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Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

RE: Docket No. OP-1747, Proposed Guidelines to Evaluate Requests for Accounts and Services at Federal Reserve Banks

Dear Ms. Misback:

Thank you for the opportunity to comment on the Federal Reserve Board's proposed guidelines for requests to the Reserve Banks for master accounts by non-traditional entities.

I am a Professor and Chair of the Department of Legal Studies and Business Ethics at the Wharton School, University of Pennsylvania. I direct the Wharton Blockchain and Digital Asset Project, which studies the business, legal, policy, and governance implications of distributed ledger technologies. Since 2017, we have hosted regulators from the U.S. and around the world, along with industry and academic legal experts, at the Wharton Reg@Tech Roundtable on Digital Assets. We also collaborated with the World Economic Forum to issue the recent *DeFi Policy-Maker Toolkit* on regulatory considerations for distributed finance. I have served as Counsel for New Technology at the Federal Communications Commission and an Expert Advisor to both the FCC and U.S. Department of Commerce. The perspectives expressed here are my own.

The proposed guidelines provide a sensible starting point for consistent treatment of account access requests. The market is witnessing rapid growth of fintech firms that exhibit some, but not all, features of traditional banks. This will force the Federal Reserve to consider how and whether to tailor its rules. A multi-level risk-based framework, as the Board proposes, could provide flexibility while maintaining a focus on the policy goals of financial regulation. How the framework would be applied in practice, however, is an important question.

I would like to focus my comments on a particular area of fintech development that, while not directly referenced in the Request for Comment, deserves consideration: stablecoins. The Federal Reserve should address the implications of major stablecoin platforms on financial stability and monetary policy. While stablecoin firms themselves may not seek access to accounts and services at Reserve Banks, their operations may impact those that do. More broadly, the Federal Reserve and other federal financial regulatory institutions should not wait to take action on the risks that unregulated or under-regulated stablecoins pose. The objective should not be to destroy stablecoins, which represent a potentially valuable area of financial innovation. It should be to create a well-functioning market and a level playing field, where risks are appropriately addressed and technologies succeed or fail based on their inherent advantages.

Global stablecoins are digital assets (cryptocurrencies) pegged to the value of a stable asset, typically the US Dollar.[1] Most seek to maintain the peg by backing the digital asset one-to-one with fiat currency, in the form of cash or other reserves. Some, such as MakerDAO's DAI, back the stablecoin with pools of digital assets and other forms of collateral locked in blockchain-based smart contracts, through systems that require overcollateralization and incentivize liquidation of undercapitalized positions. Still others seek to maintain the peg algorithmically, such as by creating and destroying tokens automatically in response to price movements.

As of July 8, 2021, total global stablecoin market capitalization according to CoinMarketCap was $114 billion, with 24-hour trading volume of $55 billion.[2] The top three stablecoins—USDT (Tether), USDC (Circle), and BUSD (Binance)—represented approximately $100 billion of the total assets, with Tether alone claiming over $62 billion. Tether is now considered the third most valuable cryptocurrency, after bitcoin and ether.

The stablecoin market has witnessed extraordinary growth over the past year. The top three stablecoins quadrupled their assets in the first half of 2021, even though the price of bitcoin was nearly the same on July 1 as January 1. Stablecoins have rapidly become essential components of the global cryptocurrency trading ecosystem. With the $80 billion initial public offering of Coinbase and the total value of digital assets in circulation briefly exceeding $2 trillion in 2020, the idea of cryptocurrencies as a significant new financial asset class is no longer hypothetical. This despite serious continuing concerns about fraud, financial crime, hacks, ransomware, energy consumption, and more.

Stablecoins address one of the biggest impediments of cryptocurrencies for activities other than investment speculation: their high price volatility. They also smooth the process of transferring assets between cryptocurrency exchanges, as well as moving between traditional financial markets and cryptocurrencies. Stablecoins are also essential foundations of decentralized finance (DeFi).[3] DeFi

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[1] Matthew Malloy and David Lowe, *Global Stablecoins: Monetary Policy Implementation Considerations from the U.S. Perspective*, Federal Reserve Board of Governors Finance and Economics Discussion Series 2021-020 (2021), https://doi.org/10.17016/FEDS.2021.020; Mitsutoshi Adachi, Matteo Cominetta, Christoph Kaufmann and Anton van der Kraaij, *A Regulatory and Financial Stability Perspective on Global Stablecoins*, European Central Bank Macroprudential Bulletin, May 5, 2020, https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/index.en.html.

