stablecoins is transferring money between crypto exchanges. Currently, the market capitalization of *all* stablecoins is $130 billion.[4]

Although the details can differ widely, all stablecoins aim to achieve price stability by tying their value to some other asset. Some of the most popular stablecoins tie their price to national fiat currencies, such as the U.S. dollar, but some anchor their price to precious metals, short-term corporate debt, or even other cryptocurrencies. Most stablecoins try to

NORBERT J. MICHEL is vice president and director of the Cato Institute's Center for Monetary and Financial Alternatives.
JENNIFER J. SCHULP is director of Financial Regulation Studies of the Cato Institute's Center for Monetary and Financial Alternatives.

achieve price stability by using cash and short-term securities as collateral, but others hold no assets in reserve.[5] The proposal in this briefing paper recommends a regulatory framework only for stablecoins that collateralize with cash and short-term securities.

One of the oldest stablecoins is Tether, which is fully backed by reserves that, according to its website, include "traditional currency and cash equivalents and, from time to time . . . other assets and receivables from loans made by Tether to third parties."[6] Tether is also the largest stablecoin, with a market value of $68 billion.[7] Another popular stablecoin is USD Coin (USDC), which has more than $32.5 billion in circulation and claims to be "fully backed by cash and equivalents and short-duration U.S. Treasuries, so that it is always redeemable 1:1 for U.S. dollars."[8] The biggest financial risk from stablecoins is whether the issuing entity has the reserves that it claims to have.[9]

THE BIDEN ADMINISTRATION'S PROPOSALS

Multiple countries increased their regulatory scrutiny of stablecoins when Facebook, with its network of several billion people, announced its Libra stablecoin project (it is now referred to as Diem). Several members of Congress, for instance, expressed concerns that digital currencies might undermine the dollar and potentially have an "unprecedented impact on the global financial system."[10] Naturally, these types of concerns ignore that monetary competition—even just the credible threat of such competition—can help expose weaknesses and inefficiencies in existing monetary systems.

Rather than acknowledge these possible benefits, the Biden administration's new report endorses several ideas that proponents of strict stablecoin regulations have been promoting for years. The report's main recommendation—that only federally insured depository institutions be allowed to issue stablecoins—is profoundly anti-competitive and in direct conflict with the administration's stated goal of guarding against an "excessive concentration of economic power."[11] Recommending that the FSOC review whether stablecoins threaten financial stability is both misguided and, at best, delays providing a clear regulatory framework.[12]

These and other ideas promoted by advocates for strict stablecoin regulations are ill-advised. Some proposals fail to provide the much-needed clarity that the cryptocurrency industry needs, and others are based on a fundamentally flawed concept of stablecoins. Some share both of these weaknesses.

For example, regulating stablecoins like bank accounts is not a good solution because unlike bank deposits, stablecoins serve a niche payment function for transferring funds between crypto exchanges without having to transfer back and forth into a national fiat currency. The stability of a stablecoin's value is tied to other assets, and stablecoin holders know that they can only convert into a national fiat currency by selling their coins. Moreover, there is no readily apparent justification for forcing federal taxpayers to back firms that issue stablecoins.

Some have suggested regulating stablecoins like money market mutual funds, but that solution is no better. Unlike money market mutual funds, stablecoins are not investments and are designed to maintain a stable value without offering the traditional principal-interest component of a capital market investment.

Former Commodity Futures Trading Commission (CFTC) chairman Timothy Massad has suggested that the FSOC require the Federal Reserve to regulate stablecoins as a systemically important payment activity.[13] But such an approach merely *assumes* that these coins pose systemic risks to financial stability—an assumption that is not warranted.[14]

Similarly, all the proposals that the administration has endorsed appear to be driven by the desire to prevent stablecoin use from growing and to isolate the banking industry from competition. The proposals go much farther than needed, thus threatening to inhibit beneficial innovations in the payments system.

SUPERIOR ALTERNATIVE PROPOSAL

The greatest risk for most stablecoin holders is whether the issuing entity has the reserves that it claims to have. A lack of transparency about the reserves that are used to stabilize the coin's value prevents a holder from evaluating the issuer's claims about stability and does little to protect holders from fraudulent misconduct.

