NELSON MULLINS

FinTech University

FinTech and Stablecoins

January 9, 2024

Agenda

- Introduction to blockchain
- Regulation of blockchain
- What are stablecoins?
- Presidential Working Group on Stablecoins
- Executive Order on Digital Assets
- SEC regulation of stablecoins
- Regulation of stablecoin trading platforms
- CFTC Regulation of stablecoins

Blockchain

- Changes to the shared database are then reflected in its digitally signed versions, which users can store locally (either in their entirety or with only a subset of transactions/accounts visible).
- Users can then extract the updated information they need for conducting their respective businesses from these locally stored databases.
- Blockchains allow their users to store and access information relating to a given set of assets and their holders in a shared database of either transactions or account balances.
- This information is distributed among users, who could then use it to settle their transfers of, or for example, securities and cash, without needing to rely on a trusted central validation system.
- In financial markets, the substantial de-materialization of securities and cash has progressively shifted the settlement of a trade from the physical delivery and paper-based recording, to a system of book transfers in digital databases.
- What remains unchanged is the need for an authoritative “golden record” of holdings to be kept by specific financial market infrastructures, and for intermediaries involved in the settlement process to update their individual databases by communicating with the other institutions involved, at the different levels of post-trading, in order to be able to reflect the changes in each other’s records.

Restricted v. Unrestricted

- Blockchains can be divided into those which are restricted and those which are unrestricted.
- Restricted blockchains are closed systems whose members are identified and accountable entities.
- Updates to the blockchain can only be proposed and validated by authorized participants.
- In unrestricted blockchains, by contrast, any entity can access the database and, depending on the specific validation method used, may be able to contribute to updating the ledger or to submit spam transactions to cause a denial of service.
- In a restricted blockchain the identity of participants is known, at least by its governance body.
- This implies that any wrongdoer can be identified and his misbehavior can be punished in the case of future activity in the ledger.
- Restricted blockchains also expose the conduct of any participants in the blockchain network to the set of rules and law-enforcement measures that typically apply to off-ledger activity.
- By definition, users of unrestricted blockchains cannot be held accountable outside the distributed ledger for their activity in the network.

What are Stablecoins?

- A stablecoin is a digital asset whose value is pegged, or tied, to a reference asset.
- The reference asset could be a currency, commodity or other financial instrument. Stablecoins are designed to maintain a stable price over time and provide an alternative to more volatile cryptocurrencies.
- The first stablecoin was issued in 2014 and, since then, stablecoins have risen in popularity. Stablecoins were primarily used to buy cryptocurrencies on trading platforms that did not offer fiat currency trading pairs.
- As adoption grew, stablecoins began to be used in several blockchain-based financial services and used to pay for goods and services.
- According to CoinMarketCap, the total market capitalization of stablecoins is estimated to be approximately US$152 billion.

Types of Stablecoins

- Stablecoins use different mechanisms to maintain their price peg.
- The two most common methods are maintaining a pool of reserve assets as collateral or using an algorithmic formula to control the supply of a coin.
- **Collateralized stablecoins**
- Collateralized stablecoins maintain a pool of collateral to support the coin's value.
- The types of collateral could include fiat currency, commodities or other cryptocurrencies.
- For example, the issuer of a stablecoin pegged to the US dollar would maintain US$1 million in reserve to support 1 million units of the stablecoin.
- Whenever the holder of the stablecoin wishes to cash out his or her tokens, an equal amount of the collateralizing asset is taken from the reserve.
- Another example is a crypto-backed stablecoin, which can be issued to launch one asset on a different blockchain.
- For example, Wrapped Bitcoin (WBTC) is a stablecoin pegged to Bitcoin and issued on the Ethereum blockchain.

Types of Stablecoins

- **Algorithmic stablecoins**

- Algorithmic stablecoins maintain their value by controlling the stablecoin's supply through an algorithm.
- Coins are either destroyed (burned) or created (minted) to keep the coin's value in line with the target price.
- For example, if the value of a stablecoin drops from the target price of US$1 to US$0.75, the algorithm will automatically burn a tranche of coins to introduce more scarcity, propping up the price of the stablecoin.
- Alternatively, if the stablecoin's price exceeds that of the target price, new tokens are issued to bring the stablecoin's value down.
- TerraUSD (UST) is an example of an algorithmic stablecoin whose price is pegged at US$1 via the minting and burning of its sister coin Luna.
- TerraUSD is not collateralized – its model operates via the algorithmic minting and burning of Luna tokens each time a UST stablecoin is bought or sold.
- However, in May 2022, TerraUSD suffered the crypto equivalent of a bank run, which resulted in a "de-pegging" of TerraUSD from its US$1 price, sending both the stablecoin and its sister coin close to zero.

Stablecoin Use Cases

- Stablecoins are predominantly used in the United States to facilitate trading, lending and borrowing of other digital assets.
- Stablecoins also allow users to store and transfer value associated with digital asset trading, lending and borrowing within the distributed ledger environment, thus reducing the need for fiat currencies and traditional financial institutions.
- In addition to digital asset trading, several stablecoin issuers seek to have the stablecoins they create be widely used by retail users to pay for goods and services and by corporations in the context of supply chain payments and international remittances.

Presidential Working Group

- On 1 November 2021, a joint task force consisting of senior regulators from the US Department of Treasury, the Federal Reserve Board (Fed), the SEC, the Commodity Futures Trading Commission (CFTC), the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) (collectively, the Presidential Working Group) issued its Report on Stablecoins, evaluating the risks and regulatory gaps presented by stablecoins and recommending several future legislative and regulatory actions on stablecoins.

