Written Statement of
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Putting the 'Stable' in 'Stablecoins:' How Legislation Will Help Stablecoins Achieve Their Promise

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I am a partner in the law firm of Davis Polk & Wardwell LLP in New York City, where I began my legal career in 2006. As a member of the firm's financial institutions group, I advise banking organizations and nonbank financial institutions on a range of M&A, regulation, policy, enforcement and governance matters – including the full gamut of the prudential regulatory framework. My practice includes a focus on the intersection of financial services laws with innovation and the future of banking and payments, including with respect to stablecoins.

I served as a senior policy advisor to the Treasury Department's Financial Stability Oversight Council office at its launch following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. I graduated with a degree in literature from Rutgers College and received my law degree from Rutgers Law School.

Today I am presenting my own views, and not those of my firm or any client of the firm.

Chairman Hill, Ranking Member Lynch, Chairman McHenry, Ranking Member Waters and members of the Subcommittee, thank you for the privilege to speak before you today.

Questions about the future of money have rightfully captured significant attention from Congress and other policymakers. As technological advances continue to push the boundaries of how we store, spend and conceptualize money, our regulatory framework also should evolve.

Among the innovations that have garnered attention and market share are products known as stablecoins. These digitally native "coins" are designed to maintain a stable value relative to a reference asset, typically the U.S. dollar.

As with other forms of money resulting from earlier innovations, stablecoins present both risks and opportunities for the financial system and for consumers. In November 2021, the President's Working Group (PWG) on Financial Markets, together with the FDIC and OCC, published their examination of a class of stablecoins referred to as "payment stablecoins" (PWG Report).[1] The PWG Report identified prudential risks associated with payment stablecoin arrangements, such as: run risks; payment system risks; and competitive and financial stability risks. The report also noted various investor protection and illicit finance risks that may be implicated by stablecoin activities. The report recommended that Congress act promptly to pass legislation regulating payment stablecoins.

Following the release of the PWG Report, many legislative proposals have been introduced to regulate payment stablecoins. I commend Chairman McHenry, Chairman Hill, Ranking Member Waters and the other Republican and Democratic members of this Subcommittee for their diligent efforts and the progress that has been made. I believe a bipartisan substantive consensus on payment stablecoin legislation should be achievable.[2]

Why stablecoin legislation is important

Stablecoins represent the latest form of a class of financial products that have long been recognized as "special"[3] and worthy of regulation: products that are (1) payable on demand at par, by their terms or by virtue of market expectations, and (2) readily transferable to third parties.[4]

[1] PRESIDENT'S WORKING GRP. ON FIN. MARKETS, THE FED. DEPOSIT INS. CORP., AND THE OFF. OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS 2 (Nov. 2021), https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf (defining "payment stablecoins" as "those stablecoins that are designed to maintain a stable value relative to a fiat currency and, therefore, have the potential to be used as a widespread means of payment"). References to "stablecoins" throughout this written statement are intended to refer to "payment stablecoins" unless otherwise noted.

[2] For a discussion of the outlook for stablecoin legislation, as well as the broader context for crypto asset legislation, *see* Daniel E. Newman & Justin Levine, *The 2023 Outlook for Crypto Legislation: What's In and What's Missing from Current Proposals*, 31, 4 MKT. SOLUTIONS, (Dec. 2022), https://www.davispolk.com/sites/default/files/2023-01/52887102_1.pdf.

[3] I have written about what makes stablecoins special previously. *See* David L. Portilla & Will C. Giles, *The Stablecoins Debate,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Oct. 24, 2021), https://corpgov.law.harvard.edu/2021/10/24/the-stablecoins-debate/#6b (using E. Gerald Corrigan's 1982 paper, "Are Banks Special?" as a framework for evaluating proper stablecoin regulation); E. Gerald Corrigan, ANNUAL REPORT 1982: ARE BANKS SPECIAL?, FED. RESERVE BANK OF MINNEAPOLIS, https://fraser.stlouisfed.org/title/annual-report-federal-reserve-bank-minneapolis-473/annual-report-1982-18309.