[2] CoinMarketCap, Top Stablecoin Tokens by Market Capitalization, https://coinmarketcap.com/view/stablecoin/.

[3] World Economic Forum and Wharton Blockchain and Digital Asset Project, *The Decentralized Finance (DeFi) Policy-Maker Toolkit*, June 8, 2021, https://www.weforum.org/whitepapers/decentralized-finance-defi-policy-maker-toolkit.

systems seek to replace financial intermediation and custodial relationships with smart contracts operating on trust-minimized blockchain settlement layers. DeFi promises to make financial services more open, accessible, and efficient, as well as more programmable and composable. Total value of digital assets locked in DeFi smart contracts increased from approximately $1 billion at the start of 2019 to $80 billion in May 2021.[4]

A full discussion of the risks and opportunities of DeFi is beyond the scope of this comment. My point is that the interlinked phenomena of cryptocurrency trading, stablecoins, and DeFi have reached the point that they should be squarely on the radar screen of the Federal Reserve in discussions about fintech and emergent regulatory or stability concerns.

With regard to this Request for Comment, the Board should not limit its consideration of account access issues to fintech neobanks, peer-to-peer lending or payments platforms, and special purpose depository institutions for cryptocurrencies. As big as the stablecoin market is today, it could soon be much bigger. Circle, the primary firm behind the USDC stablecoin, recently filed to go public through a SPAC at a valuation over $4 billion. According to its investor presentation, Circle projects USDC assets of $190 billion in FY2023.[5] This would make it far bigger than PayPal, Square, or any of the major fintech neobanks and lending platforms. It would hold assets comparable to some of the largest money market mutual funds operated by firms such as Vanguard and Fidelity.

One of the biggest arguments against applying bank regulation or other traditional rules to fintech firms is that they do not have the same features that historically were the basis for regulation. Specifically, many do not engage in classic maturity transformation by pairing liquid deposit-taking and with illiquid lending. At first glance, stablecoins do not either. They look like money market funds which maintain liquidity at reasonable risk by investing in a limited universe of high-quality assets. However, major stablecoins are increasingly engaging in aggressive lending operations with their significant asset pools, in order to provide far greater yields than investors typically earn on money market funds.

Circle’s investor presentation, for example, suggests yields in the 3% to 7% range. Other yields available on stablecoins through DeFi services are even higher. Greater returns imply greater risk. The efficiencies of cryptocurrencies cannot account for the differences. Without further regulation, it seems likely that investors will be exposed to significantly greater risks than they anticipate if they view stablecoins as equivalent to conventional money market funds.

Stablecoins today are not subject to the same regulatory obligations as banks or money market funds. Instead, those operating in the United States are generally subject to state money transmission laws as money services business (MSBs), at least in those states that treat cryptocurrencies as money. While they are required to register with FinCEN at the federal level for anti-money laundering purposes, this only imposes a general level of compliance obligations, limited to financial crime considerations. The state

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[4] Id.

[5] Circle Investor Presentation (2021), https://www.circle.com/hubfs/investors/Circle-Investor-Presentation-July2021.pdf.

MSB laws are highly inconsistent, and generally far looser in their obligations than the rules applicable to analogous traditional services.[6] Circle provides attestations rather than full audits of its reserves, and their composition includes a vague category of "approved investments" that the firm has not publicly elaborated on.[7] And some of the largest stablecoins, notably the largest, Tether's USDT, claim not to operate in the U.S. at all.[8] They operate across the world and on various decentralized blockchain networks in a largely unregulated state. Their assets and practices are opaque and their representations are subject to question.[9]

A full discussion of the risks of stablecoins generally, and the evidence of malfeasance involving Tether specifically, is beyond the scope of this comment. And regulatory determinations should be made based on evidence rather than speculation. The problem is that the lightly regulated and in many cases, effectively unregulated status of global stablecoins means that necessary information for market participants and regulators is not being disclosed. We do not know how exactly stablecoin firms are generating their returns: what they are lending and to whom, on what basis? Nor (with a handful of exceptions) do we know with full granularity the composition and size of the asset base that maintains the peg of these stablecoins, especially Tether. Nor do we fully understand the web of relationships and linkages among cryptocurrency exchanges, traders, large holders ("whales"), and the stablecoin firms.