- The Report on Stablecoins summarized the risks presented by stablecoins and stablecoin-related activity, including loss of confidence in stablecoin value, payment system risks, systemic risk and the concentration of economic power.

- In the Report on Stablecoins, the Presidential Working Group noted:

  - Depending on the facts and circumstances, a stablecoin may constitute a security, commodity, and/or derivative implicating the jurisdiction of the SEC, and be subject to the US federal securities laws, or implicating the jurisdiction of the CFTC, and be subject to the Commodity Exchange Act.

  - The federal securities laws and/or the Commodity Exchange Act may apply to the stablecoin, the stablecoin arrangement, transactions in, and/or participants involved in, the stablecoin or stablecoin arrangement, and/or derivatives of any of the foregoing instruments.

Presidential Working Group

- To that end, the SEC and CFTC have broad enforcement, rulemaking and oversight authorities over transactions and participants falling within their respective jurisdictions to address investor protection and market integrity risks.

- To the extent stablecoin-related activity such as trading, lending, borrowing and other activity falls within the jurisdiction of the Securities and Exchange Commission (SEC) or CFTC, such activity must be conducted in compliance with applicable provisions of the federal securities laws and the Commodity Exchange Act, as well as applicable regulations.

- Since the Report on Stablecoins, the chair of the SEC and other SEC commissioners have indicated in numerous articles that stablecoins are or may be securities, are subject to the jurisdiction of the SEC and that regulation of stablecoins is coming.

- The Report on Stablecoins concludes “legislation is urgently needed to comprehensively address the prudential risks posed by payment stablecoins,” and recommends that Congress “act promptly to enact legislation to ensure that payment stablecoins and payment stablecoin arrangements are subject to a federal prudential framework on a consistent and comprehensive basis.”

- The Report on Stablecoins also recommends legislation requiring stablecoin issuers be insured depository institutions, which would subject them to supervision and regulation at the depository institution level by a federal banking agency and consolidated supervision and regulation by the Federal Reserve at the holding company level.

- Stablecoin issuers thus would be subject to capital and liquidity standards designed to address safety and soundness and guard against stablecoin runs.

Presidential Working Group

- The Report on Stablecoins further recommends legislation requiring all custodial wallet providers and all other entities that perform functional activities within any stablecoin arrangement be subject to federal oversight.

- In the absence of legislation, the agencies forming the Presidential Working Group intend to continue to use their existing authorities to address prudential risks falling within each agency's jurisdiction to the extent possible.

- In evaluating a charter application, the banking agencies will seek to ensure that applicants address the risks outlined by the Report on Stablecoins, including risks associated with stablecoin issuance and other related services conducted by the banking organization or third-party service providers.

- In the context of those stablecoins that are securities, commodities or derivatives, application of the federal securities laws or the Commodity Exchange Act would provide important investor and market protections, as well as transparency benefits.

- The Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) may supervise and enforce federal anti-money laundering and combating the financing of terrorism obligations under the Bank Secrecy Act (BSA) where a stablecoin arrangement also offers money transmission services.

- Following the publication of the Report on Stablecoins, members of Congress have proposed legislation to address the lack of clarity with respect to the regulations of stablecoins.

Executive Order on Digital Assets

- In March 2022, President Joe Biden issued an Executive Order on Ensuring Responsible Development of Digital Assets (the Executive Order).
- The Executive Order called for an interagency effort to formulate policies related to the regulation of digital assets to ensure the safety and soundness of the financial system, to protect consumers, investors and businesses, and to provide broader access to safe and affordable financial services.
- In September 2022, the White House followed the Executive Order with the promulgation of a comprehensive framework for the "responsible development of digital assets."
- Among the key pillars of the framework was fostering financial stability.
- The White House noted the potentially disruptive runs on digital assets if left unregulated and specifically identified the 2022 crash of TerraUSD that effectively led to the erasure of almost US$600 billion in wealth within a few days.
- Accordingly, the White House has called on the Department of Treasury to work with US financial institutions to bolster their capacity to identify and mitigate cyber-vulnerabilities related to digital assets, including stablecoins, and to engage with other regulatory agencies to identify, track and analyze emerging strategic risks related to digital asset markets.

SEC and Stablecoins

- In September 2020, the staff of the SEC's Strategic Hub for Innovation and Financial Technology (FinHub) issued a statement in response to the OCC's Interpretive Letter 1172 noting that stablecoin reserves could constitute securities and subject issuers of such stablecoins to registration, reporting and other requirements under the federal securities laws.

- The FinHub did not provide guidance pertaining to the circumstances where a stablecoin would constitute a security.

- The FinHub stated that whether a stablecoin reserve constituted a security was an "inherently facts and circumstances determination . . . [requiring] a careful analysis of the nature of the instrument, including the rights it purports to convey, and how it is offered and sold."

- The FinHub encouraged stablecoin issuers to contact them with any questions to help ensure that such stablecoins are structured, marketed and operated in compliance with the federal securities laws.

- FinHub's statement notes that the FinHub staff is prepared to engage with market participants and, depending on the specific facts and circumstances, consider providing a "no-action" position regarding whether activities with respect to a specific stablecoin may involve the application of the federal securities laws.

SEC and Stablecoins

- On 4 April 2022, SEC Chairman Gary Gensler, speaking at the Penn Law Capital Markets Association Annual Conference, raised three policy concerns related to stablecoins.

- First, Gensler noted that stablecoins raise public policy considerations regarding financial stability and monetary policy underlying SEC regulations related to money market funds and other securities.