[4] Academics often have focused on deposit taking when analyzing stablecoins. *See, e.g.*, Gary B. Gorton & Jeffery Zhang, *Taming Wildcat Stablecoins*, 90 U. CHICAGO L.R. (Sept. 30, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3888752; Howell E. Jackson & Morgan Ricks, *Locating Stablecoins within the Regulatory Perimeter,* HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE (Aug. 5, 2021), https://corpgov.law.harvard.edu/2021/08/05/locating-stablecoins-within-the-regulatory-perimeter/. Others have focused on transforming such shorter-term obligations into longer-term assets like commercial paper. *See* Bill Nelson, *Liquidity Transformation Always*

These types of financial products are special because they pose well-known risks. Chief among them is the risk of a run – that is, requests for redemption *en masse* that cannot be met due to a mismatch in the liquidity of reserve assets. The ramifications of such a run, along with the potential need for government support, necessarily become more pronounced as stablecoins scale. We can – and should – proactively mitigate these risks by establishing a regulatory framework *now*, before these risks grow larger and scale makes change more difficult. Importantly, some form of appropriately calibrated prudential regulation can minimize the risk of needing to provide government support to stablecoin issuers during a period of stress.[5]

This is not to say stablecoins pose precisely the same risks as other products that feature similar characteristics, such as bank deposits. A stablecoin issuer that fully backs outstanding coins with high-quality liquid assets is subject to a meaningfully lower risk of debilitating runs than a deposit-taking bank that uses a fractional reserve model.[6] And stablecoins that operate on decentralized, public networks may present different types of illicit finance risks compared to products that exist purely on traditional payment rails or on private permissioned networks; however, even on public networks, technological solutions to address illicit finance concerns may be available.[7]

I cannot say with certainty whether stablecoins represent part of the future of payments. Yet I feel quite confident that the current legal framework is ill-suited to comprehensively regulate payment stablecoins. Correspondingly, legislation that enables fit-for-purpose payment stablecoin regulation would help foster an environment where this technology can develop and scale. Some of the potential that payment stablecoins offer include: the programmability of money (e.g., increased automation of transactions); an additional means for mobile-based, real-time payments for consumers; and an additional payments infrastructure on which further innovation can occur. If realized, all of these developments may amplify the potential for building a more efficient, competitive and resilient payment system.[8]

Finds That Path of Least Regulation, BPI (Sept. 23, 2021), https://bpi.com/liquidity-transformation-always-finds-that-path-of-least-regulation/.

[5] As a useful analogy, *see* Report of the President's Working Group on Financial Markets, MONEY MARKET FUND REFORM OPTIONS, (Oct. 2010), https://home.treasury.gov/system/files/136/archive-documents/10.21-PWG-Report-Final.pdf, (introducing bank-like regulation of MMFs); Report of the President's Working Group on Financial Markets, OVERVIEW OF RECENT EVENTS AND POTENTIAL REFORM OPTIONS FOR MONEY MARKET FUNDS, (Dec. 2020), https://home.treasury.gov/system/files/136/PWG-MMF-report-final-Dec-2020.pdf (examining COVID-19-related disruptions to short-term funding markets and suggesting prudential-based measures to improve market stability).

[6] That said, even high-quality liquid assets, such as three-month Treasury bills, can experience stress during market crises. At the beginning of the COVID-19 pandemic, for example, the five-day moving average bid-ask spread for three-month Treasury bills widened from one basis point to nearly eight basis points. *See* Dep't. of the Treasury, Bd. of Governors of the Fed. Reserve System, Fed. Reserve Bank of New York, Sec. and Exch. Comm'n, Commodity Futures Trading Comm'n, RECENT DISRUPTIONS AND POTENTIAL REFORMS IN THE U.S. TREASURY MARKET: A STAFF PROGRESS REPORT 15 (Nov. 8, 2021), https://home.treasury.gov/system/files/136/IAWG-Treasury-Report.pdf. This episode demonstrates that caution should be given to assuming some level of maturity mismatch is immune to run risk.