A good regulatory framework addresses this issue by providing basic collateral requirements and requiring a baseline for transparency. While state laws generally provide

protection against deceptive or unfair practices (and the state of New York did sue Tether for deceptive trading practices), dealing with up to 50 separate state laws is cumbersome and costly for both issuers and holders.[15] Therefore, it makes sense to have a streamlined federal regulatory framework for stablecoin issuers.[16]

This briefing paper suggests creating such a proper federal framework by requiring a stablecoin issuer to be regulated as a newly created "limited purpose investment company." A limited purpose investment company would be subject to basic reserve requirements and mandatory disclosure of relevant information about reserve holdings. This framework would be designed to regulate the reserves that stablecoin issuers claim to hold and, therefore, the actions that issuers undertake to maintain a stable coin value.

Congress could create such a framework, for example, by amending the Investment Company Act,[17] which would give the Securities and Exchange Commission (SEC) unambiguous regulatory authority over most stablecoin issuers, that is, those that collateralize with cash and securities.[18] First, Congress would need to add a new § 80a-3(a)(2) (renumbering the current § 80a-3(a)(2) to § 80a-3(a)(3)) to the Investment Company Act, defining a limited purpose investment company as follows:

> A limited purpose investment company engages in the business of issuing digital tokens, with a value anchored, pegged, or otherwise tied to the price of national currencies, such as the United States dollar. The value of the digital token is maintained through assets, including national currencies and short-term investment-grade securities, held in reserve by the limited purpose investment company. Only the provisions of section 80a–65 of this subchapter, for the purposes of regulatory oversight over the establishment and maintenance of reserves, shall apply to such a limited purpose company.

Second, Congress would add the following language to create § 80a–65:

> A limited purpose investment company must adhere to the following requirements for assets held in reserve:
>
> 1. Average reserve portfolio maturity may not exceed 90 days;
> 2. Reserves may not consist of assets with maturities greater than one year;
> 3. Not less than 10 percent of the reserve assets must be held in cash or securities accessible in one day;
> 4. Not less than 20 percent of the reserve assets must be held in cash or securities accessible in seven days or less;
> 5. Reserve assets must consist of only investment grade securities; and
> 6. Not more than 5 percent of securities held as reserve assets may be from a single issuer.
>   a. A limited purpose investment company must disclose in a publicly accessible manner, such as a website, a detailed explanation of its reserve holdings no more than five business days after the end of each month. The detailed explanation must include the value of the holdings and the percentage of total assets for each reserve asset category as defined in (a)(2)–(4) and cash.
>   b. In accord with its advertised policies, a limited purpose investment company may suspend conversion of its digital tokens to cash for the purpose of maintaining the token's stable value, without notice and for any length of time.

CONCLUSION

The Biden administration has missed an opportunity to provide the much-needed clarity that the blockchain industry has been seeking for close to a decade. Its new report claims that stablecoins pose a wide variety of risks to users and broader markets, and argues that both the SEC and CFTC have broad enforcement, oversight, and rulemaking authorities that might address these risks. Yet, rather than provide concrete proposals that address actual risks, the administration calls on Congress to pass legislation that might mitigate a variety of potential risks. Perhaps worse, the report recommends legislation that would insulate traditional banks from competition and also force taxpayers to stand behind stablecoin issuers.

Just as in other areas of the economy, excessive government regulation prevents financial firms from best serving the needs of their customers and, therefore, society. Federal officials have no special knowledge regarding the best way to serve financial-market participants. Financial companies do not require rules and regulations that replace the judgment of owners, employees, and investors with those of government bureaucrats. The administration's new proposals for regulating stablecoins will stifle innovation and shift risk from financial market participants to taxpayers who are not otherwise exposed to stablecoin risk. This briefing paper offers a superior alternative, one that will foster innovation while adequately addressing the main risks that stablecoin users face. Unlike the administration's proposal, this plan is entirely compatible with a free-enterprise system based on limited government principles.

NOTES

1. "Report on Stablecoins," President's Working Group on Financial Markets, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency, November 2021, https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf. Also see Christopher Rugaber, "Treasury Report Calls For Stricter Oversight of Stablecoins," *Washington Post*, November 1, 2021, https://www.washingtonpost.com/business/treasury-report-calls-for-stricter-oversight-of-stablecoins/2021/11/01/64ec619c-3b46-11ec-bd6f-da376f47304e_story.html.

2. "Report on Stablecoins," p. 16.

3. "Report on Stablecoins," p. 18. Also see Norbert J. Michel, "Treasury's Misguided Focus on the Systemic Risk of Stablecoins," Cato Briefing Paper no. 127, October 19, 2021.