- These considerations include how a stablecoin is backed and the effect the loss of a peg or the failure of an issuer could have on the wider crypto ecosystem.

- Second, Gensler noted that stablecoins raise issues related to their potential use for illicit activity. Specifically, Gensler expressed his concern with a stablecoin's ability to facilitate those seeking to sidestep public policy goals connected to the traditional banking and financial system, such as anti-money laundering, tax compliance and sanctions.

- Third, Gensler noted concerns related to investor protection that could benefit from greater oversight. Gensler expressed his concern with potential conflicts of interest and market integrity questions raised by stablecoins owned by crypto trading and lending platforms where customers have a counterparty relationship with the platform.

- Although Gensler's views are his own and do not constitute formal SEC guidance or rulemaking, Gensler's comments provide insight on the SEC's potential concerns regarding stablecoin regulation.

SEC and Stablecoins

- The SEC has not, to date, taken action to regulate stablecoin issuers or platforms that facilitate the trading of stablecoins.
- SEC Chairman Gary Gensler has said, however, that some stablecoins may qualify as “securities” under federal law—a designation that would subject issuers to registration and reporting requirements.
- Gensler has not elaborated on the details of this assessment, but stablecoins would qualify as securities under existing law if they represent “investment contracts.” In addition, stablecoins may qualify as securities if they represent “notes.” Each category has its own legal test.

Digital Asset Securities

- The definitions of "security" under the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act) are nearly identical, and each is broad enough to include the various types of instruments that are used in commercial marketplaces that one might suspect to fall within the ordinary concepts of a security.

- This would include common instruments like stocks, bonds, and notes, as well as the various collective investment pools and common enterprises devised by persons seeking to generate profits from the efforts and investments of others (i.e. investment contracts and instruments commonly known as securities).

- Section 2(a)(1) of the Securities Act defines a "security" as:

  [A]any note, stock, treasury stock, security future, security-based swap, bond, debenture, evidence of indebtedness, . . . transferable share, ***investment contract***, . . . any put, call, straddle, option, or privilege on any security, certificate of deposit, . . . or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Digital Asset Securities

- Although the term “note” is specifically enumerated in the Securities Acts' definitions of “security,” courts have not found all notes to be securities because notes are used in a variety of contexts.
- A note may function as both a commercial vehicle, which is not a security, as well as an investment vehicle, which courts have deemed to be a security.
- In Marine Bank v. Weaver, 455 U.S. 551 (1982), the U.S. Supreme Court addressed whether the sale of a $50,000 certificate of deposit, with a 6-year maturity that featured a 7.5% interest rate was a security.
- The note also provided that, if the bank permitted early withdrawal, the depositor would earn interest at the bank's current savings passbook rate on the amount withdrawn, except that no interest would be paid for the three months prior to withdrawal.
- The Court noted that while the definition of “security” in the Exchange Act is quite broad, Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud.

Digital Asset Securities

- The Court cautioned, however, "[t]he definition of 'security' in the Exchange Act provides that an instrument which seems to fall within the broad sweep of the Act is not to be considered a security if the context otherwise requires."
- The Court also noted that a certificate of deposit is not the functional equivalent of the withdrawable capital shares of a savings and loan association held to be securities, nor is it similar to any other long-term debt obligation commonly found to be a security.
- The purchaser of a certificate of deposit is virtually guaranteed payment in full, whereas the holder of an ordinary long-term debt obligation assumes the risk of the borrower's insolvency.
- The Court held neither the certificate of deposit nor the agreement in question was a security within the meaning of § 10(b) of the Securities Act.

Regulation of Stablecoin Platforms

- In an April 2021 speech, SEC Chairman Gensler noted:

  I'd briefly like to discuss the intersection of security-based swaps and financial technology, including with respect to crypto assets. There are initiatives by a number of platforms to offer crypto tokens or other products that are priced off of the value of securities and operate like derivatives. ***Make no mistake: It doesn't matter whether it's a stock token, a stable value token backed by securities, or any other virtual product that provides synthetic exposure to underlying securities. These platforms – whether in the decentralized or centralized finance space – are implicated by the securities laws and must work within our securities regime.***

- If a stablecoin is a security, the platform facilitating the sale and secondary trading of the stablecoin may have to register with the SEC as an exchange or a broker-dealer and alternative trading system (ATS).

Securities Exchange

- Section 3(a)(1) of the Exchange Act defines an "exchange" as "any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange."

- Exchange Act Rule 3b-16(a) interprets the definition to mean any organization, association, or group of persons that: (1) ***brings together the orders of multiple buyers and sellers*** and (2) uses established, nondiscretionary methods (***whether by providing a trading facility*** or by setting rules) ***under which such orders interact with each other, and the buyers and sellers entering such orders agree to the terms of a trade***.

- Absent an exemption, an exchange must register as a national securities exchange pursuant to section 6 and section 19(a) of the Exchange Act.

- If a stablecoin is a security, any platform that brings together multiple buyers and sellers of the stablecoin using non-discretionary methods will likely be deemed an exchange.

Alternative Trading System

- In 1998, the SEC adopted Regulation ATS, which allows an ATS to choose whether to register as a national securities exchange or to register as a broker-dealer and comply with additional requirements of Regulation ATS.

- An "alternative trading system" means any organization, association, person, group of persons, or system: (1) that constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange within the meaning of Rule 3b-16 under the Exchange Act, and (2) that does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such organization, association, person, group of persons, or system; or discipline subscribers other than by exclusion from trading.