[7] Technological innovations related to blockchain tracing and whitelisting capabilities may offer a viable approach to mitigate these risks. *See, e.g.*, Forge Societe Generale Grp., *EUR CoinVertible (EURCV) Stablecoin White Paper* 18 (Apr. 2023), https://www.sgforge.com/wp-content/uploads/2023/04/SGF_Coinvertible_White-Paper-v1.0.pdf ("[O]nly addresses that are whitelisted by SG-FORGE will be eligible to receive our stablecoins. Such whitelisting process based on the CAST Framework means that SG-FORGE has performed compliance controls (KYC, AML-CFT, sanctions and embargoes) according to Societe Generale Group policies, and has duly onboarded the owner of such address.").

[8] For a discussion of the potential benefits of payment stablecoins and the role regulation can play, *see generally Stablecoins: How Do They Work, How Are They Used, and What Are Their Risks?*: *Hearing Before the S. Comm. On Banking, Housing and Urban Affairs*, 117th Cong. (Dec. 14, 2021) (statement of Jai Massari, Partner, Davis Polk & Wardwell LLP), https://www.banking.senate.gov/imo/media/doc/Massari%20Testimony%2012-14-211.pdf.

Key issues for stablecoin legislation

The remainder of my remarks will focus on what I believe are the key issues that should be addressed in any payment stablecoin legislation.[9] A common theme in my testimony today is that a one-size-fits-all approach is neither necessary nor prudent. I believe payment stablecoin legislation should establish privileges and responsibilities for stablecoin issuers along a spectrum. As a general principle, greater privileges from the government should be coupled with more stringent regulatory and supervisory oversight; a more tailored regulatory approach, on the other hand, should be coupled with appropriately calibrated privileges from the government.

1. *Who should be permitted to issue payment stablecoins?*

A threshold question relating to the regulation of stablecoins is, quite simply, *who* should be allowed to issue them? The PWG Report, for example, recommended that stablecoin issuers be limited to insured depository institutions.[10] Since its release, many domestic and international regulatory bodies appear to have shifted away from this recommendation.[11] Indeed, Treasury Under Secretary for Domestic Finance Nellie Liang, a lead contributor to the PWG Report, subsequently acknowledged that an appropriate regulatory structure for nonbank stablecoin issuers could "plausibly address concerns about stablecoin runs and payment system risk."[12] In addition, many of the legislative proposals released to date have contemplated a dual approach, whereby nonbanks would be permitted to issue stablecoins provided they comply with varying degrees of prudential regulation.[13] These approaches make sense, given that the common conception of a payment stablecoin business (that is, issuance and redemption of an instrument backed by a discrete pool of high-quality liquid assets) is distinct from the business of fractional reserve banking.[14]

Because payment stablecoins typically hold a limited range of reserve assets, the regulatory framework should be designed to address the specific characteristics of this business model and the risk tradeoffs it presents. This principle is true whether the stablecoin issuer is a nonbank entity lacking any affiliation with a banking organization, or a subsidiary or affiliate

[9] The issues I discuss in my testimony are not exhaustive, and many other important questions remain. For example, even if payment stablecoin legislation is enacted, there would still be questions around other types of stablecoins, such as the various categories of decentralized and algorithmic stablecoins. It is also not entirely clear how the regulation of payment stablecoins might interact with the potential for a future in which central bank digital currencies (CBDCs) or tokenized demand deposits issued by banks, also known as deposit coins, become mainstream.

[10] PWG Report, *supra* note 1 at 2.

[11] S*ee, e.g.*, FIN. STABILITY OVERSIGHT COUNCIL, REPORT ON DIGITAL ASSET FINANCIAL STABILITY RISKS AND REGULATION (Oct. 2022), https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf; FIN. STABILITY BD., REVIEW OF THE FSB HIGH-LEVEL RECOMMENDATIONS OF THE REGULATION, SUPERVISION AND OVERSIGHT OF "GLOBAL STABLECOIN" ARRANGEMENTS (Oct. 11, 2022), https://www.fsb.org/wp-content/uploads/P111022-4.pdf.

