

*Testimony of Steven L. Schwarcz, the Stanley A. Star Distinguished Professor of Law & Business, Duke University School of Law, for the May 18, 2023 Stablecoin Hearing, U.S. House of Representatives, Financial Services Committee, Digital Assets Subcommittee*

## INTRODUCTION

The principal challenge for digital, or electronic, currencies is facilitating day-to-day retail payments, in order to improve speed, reduce costs, and increase consumer financial access. Businesses already quickly and efficiently send large “wholesale” payments electronically through Fedwire, SWIFT, and other electronic wire-transfer systems.

The Federal Reserve could simply and cost-effectively utilize these existing wire-transfer systems to implement a retail central bank digital currency, or CBDC.<sup>1</sup> Although such a CBDC would require consumers to have bank accounts, consumers could use their ordinary commercial bank accounts.<sup>2</sup> Still, that could potentially limit financial access to the unbanked.

Stablecoins represent nongovernment-issued “currencies”<sup>3</sup> that are backed by—that is, exchangeable for—highly liquid assets (sometimes called “reference assets”) that have intrinsic value.<sup>4</sup> Being cryptographically recorded, their transfer does not require the use of bank

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<sup>1</sup> See Steven L. Schwarcz, *Regulating Digital Currencies: Towards an Analytical Framework*, 102 BOSTON UNIVERSITY LAW REVIEW 1037, 1051-55 (2022) (hereinafter, “*Regulating Digital Currencies*”).

<sup>2</sup> *Id.*

<sup>3</sup> Stablecoins represent currencies insofar as they operate as a medium of exchange to facilitate the sale of goods and services and to otherwise make payments and satisfy debts. *Id.* at 1046. That function does not depend on a stablecoin being seen as “legal tender.” See Steven L. Schwarcz, *Regulating Global Stablecoins: A Model-Law Strategy*, 75 VANDERBILT LAW REVIEW 1729, 1747-48 (2022) (hereinafter, “*Regulating Global Stablecoins*”) (observing, among other things (*id.* at 1747 n.113), that the United States does not limit the medium of legal payment; rather, it allows any commercially reasonable and widely accepted medium to be used for payment).

<sup>4</sup> Stablecoins contrast sharply with bitcoin and other nongovernment-issued digital “currencies” that are *not* backed by reference assets. Those generic cryptocurrencies have unpredictably fluctuating values, which makes it difficult for consumers to use them on a daily basis as an alternative to cash; a successful retail currency should have a stable value. *Regulating Global Stablecoins*, *supra* note 3, at 1736-37.

accounts. (A CBDC could also be designed to be cryptographically recorded and thus not require the use of bank accounts.<sup>5</sup>)

Not being government issued, stablecoins present complex and novel domestic and, when used for making international payments, cross-border regulatory challenges. My testimony today focuses on the domestic regulation of stablecoins that are intended to be used as mediums of exchange. My testimony also concerns a Discussion Draft of a Bill to “provide for the [effectively, domestic] regulation of payment stablecoins, and for other purposes” (hereinafter, the “Bill”).<sup>6</sup>

If interested, please note that I have separately analyzed in detail the possible cross-border regulation of stablecoins.<sup>7</sup>

## **OVERVIEW OF REGULATORY CHALLENGES**

The principal challenges for the domestic regulation of stablecoins include protecting consumers and their privacy, protecting monetary integrity (including prohibiting money laundering and restricting the financing of terrorism and weapons proliferation that could threaten national security), protecting against breaches of cybersecurity and failures of operational resilience, and protecting against factors that could undermine financial stability or otherwise threaten the broader financial system.<sup>8</sup>

Of these challenges, the most fundamental to the nature of stablecoins is their underlying financial stability. Consumers could lose confidence in a stablecoin due to the issuer’s inability

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<sup>5</sup> See *Regulating Digital Currencies*, *supra* note 1, at 1051-55.

<sup>6</sup> Bill § 2(13)(A), at p. 4, lines 10-11. *Cf. supra* note 3 (observing that stablecoins would represent currencies if they operate as a medium of exchange).

<sup>7</sup> See *Regulating Global Stablecoins*, *supra* note 3.