- A stablecoin platform may be required by the SEC to register as an ATS if it maintains a marketplace or facilities for bringing together purchasers and sellers of digital assets that are deemed securities, and it does not set rules governing the conduct of subscribers other than the conduct of such subscribers' trading on such platform.

- If the platform is not required to register as an ATS, the operator of the platform may be required to register as a broker-dealer.

Broker-Dealer

- Section 15 of the Exchange Act requires registration with the SEC of all broker-dealers using interstate commerce or the facilities of any national securities exchange to effect transactions in securities (other than exempted securities and certain short-term debt instruments).
- Section 3(a)(4)(A) of the Exchange Act defines a "broker" as "any person engaged in the business of effecting transactions in securities for the account of others.
- The Exchange Act and the rules thereunder do not define these terms.
- The courts and the SEC have taken an expansive view of the scope of these terms.
- The SEC and the courts apply a "facts and circumstances" analysis in evaluating whether a person has acted as a broker, with no single element being dispositive.
- The SEC could deem a platform that is facilitating transactions in digital assets to be affecting securities transactions if it is helping an issuer to identify potential purchasers of securities.
- A stablecoin platform that solicits securities transactions and facilitates negotiations between the issuer and the investor could be deemed to be affecting securities transactions. The operator of a stablecoin trading platform that takes, routes or matches orders or facilitates the execution of a securities transaction, could be viewed as effecting transactions in securities.
- Finally, the operator of a stablecoin trading platform that handles customer funds (even if the funds are a digital currency) or securities could be deemed to be affecting transactions.

CFTC Regulation of Stablecoins

- In October 2021, the CFTC settled an enforcement action with stablecoin issuer Tether whose stablecoin USDT claimed to be pegged to the US dollar.
- According to the CFTC, at various times between June 2016 and February 2019, Tether made misleading or untrue statements regarding whether it held sufficient US dollar reserves to fully back up UDST.
- In the settlement order, the CFTC defined a “stablecoin” as a type of virtual currency whose value is derived from a fiat currency.
- In reaching its decision in the settlement order, the CFTC determined that stablecoins, like USDT, fall within the definition of a “commodity” under the Commodity Exchange Act on the basis that courts have ruled that digital currencies fall within the definition of a commodity.
- In the settlement order, the CFTC alleged that since the introduction of USDT in 2014, Tether made numerous public representations that USDT was linked directly to fiat currency.

CFTC
COMMODITY FUTURES TRADING COMMISSION

CFTC Regulation of Stablecoins

- However, according to the settlement order, Tether did not actually hold sufficient fiat currency reserves to back each stablecoin in circulation.
- For example, between 2 September 2016 and 1 November 2018, the order alleges that USDT was only fully backed by actual fiat currency 27.6 per cent of the time.
- The order also alleged that Tether relied on unregulated entities and third parties to hold customer funds, commingled reserve funds with the company's corporate funds and held reserves in non-cash products such as commercial paper and bank repurchase agreements.
- Additionally, according to the settlement order, at least until 2018, Tether utilized a manual process to track its reserves, which did not capture the real-time status of the reserves.
- Furthermore, the settlement order noted that Tether's reserves were not routinely audited.
- As a result of Tether's misrepresentations to customers and the market, the CFTC ordered Tether to pay a civil monetary penalty of US$41 million based upon the CFTC's anti-market manipulation regulations.

CFTC
COMMODITY FUTURES TRADING COMMISSION

OCC Regulation of Digital Assets

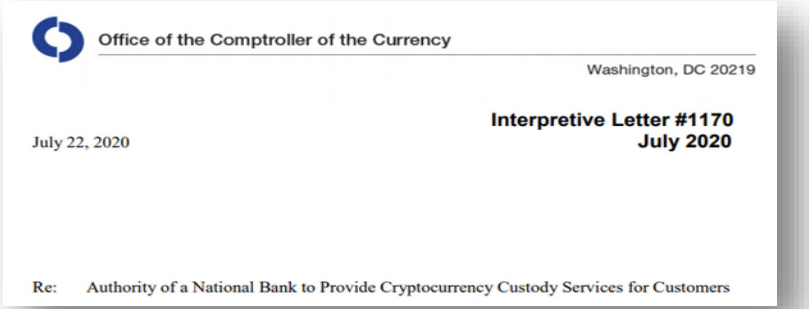
- On July 22, 2020 (the 2020 Letter), the OCC published an **interpretive letter** recognizing that a national bank may provide custody services for cryptocurrencies, including providing storage for the cryptographic keys associated with these assets.

- The 2020 Letter discussed the custody services provided by banks and concluded banks may provide "cryptocurrency custody services, including holding the unique cryptographic keys that permit the control and transfer of the customer's cryptocurrency, is a modern form of these traditional bank activities."

- The 2020 Letter recognized past OCC interpretive letters that authorize national banks to provide similar services such as escrow encryption keys used in connection with digital certificates, and secure web-based document storage, retrieval and collaboration of documents and files containing personal information or valuable confidential trade or business information.

- The 2020 Letter notes providing custody for cryptocurrencies will require a bank to provide custody for cryptographic keys. The OCC reiterated that national banks have the authority to provide custody for this type of digital assets.

- The OCC also affirmed the agency's belief in its own expansive power to "authorize national banks to perform, provide or deliver through electronic means and facilities any activities that they are otherwise authorized to perform."