[12] Under Secretary for Domestic Finance Nellie Liang, Remarks at King's College London's Global Banking and Finance Conference (July 5, 2022), https://home.treasury.gov/news/press-releases/jy0850. Under Secretary Liang did, however, caution that bank stablecoin issuance and nonbank stablecoin issuance might have "different implications for financial stability." *Id.*

[13] *See, e.g.*, Sam Sutton, Eleanor Mueller, *McHenry's scaled-back stablecoin plan would give states flexibility,* POLITICOPRO (Apr. 2023), https://subscriber.politicopro.com/article/2023/04/mchenry-scales-back-stablecoin-plan-gives-states-flexibility-00093539?source=email (publishing revised discussion draft of stablecoin bill reportedly being developed by Rep. McHenry); Discussion Draft, S. __ 118th Cong. (2022), https://docs.house.gov/meetings/BA/BA21/20230419/115753/BILLS-118pih-Toproviderequirementsforpaymentstablecoinissuersresearchonadigitaldollarandforotherpurposes.pdf (discussion draft of stablecoin bill posted for Apr.19, 2023 House Financial Services Committee hearing); Lummis-Gillibrand Responsible Financial Innovation Act, S. 4356, 117th Cong. (2022); Stablecoin Transparency of Reserves and Uniform Safe Transactions Act of 2022, S. 3970 117th Cong. (2022); Gottheimer Stablecoin Innovation and Protection Act of 2022, S. __ 117th Cong. (2022).

[14] In contrast, an insured depository institution could (and should be permitted to) issue tokenized deposits.

of a banking organization. For example, the existing minimum, non-risk sensitive leverage capital ratios that apply to banks would likely need to be modified to reduce the potential negative capital implications arising from a direct or indirect subsidiary of a bank or bank holding company issuing stablecoins.[15]

2. Who should regulate payment stablecoins?

The next question that naturally follows is one of jurisdiction: who should be the primary regulator of payment stablecoin issuers? Should stablecoin issuers be regulated at the federal or state level?

Federal regulation of stablecoin issuers would offer more uniform, consistent rules, whereas state regulation could promote more diversity and innovation in regulation and supervision. Today, for example, the most detailed publicly available prudential guidance and standards regarding stablecoins and related topics have been issued by a state regulator.[16] But the answer to this question need not be binary. Many of the legislative proposals released by Congress to date have followed the model of our dual-banking system. That is, they would establish a framework in which stablecoin issuers could be regulated either (1) directly at the federal level, or (2) primarily at the state level, with an overlay of federal oversight. Options include providing federal regulation as a backup to state regulation or an approach that toggles based on the scale of an issuer. In all cases, the roles of federal and state regulators should be clear to avoid overlap, confusion and inefficiency.

3. Should nonbank payment stablecoin issuers be provided access to the Federal Reserve's payment system or discount window?

The question of who should be entitled to have a master account has emerged as a key policy question for the U.S. financial system. A master account at one of the twelve Federal Reserve Banks is necessary for an institution to have direct access to the Federal Reserve's payment systems, as well as to settle transactions in central bank money.[17] Technological changes in the payments landscape have driven a number of fintech and crypto asset-based companies to seek access to these services.

Granting nonbank payment stablecoin issuers access to master accounts could help them provide more efficient services to their customers. It also carries monetary policy and political implications. Here, again, multiple options are possible. Perhaps legislation could grant nonbank stablecoin issuers with access to Federal Reserve Bank services, but limit those services in both scale and scope. For instance, the absolute or relative amount of reserves that a nonbank stablecoin issuer may invest in central bank deposits could be limited by the

[15] *See* DAVIS POLK & WARDWELL LLP, *U.S. Regulators Speak on Stablecoin and Crypto Regulation* (Nov. 12, 2021), https://www.davispolk.com/insights/client-update/us-regulators-speak-stablecoin-and-crypto-regulation#:~:text=The%20PWG%20Report%20on%20Stablecoins&text=The%20Report%20announces%20no%20immediate,issuers%20and%20custodial%20wallet%20providers (explaining challenges for stablecoins associated with the minimum leverage capital ratios that apply to banks today). *Cf.* Economic Growth, Regulatory Relief, and Consumer Protection Act, S. 2155, 115th Cong. (2018) (tailoring the supplementary leverage ratio for custodial banks).

[16] *See* N.Y. DEP'T OF FIN. SERV., GUIDANCE ON THE ISSUANCE OF U.S. DOLLAR-BACKED STABLECOINS (June 8, 2022), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20220608_issuance_stablecoins; N.Y DEP'T OF FIN. SERV., GUIDANCE ON CUSTODIAL STRUCTURES FOR CUSTOMER PROTECTION IN THE EVENT OF INSOLVENCY (Jan. 23, 2023), https://www.dfs.ny.gov/industry_guidance/industry_letters/il20230123_guidance_custodial_structures.