<sup>8</sup> See, e.g., PRESIDENT’S WORKING GRP. ON FIN. MKTS., FED. DEPOSIT INS. CORP. & OFF. OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS 1, 3 (2021), [https://home.treasury.gov/system/files/136/StableCoinReport\\_Nov1\\_508.pdf](https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf) [<https://perma.cc/2A79-AL95>]; *Regulating Global Stablecoins*, *supra* note 3, at 1743-44.

to timely redeem the stablecoin for its underlying reference asset.<sup>9</sup> Consumer could even lose confidence due to doubt about that ability.<sup>10</sup> That loss of confidence could trigger a run on the issuer that resembles a classic bank run: the issuer may well be unable to obtain sufficient reference assets in time to satisfy correlated demands by stablecoin holders.<sup>11</sup>

I have separately proposed possible text for a model law to regulate stablecoins.<sup>12</sup> That text includes various ways to protect against the aforesaid run risk, including by collateralizing the redemption obligation by segregated investment-grade short-term money market instruments or by making stablecoins the equivalent of insured deposits.<sup>13</sup> That text also includes protections against the other above-referenced regulatory challenges.

The text of my model law is “generally consistent with the principles and recommendations advanced by the world’s leading central banks [including the U.S. Federal Reserve] and multinational financial organizations [including the Bank for International Settlements (BIS) and the G20’s Financial Stability Board]” for regulating stablecoins.<sup>14</sup> For that reason, I will reference the model law’s text as applicable when analyzing the Bill, below.

## **ANALYSIS OF THE BILL**

The Bill protects against certain of the above identified regulatory challenges. I next address each such regulatory challenge. Thereafter, I provide some additional observations.

## **REGULATORY CHALLENGES**

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<sup>9</sup> *Regulating Global Stablecoins*, *supra* note 3, at 1758.

<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *See* Appendix – Proposed Text for a Model Law, *Regulating Global Stablecoins*, *supra* note 3, at 1778-85.

<sup>13</sup> *Id.* at 1758-59 & 1782.

<sup>14</sup> *Id.* at 1778.

*Protecting against factors that could undermine financial stability or otherwise threaten the broader financial system.* Section 4(a)(1) of the Bill (at pp. 8-9) reasonably requires permitted stablecoin issuers to “maintain reserves backing the issuer’s payment stablecoins outstanding on an at least one to one basis” with reasonably liquid assets. You may wish to analyze, however, whether 90-day maturity Treasury bills would enable an issuer to timely meet a run.

Section § 4(a)(3) of the Bill (at pp. 10-11) appropriately contemplates the possible issuance of capital, liquidity, and risk-management regulatory requirements. The “may not exceed what is sufficient” language is odd, though. Although that language may well be politically motivated, I’d have preferred “is sufficient.” Also (and though I recognize the political backlash against creating moral hazard), I wonder whether some government entity should serve as a discretionary emergency liquidity provider, as I have separately proposed for consideration.<sup>15</sup>

The Bill also lacks a clear mechanism for the government to restrict stablecoin issuance and use in order to protect monetary policy.<sup>16</sup>

*Protecting consumers.* I did not see any consumer protection provisions in the Bill. That may well be because the U.S. Electronic Fund Transfer Act<sup>17</sup> already provides at least some protection.<sup>18</sup> Section 3.02 of my proposed model law provides possible comparative consumer-protection text.<sup>19</sup>

A question might arise whether the Bill should require segregation (and prohibition against commingling) of customer assets. I do not believe that would be relevant because stablecoin issuers would not, in their capacity as issuers, operate as exchanges or hold (in a

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<sup>15</sup> Cf. *Regulating Global Stablecoins*, *supra* note 3, at 1761-62 & 1781.

<sup>16</sup> Cf. *id.* at 1767-68 & 1781 (discussing how to protect monetary policy).

<sup>17</sup> 15 U.S.C. § 1693.

<sup>18</sup> Cf. *Regulating Global Stablecoins*, *supra* note 3, at 1751 (discussing consumer protections for stablecoins).

<sup>19</sup> *Id.* at 1782.

custodial capacity or otherwise) or trade customer assets. The relevant segregation requirement regards collateral being used to satisfy the redemption obligation.<sup>20</sup>

*Protecting privacy.* I did not see any privacy protections in the Bill.<sup>21</sup> Section 3.03 of my proposed model law provides possible comparative privacy-protection text.<sup>22</sup>

*Protecting monetary integrity.* I did not see any provisions in the Bill prohibiting money laundering or restricting the financing of terrorism and weapons proliferation that could threaten national security. That may well be because the U.S. government already is committed to observe (and separately will be observing) the Financial Action Task Force’s recommendations to implement these types of protections.<sup>23</sup> Section 3.05 of my proposed model law provides possible comparative text regarding anti-money-laundering and related protections.<sup>24</sup>

*Protecting against breaches of cybersecurity and failures of operational resilience.* I did not see these types of protections in the Bill.<sup>25</sup> Section 3.04 of my proposed model law provides possible comparative text regarding these types of protections.<sup>26</sup>

## ADDITIONAL OBSERVATIONS

I support § 2(7) of the Bill (at p. 3), which allows nonbank entities to be approved by the primary Federal payment stablecoin regulator. Allowing “nonbanks to become stablecoin issuers” would “provide[] additional commercial flexibility for experimentation and innovation.”<sup>27</sup>

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<sup>20</sup> See *supra* note 13 and accompanying text.