Office of the Comptroller of the Currency

Washington, DC 20219

July 22, 2020

Interpretive Letter #1170
July 2020

Re: Authority of a National Bank to Provide Cryptocurrency Custody Services for Customers

OCC on Custody of Digital Assets

- National banks have declined to provide custody services for cryptocurrencies and other digital assets because of the lack of clarity on the permissibility of custody of digital assets.
- While some state-chartered trust companies have provided these services, the majority of state banks have also declined to do so because of the lack of regulatory clarity.
- The OCC guidance may expand the number of banks that are willing to provide custodial services for digital assets which will enable more institutions and individuals to invest in digital assets.
- The 2020 Letter may also enable registered investment advisers, which are required to maintain custody of their assets at banks under the Investment Company Act, to hold cryptocurrencies.
- The 2020 Letter may also enable registered investment advisers with retail customers, whose assets are commonly held in brokerage accounts, to advise on cryptocurrencies.
- Finally, the 2020 Letter may enable broker-dealers to hold cryptocurrencies in customer accounts consistent with the requirements of the Customer Protection Rule (Rule 15c3-3), however, this is complicated by the Securities Investors Protection Act of 1970.

SEC Response to 2020 OCC Letter

- On September 21, 2020, the staff of the SEC Strategic Hub for Innovation and Financial Technology (FinHub Staff) issued a **statement** noting the OCC issued a ***limited interpretation*** regarding holding reserves of a stablecoin associated with hosted wallets that is backed by a single fiat currency and redeemable by the holder of the stablecoin on a 1:1 basis for the underlying fiat currency upon submission of a redemption request to the issuer.

- The FinHub reminded firms that whether a digital asset is a security under the federal securities laws is based on a facts and circumstances analysis.

- On December 23, 2020, the SEC issued a **statement and request for comment regarding the custody of digital asset securities** by broker-dealers in order to encourage innovation around the application of the Customer Protection Rule to digital asset securities.

- The statement sets forth the SEC's position that, for a period of five years, a broker-dealer operating under the circumstances set forth in the statement will not be subject to an SEC enforcement action on the basis that the broker-dealer deems itself to have obtained and maintained physical possession or control of customer fully paid and excess margin digital asset securities.

OCC and Digital Assets

- Services Identified by the OCC the 2020 Letter:
  - Crypto-to-crypto exchanges
  - Crypto-to-fiat exchanges
  - Transaction settlement
  - Trade execution
  - Recordkeeping, valuation, and tax services
  - Custodian for the digital assets
  - Custodian for the cryptographic keys in digital or physical forms
- Services could be performed in a fiduciary or non-fiduciary context (the former subject to the trust or custody requirements of national banks).
- All of these services would fall within the “powers” granted to national banks and federal savings banks.

OCC January 2021 Letter

- On January 4, 2021, the OCC published a **Chief Counsel's Interpretative letter** (the 2021 Letter) confirming the authority of national banks' and federal savings associations' to participate in independent node verification networks (INVN) (distributed ledger technology), and use stablecoin cryptocurrency to conduct payment activities and other bank permissible functions.

- The 2021 Letter concludes a national bank or federal savings association may validate, store, and record payments transactions by serving as a node on an INVN.

- A bank may use INVNs and related stablecoins to carry out other permissible payment activities.

Acting Comptroller Brooks stated:

Our letter removes any legal uncertainty about the authority of banks to connect to blockchains as validator nodes and thereby transact stablecoin payments on behalf of customers who are increasingly demanding the speed, efficiency, interoperability, and low cost associated with these products.

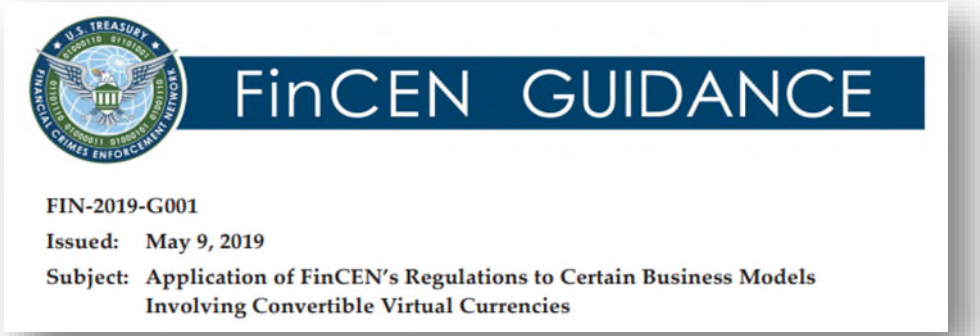
OCC January 2021 Letter

- The use of stablecoins by national banks to effect payments is one step away from authorizing the creation of stablecoins by individual banks.
- A major Japanese bank has created its own yen pegged stablecoin and a major U.S. bank has issued its own stablecoin.
- The National Bank Act passed during the presidency of Abraham Lincoln authorized the creation of national banks.
- Banks were permitted to deposit government bonds with the U.S. Treasury to provide security to back bank notes issued by the individual banks, a new uniform national currency that could be redeemed for gold or silver.
- It was this function which gave the regulator its name “Comptroller of the Currency”
- The authority to issue bank notes was taken from the banks by the Federal Reserve Act of 1913 and conferred on the Federal Reserve Banks which to this day issue Federal Reserve Notes as legal tender which has become the medium of exchange for most all major forms of global commerce.