4. Michel, "Treasury's Misguided Focus on the Systemic Risk of Stablecoins."

5. Instead, these types of stablecoins use a computer algorithm to create or destroy coins based on a predetermined set of rules to maintain their value. Alyssa Hertig, "What Is a Stablecoin?," *Coindesk*, December 29, 2020, https://www.coindesk.com/markets/2020/12/29/what-is-a-stablecoin/.

6. In May 2021, as part of a settlement agreement with the New York attorney general's office, Tether released data showing that its reserves "were composed of 75.85% cash and equivalents, 12.55% secured loans, 9.96% in corporate bonds and precious metals and 1.64% in other investments, including digital currencies," with the cash and equivalents account consisting of "65.39% commercial paper, 24.2% fiduciary deposits, 3.87% cash, 3.6% reverse repo notes and 2.94% Treasury bills." See Nikhilesh De and Marc Hochstein, "Tether's First Reserve Breakdown Shows Token 49% Backed by Unspecified Commercial Paper," *CoinDesk*, May 13, 2021, https://www.coindesk.com/markets/2021/05/13/tethers-first-reserve-breakdown-shows-token-49-backed-by-unspecified-commercial-paper/.

7. The market value is as of October 1, 2021. Alana Benson, "Stablecoins: What They Are and How They Work," *Nerdwallet*, October 1, 2021, https://www.nerdwallet.com/article/investing/stablecoin.

8. "USDC: The World's Leading Digital Dollar Stablecoin," Circle, https://www.circle.com/en/usdc.

9. After settling its case with the New York attorney general's office, Tether also reached a settlement agreement with the Commodity Futures Trading Commission over whether the company truly maintained sufficient reserve assets to back tokens. See Ryan Browne, "Cryptocurrency Firms Tether and Bitfinex Agree to Pay $18.5 Million Fine to End New York Probe," *CNBC*, February 23, 2021, https://www.cnbc.com/2021/02/23/tether-bitfinex-reach-settlement-with-new-york-attorney-general.html; and "CFTC Orders Tether and Bitfinex to Pay Fines Totaling $42.5 Million," Commodity Futures Trading Commission, Press Release no. 8450-21, October 15, 2021, https://www.cftc.gov/PressRoom/PressReleases/8450-21.

10. See Norbert J. Michel, "Facebook's Libra: the Latest Reminder That Money Does Not Have to Be Centrally Provided by the Government," *Forbes*, July 1, 2019, https://www.forbes.com/sites/norbertmichel/2019/07/01/face books-libra-the-latest-reminder-that-money-does-not-have-to-be-centrally-provided-by-the-government/?sh=6c1392ee3dc2; and Pete Schroeder, "Waters Leads a Chorus of Caution about Facebook Cryptocurrency," *Mercury News*, June 18, 2019, https://www.mercurynews.com/2019/06/18/waters-leads-a-chorus-of-caution-about-facebook-cryptocurrency/.

11. "Report on Stablecoins," p. 14.

12. Michel, "Treasury's Misguided Focus on the Systemic Risk of Stablecoins."

13. Timothy Massad, "Regulating Stablecoins Isn't Just about Avoiding Systemic Risk," Brookings, October 5, 2021, https://

www.brookings.edu/research/regulating-stablecoins-isnt-just-about-avoiding-systemic-risk/#footnote-5.

14. Michel, "Treasury's Misguided Focus on the Systemic Risk of Stablecoins." A forthcoming Cato briefing paper will further address the claim that stablecoins pose systemic risks.

15. Carol R. Goforth, "The Case for Preempting State Money Transmission Laws for Crypto-Based Businesses," *Arkansas Law Review* 73, no. 2 (August 2020), https://scholarworks.uark.edu/alr/vol73/iss2/3/.

16. Some industry participants might still prefer to operate under a predominantly state-based framework. See the Digital Chamber of Commerce's open letter to the President's Working Group, "Chamber of Digital Commerce Submits Open Letter to President's Working Group on Stablecoins," October 19, 2021, https://digitalchamber.org/open-letter-presidents-working-group-stablecoin/.

17. The Investment Company Act of 1940 is codified at 15 U.S. Code, §§ 80a-1–80a-64.

18. It is not clear whether the SEC has the authority to regulate stablecoin issuers under the Investment Company Act without Congressional action.

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