The Crypto Exchange: Unpacking the Lummis-Gillibrand Payment Stablecoin Act: Implications for the Digital Asset Industry
Speakers: Ethan Ostroff and Addison Morgan

Ethan Ostroff:

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Today, I'm excited to be joined by my colleague, Addison Morgan, for a discussion about the newest bill on the hill about stablecoins, the Lummis-Gillibrand Payment Stablecoin Act, which was just introduced on April 17th.

Addison, thanks for joining me today. I thought we start just with a little bit of a high-level discussion, right? By way of background, this bill is intended to create a state and federal regulatory framework for how stablecoins issued by US companies would be overseen, how they could maintain their peg, spoiler alert, by banning algorithmic stablecoins completely, details in FDIC process for possible collapses, and how consumers might be protected.

This is not the first time we've seen digital asset-related legislation, obviously, from these two senators. They authored two iterations so far of their Responsible Financial Innovation Act, which attempts to create a more holistic comprehensive regulatory framework for the digital asset industry.

Now, there were some press releases they issued indicating their belief that getting a regulatory framework on the books for stablecoins is really important to maintain the US dollar's dominance, to promote responsible innovation, protect consumers. They did also mention that cracking down on money laundering and illicit finance, right? Two issues that have been top of line for many people in Congress very recently, given the activities particular in the last 8, 10 months internationally, and intending to preserve the dual banking system, which is an interesting mention I thought.

Now, Addison, I thought it was very interesting. It seemed like the immediate reaction from industry was that, obviously, there's focus on the blanket ban on algos, right? Algorithmic stablecoins. But also no accounting for crypto-backed tokens like DAI that exist out there. Also, I thought interesting that not a lot of coverage for foreign company-issued tokens and not a lot of indication about why it is the senators think that malign actors will no longer have the option to use unregulated foreign stablecoins passing through the US financial system.

Also, there's a $10 billion limit or the stablecoin issuer would need to be a state or federally-chartered depository institution. I mean, that already affects certain players in the space who are

already above that limit. It's very questionable to me about whether or not these people could ever get any type of state or federally-chartered depository approval.

I guess maybe we could start, Addison, by talking about the ban on algorithmic stablecoins. I mean, is it your sense that while the bill has good intentions, it's sort of fallen short of that goal of promoting innovation while protecting consumers and deterring illicit finance by adopting a total ban?

Addison Morgan:

Yes and no. Like you alluded to earlier, the kind of categorical ban on algorithmic stablecoins, I think this is something that I understood what happened. I think it's just very surprising to see it in ink in the bill. As we know in the senator's first digital asset-related legislation, the Responsible Financial Innovation Act, which they released the second iteration back in 2023, in that bill, they prohibited or by virtue of limiting issuance of stablecoins to depository institutions. They by extension prohibit private stablecoin issuers from issuing stablecoins. I don't think the categorical ban on algorithmic stablecoins is far-fetched from what the senators were already – kind of the policy they were already adopting.

I think it does stifle innovation. Like the point you made earlier, these products, respect to algos, they're still going to exist in the DeFi space, whether that be in the US or whether that be overseas. So we can kind of just rip the mandate off and move to the TerraUSD-Luna discussion. I assume that this ban is based on the $20 billion of value that was lost in the crash of that protocol. But the way I look at it is that, well, there was $20 billion of value locked in that protocol at a certain point in time.

To me, what the market is saying is that market participants want access to an algorithmic stablecoin. In the land of DLT and digital assets, free market dynamics really drive a participant decision. I think the senators here are making a decision on behalf of traditional financial institutions that they would not want to enter this space and in a safe responsible and systematic way provide the general public with access to an algorithm stablecoin.

Now, obviously, with algos, it will be very difficult to kind of comply with the pre-existing regulations these financial institutions are subjected to like the BSA, for example, which we'll likely discuss later. But the bill does promote innovation because this is the first time we've ever had a stablecoin regulatory framework presented.