Other Regulatory Guidance

- **U.S. Banking Agencies**
  - **July 2021:** Federal banking agencies issue **proposed interagency guidance** on how banks should manage third-party relationships.
  - **August 2021**: Federal banking agencies **issue interagency guidance to help community banks evaluate FinTech relationships**.
  - **September 2021:** Federal Reserve publishes **paper describing landscape of partnerships between community banks and FinTechs**.
- **Additional Prudential Efforts**
  - **Presidential Working Group on Financial Markets:** Comprised of top financial regulators to address rapid growth of stablecoins and its potential risks to users.
  - **Bank of International Settlements:** In June 2020, issues **consultative document** exploring the potential prudential treatment of digital asset exposures.

Digital Currencies and FinCen



FinCEN GUIDANCE

FIN-2019-G001

Issued: May 9, 2019

Subject: Application of FinCEN's Regulations to Certain Business Models Involving Convertible Virtual Currencies

- FinCEN Requirements (a quick primer):
  - **Exchanges** (whether digital currency-to-digital currency or fiat-to-digital currency) must register with FinCEN and comply with money transmitter requirements.
  - **Digital currency ATM providers** must comply with BSA/AML and FinCEN requirements for money transmitters.
  - **Mixers or digital currency anonymizers** are money transmitters and are subject to FinCEN registration and requirements.
  - **Digital currency payment processors** do not have exemptions for merchant payment processing is regulated as money transmission.

FinCEN

- Virtual currencies are not created or overseen by a central bank in the manner of traditional currencies.
- The fact that virtual currencies are not subject to traditional regulatory oversight has drawn the attention of federal regulators including the Treasury (through FinCEN), the SEC, and the CFTC.
- FinCEN is delegated authority under U.S. Department of Treasury Order 180-01 to administer the BSA and to thereby regulate money transmission to detect and prevent money laundering, fraud, and other illegal practices.
- FinCEN regulates money services businesses (MSBs) and money transmitters.
- The BSA and FinCEN regulations considers each of the following to be MSBs: currency exchangers; issuers, redeemers, or cashiers of travelers' checks, checks, money orders, or similar instruments; the United States Postal Service; a person who engages as a business in the transmission of funds; and any business or agency which engages in any activity determined by regulation to be an activity similar to, related to, or a substitute for these activities.

Money Transmission

- The term “money transmitter” includes a person that engages in the acceptance of currency, funds, or other value that substitute for currency from one person and the transmission of currency, funds, or other value that substitutes for currency to another location or person by any means.
- It is important to note that the definition of a money transmitter does not differentiate between real currencies and instruments deemed convertible virtual currencies (CVCs).
- A person accepting or transmitting anything of value that substitutes for currency (such as Bitcoin or other digital asset) will be viewed as a money transmitter.
- Any entity or person, including certain foreign-located persons that engage in money transmission in any amount is subject to the BSA rules.
- Persons operating money transmitting businesses must register as such with FinCEN. The failure to register a money transmitting business is a federal offense punishable by civil and criminal penalty.
- The jurisdiction of FinCEN is proscribed under the BSA.

Money Transmission

- Since 2011, FinCEN has regulated money services business models involving money transmission denominated in virtual currencies through a series of administrative rulings and guidance.
- In 2019, FinCEN issued guidance that consolidated its regulations and related administrative rulings and guidance applicable to MSBs utilizing models that involve convertible virtual currencies.
- "Money transmission" includes the "acceptance…of…other value that substitutes for currency."
- The term "other value that substitutes for currency" encompasses transmission activities that do not involve currency, but instead involves something that the parties to the transaction recognize has value that is equivalent to or can substitute for currency, which may include virtual currencies.
- FinCEN defines "virtual currency" as a "medium of exchange that can operate like a currency but does not have all the attributes of "real" currency, including legal tender status."
- The guidance further clarifies that convertible virtual currencies (CVCs) are a type of currency that either has an equivalent value as currency, or acts as a substitute for currency, and is therefore a type of "value that substitutes for currency."
- Accordingly, the definition of money transmitter does not differentiate between real currencies and CVCs.

Money Transmission

- Accepting anything of value that substitutes for currency, such as a digital asset like Bitcoin, therefore makes that person a money transmitter.
- Virtual currencies can be divided into two primary categories: (1) convertible virtual currencies and (2) nonconvertible virtual currencies.
- Nonconvertible virtual currencies are essentially credits that can only be redeemed for products or other services.
- Non-convertible virtual currencies, like Facebook credits, generally cannot be converted into state-issued or government backed currency.
- Convertible currencies, on the other hand, may act as a substitute for real currency and have an equivalent value in real currency.
- These virtual currencies are frequently converted into and exchanged for real currency. Bitcoin is a convertible virtual currency.

Money Transmission

- FinCEN regulation is less about the type of currency involved in a transmission or transaction and more about the process by which the currency is transmitted, the purpose of the transmission and the participants involved in the transmission.

- FinCEN has stated that "[w]hat is material to the conclusion that a person is not an MSB is not the mechanism by which a person obtains the convertible virtual currency, *but what the person uses the convertible virtual currency for, and for whose benefit*".

- FinCEN has stated activities that do not constitute accepting and transmitting currency, funds or the value of funds do not fit within the definition of "money transmission services" and are not subject to FinCEN's registration, reporting, and recordkeeping regulations for MSBs (United States.

- However, a CVC user that wants to purchase goods or services with CVCs it has earned, that pays CVC to a third party at the direction of a seller or creditor, may be engaged in money transmission.