<sup>21</sup> Cf. *Regulating Global Stablecoins*, *supra* note 3, at 1752 (discussing privacy protections for stablecoins).

<sup>22</sup> *Id.* at 1782-83.

<sup>23</sup> Cf. *id.* at 1753-54 (discussing monetary integrity protections for stablecoins).

<sup>24</sup> *Id.* at 1783-84.

<sup>25</sup> Cf. *id.* at 1755-58 & 1783 (discussing cybersecurity and operational resilience protections for stablecoins).

<sup>26</sup> *Id.* at 1783.

<sup>27</sup> *Id.* at 1749.

I am concerned that the “unsafe or unsound” standard of § 5(a)(4)(C) of the Bill (at p. 15, lines 12-15) is too weak to enable denial of an application to entities that lack integrity, reliability, or stability.<sup>28</sup> At the very least, that language of the Bill appears to invite litigation; an approved stablecoin issuer should have standards that exceed not merely being unsafe or unsound.

It is unclear why the Bill fails to cover the right to trade stablecoins or otherwise to engage in stablecoin-related services or other activities.<sup>29</sup>

Questions may arise regarding state approval of stablecoin issuers. I have not yet reviewed the interaction between the Bill’s federal and state approval process sufficiently to express a view.<sup>30</sup>

There might be concern that the Bill does not explicitly address the ability of large commercial retailers to issue their own stablecoins. The Bill implicitly addresses that concern, however, by making it unlawful for any person other than a “permitted payment stablecoin issuer” to issue a payment stablecoin.<sup>31</sup>

There also might be concern that the Bill does not explicitly address algorithmic stablecoins. Algorithmic stablecoins are stablecoins that are backed by reference assets that are crypto-assets.<sup>32</sup> The Bill implicitly addresses that concern, however, by limiting the reference assets to specific high quality short-term assets that do not include crypto-assets.<sup>33</sup>

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<sup>28</sup> *Cf. id.* (discussing the importance of a stablecoin issuer having integrity, reliability, and stability).

<sup>29</sup> *Cf. id.* at 1750 & 1779-80 (discussing regulating the right to trade stablecoins).

<sup>30</sup> I note, however, that giving the Federal Reserve Board the option to decline any state-approved issuer would (at least to that extent) reduce state regulatory autonomy.

<sup>31</sup> Bill § 3, at p. 8, lines 7-9.

<sup>32</sup> The required collateral reserves would then vary on a dynamic basis based on the changing market value of those crypto-assets.

<sup>33</sup> Bill § 4(a)(1)(A), at pp. 8-9, lines 16-24 & 1-3, respectively.

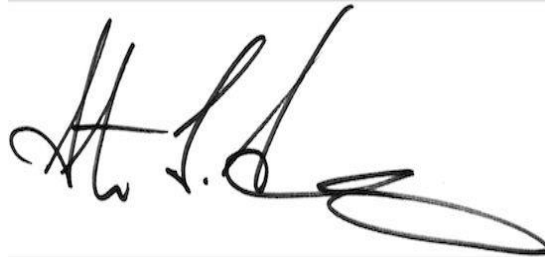
The following additional observations are more technical.

Sec. 3, p. 8, line 9 of the Bill: Should the phrase “use by any person in the United States” be expanded? For example, should non-permitted persons have the right to issue a stablecoin that is used by persons outside the United States to make payments within the United States?

Sec. 6(b)(5)(A), p. 27, line 18 of the Bill: Change ”issued” to “issued or outstanding.”

Sec. 10, p. 35, lines 16-25 of the Bill: Is “insolvency” too limited? Also, in line 23, consider changing “from” to “by.” In lines 24-25, should stablecoin holders have priority over, for example, depositors? Also, should stablecoin holders have priority over state-law perfected secured creditors?

Respectfully submitted,

A handwritten signature in black ink, appearing to read "H. I. O.", is written on a horizontal line. The signature is stylized and cursive.