[17] A master account is also a necessary, but not sufficient, condition for an institution to have access to the Federal Reserve's discount window.

Federal Reserve.[18] Or perhaps issuers could be granted access to the discount window, but only at certain times and in limited amounts. Other options include making access to Federal Reserve Bank services available at the option, or based on the scale, of an issuer. In all events, it seems that if a firm is granted access to Federal Reserve Bank services, regulation and supervision should correspond to the level of such access (including with respect to issues such as limitations on affiliations with commercial companies).

4. *To what extent (if at all) should payment stablecoins be subject to "deposit" insurance?*

Banks offer economic and societal value, in the form of increased money supply and credit, by engaging in the business of maturity and liquidity transformation.[19] But this business model is inherently susceptible to run risk.[20] Deposit insurance was introduced in the U.S. in the 1930s in an effort to mitigate this risk.

A similar form of insurance for payment stablecoins could also help mitigate run risks by making available aspects of the federal safety net to stablecoin issuers. The availability of deposit insurance would thus affect whether other bank-like requirements should be considered. For example, insured banks are subject to extensive capital, liquidity and risk management requirements, as well as activities restrictions, in part to prevent them from externalizing risks through the federal safety net.

Whether some form of insurance is ultimately needed for stablecoins may turn on the nature of the reserves that back them and, relatedly, the degree to which consumers expect their stablecoins to be redeemable on demand at par. As noted previously, a stablecoin issuer that fully backs its coins with high-quality liquid assets likely poses a meaningfully lower risk of becoming subject to a run than a bank.[21]

5. *What insolvency standards should be applicable to payment stablecoins?*

Recent high-profile bankruptcies of crypto asset-related companies have brought questions related to the treatment of customer assets in the event of an intermediary's insolvency into stark focus. To the extent payment stablecoins are designed or perceived to be effectively free of credit risk, it would be prudent to provide stablecoin holders with structural priority over an issuer's other creditors. Other important considerations include rehypothecation limits and recordkeeping requirements. In addition, a company that holds stablecoins for customers should be subject to standards to help ensure that a customer's stablecoins are not commingled with the assets of the company and, therefore, to help ensure that the customer's stablecoins would be available to the customer in the event of an insolvency of the company. Existing federal and state laws provide standards for custodians and should be useful in this context. In any case, clear rules and plain-language disclosure and terms are

[18] Similarly, the amount of interest on reserve balances could be limited or capped at a certain amount.

[19] *E.g.*, Kenneth J. Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market versus Non-market Allocation*, in JOINT ECONOMIC COMMITTEE OF THE CONGRESS OF THE UNITED STATES, THE ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURES: THE PPB SYSTEM 48 (1969) ("The creation of money is in many respects an example of a public good.").

[20] *See, e.g.*, Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) ("It is precisely the 'transformation' of illiquid assets into liquid assets that is responsible both for the liquidity service provided by banks and for their susceptibility to runs.").

[21] *But see supra* note 6.

important to provide customers and creditors confidence that their claims will be resolved in a predictable and timely manner.

6. *What other legal regimes should apply to payment stablecoins and related products and services?*

While I have focused primarily on prudential issues, payment stablecoins and related products, such as wallet and other custodial providers, also present other common regulatory concerns, such as those related to consumer protection and illicit finance. All of these considerations should be thoughtfully explored.

But this does not mean that payment stablecoins should be shoehorned into regulatory frameworks that were crafted for entirely different products. Nor does it mean that we should be vexed to paralysis in trying to answer questions that, frankly, permeate traditional finance – such as how to regulate any service provider that is adjacent to a regulated firm. Ultimately, consumers and our financial system more broadly will be best served by focusing on the above issues where I believe we can find common ground to establish a regulatory framework that treats payment stablecoins as such – payment instruments that are subject primarily to prudential regulation and supervision, rather than, for example, as an investment asset subject to market and investment management regulation.

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Thank you again for the opportunity to participate today. I look forward to addressing your questions.