The lack of sufficient information is not proof of illicit activity or unreasonable risks. And some stablecoin firms such as Circle have repeatedly stated a commitment to compliance and transparency, as well as to verifiable one-to-one backing of USDC with dollars. The problem is two-fold: The legal categories where on-shore stablecoins have been able to operate are too limited and ill-fitting, and off-shore stablecoins are effectively not regulated at all. Both situations call for action. Measures should be implemented to ensure that stablecoins have sufficient transparency, reserve requirements, investment limitations, AML compliance obligations, and stability oversight. At the same time, enforcement actions must be taken against those actors who evade legal obligations, and as appropriate, regulated firms that interact with them. The enforcement activity will require global cooperation. Updating the domestic regulatory framework will in all likelihood require legislation for full effectiveness,[10] but the Federal Reserve and other government agencies should examine what steps they can take under existing authority.

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[6] Dan Awrey, *Bad Money*, 106 Cornell L. Rev. 1 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3532681.

[7] JP Koning, *Circle Isn't Winning the Stablecoin Transparency Race*, Coindesk, July 6, 2021, https://www.coindesk.com/circle-is-not-winning-stablecoin-transparancy-race.

[8] The New York Attorney General charged Tether with illegally operating in New York nonetheless, as well as with false statements concerning its backing and mismanagement of funds. The case was settled in February 2021 for a penalty of $18.5 million and conduct obligations. Attorney General James Ends Virtual Currency Trading Platform Bitfinex's Illegal Activities in New York, February 23, 2021, https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal.

[9] Researchers have also found evidence that Tether is used to manipulate the price of bitcoin and the cryptocurrency market. John M. Griffin and Amin Shams, *Is Bitcoin Really Untethered?*, 75 Journal of Finance 1913 (2020), https://onlinelibrary.wiley.com/doi/full/10.1111/jofi.12903.

[10] The STABLE Act, proposed in the US House of Representatives in 2020, would require stablecoins to obtain bank charters, although it would provide greater flexibility than for traditional institutions. Stablecoin Tethering and

The way forward for cryptocurrencies is to aim for regulatory clarity. That is not analogous to "no regulation." Digital assets are powerful innovations which hold the promise of significant benefits for Americans, including lower costs, greater financial innovation, improved financial privacy, and lower market concentration. Stablecoins are an important part of that story. However, the full benefits of DeFi and cryptocurrency markets will not be realized without trust. And as we know from centuries of financial history, appropriate regulation is essential over the long term to instill that trust.[11] Financial markets without regulation, or with poorly designed regulation, eventually go off the rails, hurting almost everyone. The bigger the asset base in stablecoins, and the more integrated they become with traditional finance, the greater the costs when things go wrong.

Central bankers and other government actors around the world are starting to acknowledge the risks of the current stablecoin environment.[12] Chair Powell has indicated that the Federal Reserve is examining questions around stablecoins, along with the possibility of a central bank digital currency.[13] The explosive expansion of stablecoins over the past year, and the prospects for further rapid institutionalization, mean that the time to act is now. The goal should not be to threaten or stamp out stablecoins, but to provide a pathway to compliance and trust that addresses major policy concerns.

The proposed guidelines for account access, which offer flexibility while imposing consistent standards on the reserve banks, and which put policy objectives front-and-center, are consistent with this model. The Federal Reserve should not stop with standards for account access. It should actively develop policies to address the stablecoin market, both itself, through mechanisms such as the Financial Stability Oversight Council, and through other cross-governmental and international means of collaboration.

Bank Licensing Enforcement (STABLE) Act, https://tlaib.house.gov/sites/tlaib.house.gov/files/STABLE_Act_One_Pager.pdf.

[11] Kevin Werbach, *The Blockchain and the New Architecture of Trust* (MIT Press 2018).

[12] Marc Hochstein, *US Fed Official Calls Tether a 'Challenge' to Financial Stability*, Coindesk, June 25, 2021, https://www.coindesk.com/us-fed-official-calls-tether-a-challenge-to-financial-stability; Sebastian Sinclair, *China's Central Bank 'Worried' Stablecoins Pose Risk to Financial System*, Coindesk, July 8, 2021, https://www.coindesk.com/china-central-bank-pboc-worried-stablecoins.

[13] Transcript of Chair Powell's Message on Developments in the U.S. Payments System, May 20, 2021, https://www.federalreserve.gov/mediacenter/files/payment-innovation-message-transcript-20210520.pdf.