



FedFin Client Report

Thursday, May 18, 2023

Preemption, SEC Remain Principle Stablecoin Roadblocks

Client Report: CRYPTO44

Executive Summary

Although there were still considerable party-line differences of opinion on stablecoin legislation, today's HFSC Digital-Assets Subcommittee hearing suggests that remaining divides are narrowing, increasing the odds of a new federal-regulatory framework. However, this is not to say that HFSC Members will be able to overcome the most partisan differences – the role of the SEC and federal preemption – or that Sen. Brown (D-OH) will agree to yet another regulatory role for the Fed even if he does decide to advance a bill in this arena.

Analysis

Opening Statements

Chairman Hill (R-AR) emphasized the similarities between the two stablecoin proposals and confidence that bipartisan agreement on legislation would be reached. He also noted that both proposals included [recommendations](#) from Treasury Under-Secretary Liang that stablecoin legislation must include strict requirements for reserves, capital, disclosures, and attestations. Ranking Member Lynch (D-MA) still has concerns with the Republican bill regarding custody, the role of the SEC, consumer protection, CBDC study, CBDC, and preemption.

Testimony

Fennie Wang of Humanity Cash stated that the industry needs a cost-effective regulatory framework with guardrails against bad actors. Matt Homer of the Department of XYZ stressed the importance of ensuring the competitiveness of US-based stablecoins, while Robert Morgan of the USDF Consortium defended the financial inclusion and efficiency benefits of stablecoins. Delicia Reynolds Hand of Consumer Reports also noted the financial inclusion benefits but supported the provisions in Ranking Member Waters' (D-CA) bill allowing the Fed to reject issuers and requiring diversity disclosures. David Portilla of Davis Polk & Wardwell supported permitting nonbank issuers of stablecoins to access Fed services such as the discount window.

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Q&A

- **Preemption:** Chairman Hill and Reps. Davidson (R-OH) and Flood (R-NE) stressed the importance of balancing state and federal regulation, with Mr. Davidson highlighting that legislation will provide a strong federal floor so states cannot “game the system.” Ranking Member Lynch reiterated his concerns about state regulatory arbitrage, claiming that states like New York would be penalized given their stronger regulations. Committee Ranking Member Waters stressed the importance of a provision in her bill allowing the Fed to reject state registered stablecoin issuers, noting its alignment with current bank regulations. Rep. Nickel (D-NC) asked how this power could be narrowed; the witness representing the Department of XYZ noted that the two-tiered approach in place in some foreign jurisdictions could provide a model.
- **Fed Regulation:** Rep. Steil (R-WI) asked if the Fed would regulate a firm that did not issue stablecoins but did conduct other market activities under the Waters’ bill. After the witness representing Davis Polk & Wardwell said it could, Mr. Steil argued that this would fall outside the Fed’s typical regulatory activities and expertise. In response to Rep. Timmons (R-SC) asking if the McHenry bill still gave considerable authority to the Fed, the witness representing Davis Polk & Wardwell replied that it would have authority regarding backstop supervision and enforcement actions. Rep. Torres (D-NY) asserted that, if the Fed regulated stablecoin issuers, then they should not also be under the purview of the SEC.
- **Ties to Banking System:** Citing the Fed’s advisory about a range of crypto risks ([see FSM Report CRYPTO31](#)), Ranking Member Lynch, along with Rep. Casten (D-IL), questioned why crypto should have any ties to the banking system or access to Fed services.
- **Global Competitiveness:** Rep. Davidson argued that denying crypto firms access to the U.S. market drives them overseas, harming US innovation and competitiveness. Rep. Steil argued that a lack of regulatory clarity does the same.
- **Interday Reserve Validation:** Chairman Hill asked whether the technology is available for stablecoin issuers to conduct interday reserve validation; the witness representing the Department of XYZ said it was. Rep. Foster (D-IL) argued that requiring stablecoin issuers to receive reserve attestation from the Fed before conducting a mining operation would be a simpler and more effective method than interday monitoring.
- **Financial Inclusion:** Rep. Rose (R-TN) denounced the provision in Ranking Member Waters’ bill requiring the disclosure of diversity data and asked whether financial inclusion data could indicate a firm’s financial soundness; the witness representing Davis Polk & Wardwell agreed that it did not. Rep. Timmons asked about the consequences of the Waters’ bill allowing the Fed to consider more open-ended or subjective criteria when judging a stablecoin issuer’s application. The witness

representing the Department of XYZ replied it creates regulatory burden and may give the Fed too much discretion.

- **Fraud:** Rep. Sherman (D-CA) continued his campaign against crypto, arguing that private wallets and a regulatory framework that allows firms to choose the weakest state regulator will facilitate fraud. Rep. Timmons pushed back on the connection between state regulation and fraud, noting that the McHenry bill classifies stablecoin issuers as financial institutions for the purposes of BSA, subjecting them to enhanced requirements such as registering with FinCEN and reporting suspicious activity reports.
- **Asset Segregation:** Ranking Member Waters criticized the Republican bill for its lack of oversight of the wallets in which firms would hold stablecoins and asked about the importance to restricting comingling of customer assets. The witness representing Consumer Reports stated that consumers not being made whole from FTX's collapse illustrates the importance of such restrictions.
- **Sanctions and the Dollar's Dominance:** Rep. Sherman argued that enabling stablecoins to succeed as a payment medium erodes the efficacy of sanctions by weakening the dollar's global status. Rep. Nickel asked how legislation could ensure sanctions compliance protect the impact of sanctions; the witness representing the Department of XYZ asserted that sanctions rely on the dollar's dominance and significant stablecoin issuance outside the US would weaken its role. Rep. Torres argued that stablecoins can protect the dollar's dominance, citing that they already outcompete the digital Yuan internationally.
- **Broker Dealers:** Rep. Casten argued that crypto firms registered as broker-dealers should not be able to unilaterally halt trading, aligning them with securities broker-dealers.
- **Howey Test:** Rep. Steil asked if stablecoin issuers expect profits, per the Howey test; the witness representing the Department of XYZ said they do not.
- **Tokenized Deposits:** Rep. Rose asked about the benefits of tokenized deposits; the witness representing the USDF Consortium replied that it enables the banking sector to benefit from the technological advantages of the blockchain.
- **CBDC:** Rep. Rose claimed a CBDC would gravely harm financial privacy and urged an end to its consideration.