Money Transmission

- FinCEN's guidance defines CVC wallets as "interfaces for storing and transferring CVCs."
- There are different wallet types that vary according to the technology employed, where and how the value is stored, and who controls the value.
- Wallets where user funds are controlled by third parties are called "hosted wallets," whereas wallets where users control the funds are called "unhosted wallets."
- FinCEN states that the regulatory obligations of persons that act as intermediaries between the owner of value and the value itself (i.e., a money transmitter) is technology agnostic.
- Determining the regulatory treatment of a digital wallet depends on four criteria: (i) who owns the value; (ii) where the value is stored; (iii) whether the owner interacts directly with the payment system where the CVC runs; and (iv) whether the person acting as intermediary has total independent control over the value.

Money Transmission

- FinCEN refers to the participants in generic virtual currency arrangements, using the terms “user, ” “exchanger,” and “administrator”.
- A user is a person that obtains virtual currency to purchase goods or services. How a person engages in “obtaining” a virtual currency may be described using any number of other terms, such as “earning,” “harvesting,” “mining,” “creating,” “auto-generating,” “manufacturing,” or “purchasing,” depending on the details of the specific virtual currency model involved. For purposes of the guidance,
- FinCEN has noted the label applied to a particular process of obtaining a virtual currency is not material to the legal characterization under the BSA of the process or of the person engaging in the process.
- An exchanger is a person engaged as a business in the exchange of virtual currency for real currency, funds, or other virtual currency.
- An administrator is a person engaged as a business in issuing (putting into circulation) a virtual currency, and who has the authority to redeem (to withdraw from circulation) such virtual currency.

Federal Regulation of Stablecoins

- Currently, there is no comprehensive nationwide regulatory framework for stablecoins.
- There is uncertainty as to whether stablecoins should be regulated as securities by the SEC or as commodities by the CFTC.
  - On June 5, 2023, the SEC sued Binance for offering and selling BUSD (US dollar-backed stablecoin) as an unregistered security. The SEC alleged that Binance improperly marketed and touted BUSD as a profit-generating instrument by promising interest payments to investors who merely held BUSD on the Ethereum blockchain.
  - On October 15, 2021, the CFTC settled charges with the companies that created the stablecoin Tether for alleged misrepresentations regarding the reserves backing the stablecoin. The order against the Tether companies required them to pay a $41 million fine and cease and desist from further violations of the CEA.
- There are several proposed bills
  - On July 27, 2023, H.R. 4766, the Clarity for Payments Stablecoins Act of 2023, passed out of committee with a bipartisan vote and is now on the floor of the House of Representatives for consideration.
  - The bill would require the U.S. Federal Reserve write requirements for issuing stablecoins while preserving the authority of state regulators.

State Regulation of Stablecoins

- Several states have adopted legislation permitting entities to issue stablecoins.
- For example, in New York, stablecoin issuers can operate as a state-chartered trust company, such as a limited purpose trust company under the New York Banking Law.
- On June 8, 2022, the New York Department of Financial Services (DFS) issued its Guidance on the Issuance of U.S. Dollar-Backed Stablecoins (DFS Guidance), which outlined general requirements for USD-backed stablecoins issued by issuers subject to DFS oversight.
- The DFS Guidance focused on three areas of requirements: redeemability; reserves; and attestations.
- In September 2023, Paypal (that holds Bitlicense issued by DFS), in partnership with Paxos, launched PayPal USD (PYUSD).

Central Bank Digital Currencies

- At the end of 2019, central banks representing a fifth of the world's population reported that they were likely to issue CBDCs in the near future.
- The number of central banks that are likely to issue a retail CBDC over the next couple of years doubled in 2019, to 20%.
- By October 2020, 80% of surveyed central banks indicated that they are engaging in research, experimentation or development of CBDCs.
- The interest in CBDCs appears to have been fuelled by the COVID-19 pandemic.
- Eighty-one countries that represent over 90% percent of global GDP are now exploring a CBDC.
- In May 2020, only 35 countries were considering a CBDC.
- A January 2021 report by the Bank of International Settlements indicated that of the 65 central banks surveyed in 2020 regarding their interest in CBDC, over 55 of them were exploring general purpose (i.e., retail) CBDC, of which 15 have either launched, piloted or are in the very advanced stages of exploring CBDCs.
- Safety measures such as social distancing, public concerns that traditional currencies may transmit the COVID-19 virus, and new government-to-person payment schemes have accelerated the use of digital payments.

CBDC Models

Retail CBDC

- A retail CBDC would be a digital liability of a central bank that can be used by the public.
- A retail CBDC instrument would not be commercial bank money, credit cards, or mobile payment application balances because it would be a liability of the central bank.
- A retail CBDC would be different from traditional currency because it would only exist in digital form.

Wholesale CBDC

- Wholesale CBDC is a digital liability of a central bank that is limited to certain financial institutions and is not available to the general public.
- Wholesale CBDC is designed for use by financial institutions and is similar to traditional central bank reserve and settlement accounts.

Centralized v. Decentralized

Centralized Ledger

- A centralized ledger would require an intermediary to manage and transfer the liabilities, which likely would mean, for the United States, the Fed (as the U.S. central bank) would serve as the intermediary and be the controller of token distribution and/or account management.
- In a token-based system, the Fed would take on the role of the validator for the technology that facilitates the distribution of the CBDC.
- In an account-based system, centralization would mean that the Fed would serve as the administrator of all accounts and would take on the responsibility of verifying all account holders.

Decentralized Ledger

- A decentralized ledger refers to a system where the central bank delegates responsibility to other parties (like private commercial banks).
- In a token-based system, third parties (such as commercial banks) would replace the central bank as validators within the technology infrastructure that facilitates the transfer and validation of CBDC-based transactions.
- In an account-based system, decentralization involves third parties that are responsible for managing user accounts.