But at the same time, I think that the senators could have adopted the approach that Patrick McHenry, the Chairman of the House Financial Services Committee, adopted in his stablecoin bill back in 2023 which was called The Clarity for Payment Stablecoins Act, where in that act he kind of presents a two-year moratorium on the issuance of stablecoins, algorithmic stablecoins. He directs the US Treasury to engage a variety of studies, respect to the possible algorithms because the burn and mechanism that TerraUSD relied on is not the only algorithmic stablecoin framework that one could adopt. There are a multitude that exists today. I just think there are certain other things that the senators could have looked at before just categorically banning algos altogether.

Ethan Ostroff:

Yes. I mean, to me, it seems like they're kind of picking the winners and losers here, right? I mean, they're not going to push algos completely out of the DeFi space simply by trying to regulate stablecoins issued by US-based entities, right? The rest of the world will continue to innovate around the various different ways of creating algorithmic stablecoins and continue to progress further along that path, while companies who are issuing them in the States will be left behind, right?

Addison Morgan:

Exactly.

Ethan Ostroff:

I mean, I guess, now that we sort of talked about what these senators want to basically take off the menu, right? Maybe we talk a little bit about what they do want to permit and how they want to go about creating a regulatory framework for reserve-backed stablecoins.

Addison Morgan:

Sure. Yes. Like you just mentioned, the only type of stablecoins permitted under the bill are reserve-backed stablecoins. Here, the eligible reserves are your typical legal tender, so US dollars. But they also – kind of surprisingly, I don't think I saw this in the rFIA. They are also permitting demand deposits now and treasury bills and repo agreements. I think they alluded to this, too, in the press release, but it seems that the senators are really trying to maintain the status quo with respect to just how the traditional financial system works. Taking that entire framework and really just integrating it into the digital asset industry.

I mean, demand deposits as collateral, I mean, that's what banks do today. In the fractional reserve banking system that we live in, T-bills will always be a very liquid and a very, very dependable form of collateral. As you noted earlier, like I said, with respect to promoting Innovation, I think there could have been some carve-out for crypto-collateralized stablecoins like a DAI, which has never really crashed. I know that price fluctuates minimally in between 99 cents and a little bit over a dollar, depending on market conditions. But DAI has been around for a very long time and has never had a down draw like Terra Luna had, where we're losing basically $20 billion of value in a very short period of time.

Ethan Ostroff:

Yes. To me, it just smacks off trying to overlay traditional finance onto the space and then simply say no to things that don't fit into those particular round holes that have already been carved. Maybe we could talk a little bit about some of the specifics, right? Some more of the specifics, right? For example, the bill identifies entities that can issue stablecoins, right? Basically, non-depository trust companies and depository institutions that have been authorized as a national stablecoin issuer. Are there exceptions here, or is that it?

Addison Morgan:

No. There are no exceptions. Your point about taking the traditional financial model and just overlaying it onto the digital asset industry is a good one because, yes, the only entities that are permitted to issue stablecoins under the bill are non-depository trust companies. I mean, there are certain jurisdictions that provide charters for these type of companies. We know the NYDFS has a trust charter, and there are a few digital asset-related companies who have already obtained those charters. I think Wyoming also does, too.

The second category entities, depository institutions, I believe the bill defines that term or the bill extracted that term from the Federal Reserve Act. We're dealing with traditional banks that have FDIC insurance and the like.

Ethan Ostroff:

Right. Depository institutions would need to be authorized as a national stablecoin payment issuer to issue stablecoins under the bill. Is there a process that's laid out for this?

Addison Morgan:

Yes. The funny thing about the bill is that even if you are a non-depository trust company or a depository institution for that matter, you're not automatically permitted to issue stablecoins. There is an application process. Both entities would have to obtain authorization from their prudential regulators, which under the bill could be the OCC for national banks or depository institutions. Then it could also be an analogous state banking supervisor or the Federal Reserve.