Where to Look When Moving to Digital

- **OCC: Office of Innovation –** Established in January 2017, implements a framework supporting responsible innovation that enhances the safety and soundness of the federal banking system, treats customers fairly, and promotes financial inclusion.

- **FDIC: FDiTech –** Established in 2019 to collaborate with community banks on how to deploy technology in delivery channels and back-office operations to better serve customers. In February 2021, the FDIC appointed its first Chief Innovation Officer to lead the FDiTech team and to promote the adoption of innovative technologies across the financial services sector.

- **Federal Reserve: Innovation Policy –** Established in 2019 to support responsible innovation among regulated institutions and in the financial markets broadly.

- **SEC: FinHub –** Coordinates the SEC's oversight and response regarding emerging technologies in financial, regulatory, and supervisory systems, including in the areas of distributed ledger technology (for example, digital assets), automated investment advice, digital marketplace financing, and artificial intelligence/machine learning.

- **CFTC: LabCFTC –** Focal point for the CFTC's efforts to promote responsible FinTech innovation and fair competition for the benefit of the American public. LabCFTC is designed to be the hub for the agency's engagement with the fintech innovation community.

UK Regulation of Fiat-Backed Stablecoins

- The UK government is also currently legislating in the Financial Services and Markets Act 2023 (FSMA 20**23**) to introduce a regime that will allow for the regulation of fiat-backed stablecoins which are used for payments, similar to that for other payment methods given that these stablecoins have the potential to become widely used as a form of payment.

- This is part of what HM Treasury refer to as "Phase 1" in relation to cryptoasset regulation. The regime will address issuance and custody activities relating to fiat-backed stablecoins as well as payment-related activities for those fiat-backed stablecoins which are used in payments.

- The regime will address issuance and custody activities relating to fiat-backed stablecoins as well as payment-related activities for those fiat-backed stablecoins which are used in payments.

- These digital settlement assets (DSA) are defined as a digital representation of value or rights, whether or not cryptographically secured, that —

  - can be used for the settlement of payment obligations

  - can be transferred, stored or traded electronically, and

  - uses technology supporting the recording or storage of data (which may include distributed ledger technology).

Presenter Biographies

KEVIN TRAN

Kevin assists financial institutions and technology clients with financial regulatory, securities, and corporate matters. He focuses on the representation of early stage, mid-stage, and publicly traded FinTech companies focused on blockchain technology, digital assets, and cryptocurrencies, including broker-dealers, digital asset and currency trading platforms, digital asset custodians, alternative trading systems, and securities exchanges and swap execution facilities.

BOBBY WENNER

Bobby counsels financial services and technology firms on financial services regulatory and corporate matters. He focuses on the representation of financial technology companies working with blockchain, tokenization, digital assets, and cryptocurrencies, including broker-dealers, alternative trading systems (ATS), digital asset and currency trading platforms, digital asset issuers and custodians, securities exchanges, and derivatives trading platforms including swap execution facilities.

Moderator Biography

RICHARD B. LEVIN

Richard is chair of the FinTech and Regulation Practice and was one of the first lawyers to focus on the regulation of blockchain and digital assets. He is considered a thought leader in the FinTech space. Richard brings his experience as a senior legal and compliance officer on Wall Street and in London to bear in advising clients on corporate, FinTech, securities, and regulatory issues. A problem-solver by nature, he has been advising FinTech clients on legal and regulatory issues since the start of electronic trading in the late 1990s. His practice focuses on helping financial services and technology clients identify and address regulatory issues as they build their businesses.

Richard's practice focuses on the representation of early stage and publicly traded companies in the FinTech space, including investment banks, broker-dealers, investment advisers, peer-to-peer lending platforms, digital currency trading platforms, alternative trading systems (ATSs), exchanges, and custodians. He represents these firms before the U.. Securities and Exchange Commission (SEC), the U.S. Commodity Futures Trading Commission (CFTC), the Financial Industry Regulatory Authority (FINRA), the U.S. Department of the Treasury, Office of the Comptroller of the Currency (OCC), state regulators, and Congress. Richard has represented clients before regulators in Australia, Canada, France, Germany, Hong Kong, Ireland, Japan, Singapore, South Korea, and the United Kingdom. His current and past clients include leading national financial institutions, multinational financial services holding companies, leading firms in the FinTech space, and institutions engaging in global investment banking, investment management, securities, and other financial services with institutional clients.

Richard has been identified by Chambers and Partners as one of the leading lawyers in the Blockchain and Cryptocurrencies category since the inception of the category. He has been recognized by Chambers for his knowledge on regulatory matters, great relationships with regulators, for helping clients push the boundaries of the FinTech sector, and for his advice on matters such as broker-dealer licensing and alternative trading systems. Richard is routinely quoted by leading publications including Bloomberg, the New York Times, Reuters, and the Wall Street Journal and is a frequent speaker at conferences around the world on the regulation of FinTech, blockchain, and digital assets.

Contact Details

To learn more about our FinTech and Regulation practice, or to contact a member of our team, click here or visit our website at nelsonmullins.com.

To learn more about this presentation, please contact:

Richard B. Levin
1400 Wewatta Street
Suite 500
Denver, CO 80202
Tel. 303.583.9929
richard.levin@nelsonmullins.com

Kevin Tran
1222 Demonbreun Street
Suite 1700
Nashville, TN 37203
Tel. 615.664.5322
kevin.tran@nelsonmullins.com

Bobby Wenner
1400 Wewatta Street
Suite 500
Denver, CO 80202
Tel. 303.583.9907
bobby.wenner@nelsonmullins.com

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