For non-depository trust companies, they must obtain authorization from a state banking supervisor before issuing stablecoins. After that happens, they have to submit a registration form with the Federal Reserve. Then they're good to go, assuming that the state banking supervisor actually approves their application. For depository institutions, they have to obtain authorization from either the OCC or a state banking supervisor, depending on their charter.

It’s really just encapsulating that dual banking system that we already live in, right? The OCC charters national banks, and you can still obtain a charter from regular state banking supervisor if you don't want to become a national bank. For those institutions, after approval is obtained, they must apply to the FED for authorization to become a national payment stablecoin issuer. Only depository institutions are permitted to become a national payment stablecoin issuer.

Ethan Ostroff:

Got you. When we talk about non-depository trust companies versus national payment stablecoin issuers, there's this limit on the value of stablecoins a non-depository trust company can issue, right? Cannot exceed 10 billion. If it issues more than 10 billion, it's got to get that depository institution charter. Then we mentioned some of the different regulators that would be involved here in the process of getting approval, right? How does the bill then treat supervisory and enforcement authority over payment stablecoin issuers?

Addison Morgan:

Yes. Non-depository trust companies are regulated by state banking supervisors in the FED, and that's how it works currently in the traditional financial system framework. Then national payment stablecoin issuers are regulated by the OCC. If you're a national bank and you want to issue stablecoins, the OCC will be your regulator. If you're a state charter bank and you want to issue stablecoins, the state banking supervisor will be your regulator. Depending on the circumstances, the Federal Reserve would come in and have supervisory authority over both.

Ethan Ostroff:

Got you. Just sort of drawing this full circle, in the Responsible Innovation Act, Lummis and Gillibrand focused on increasing consumer protection, in particular in the digital asset industry. Does this bill further that objective in some way?

Addison Morgan:

Yes, I think it does. It definitely supplements the rFIA greatly in my opinion. The first thing that these payment stablecoin issuers are required to do is segregate consumer assets. Due to the pausing of withdrawals and the dissolution of the digital asset financial services companies in the past, segregation has been an issue, I think, at top of mind for state and federal regulators alike. Here, they just have a simple carve-out. That title of a payment stablecoin if you're offering custodial services to consumers, that title of those coins belong to the consumers. You can't draft any contractual provisions to try to work around that carve-out.

The next one is prohibition on rehypothecation. This is another one that we witnessed a ton of digital asset financial services companies doing last year and maybe in a little bit of 2022 as well, where I will permit consumers to deposit their digital assets onto my platform. But in that, I am utilizing those assets as collateral to take out loans myself, being the company. The bill just prohibits that from happening.

The next one is another very fascinating topic of this idea of proof of reserves. As we know, the industry had been calling for some sort of cryptographically provable proof of reserves where we can have proof of reserves on chain and publicly transparent for all to see. Here, the senators decided to take a different approach. Proof of reserves have to be publicly disclosed, right? But the CFO of a digital asset financial services company, he or she is required to file that same public disclosure of the company's standing with respect to its reserves. He has to file that summary with the FED under penalty of perjury.

I think that's the senators kind of splitting the baby, so to speak. Well, no, we're not going to require these entities to cryptographically prove the reserves backing their stablecoins. But what we'll do is we'll just have the CFO kind of put his neck out on the line and say, “Hey, this is where our proof of reserves are here this month.”

The next kind of section is the disclosures to consumers. As we know, the FDIC has been very vocal about these companies making certain misrepresentations with respect to federal deposit insurance. Here, the only disclosure the senators are requiring these companies to make is that they say, one, payment stablecoins are not guaranteed by the US government. Then, two, these stablecoins are also not subject to FDIC insurance or insurance offered by the National Credit

Administration. Companies that make misrepresentations about FDIC insurance will be held liable under the Federal Deposit Insurance Act.

Then lastly, and this is a point we alluded to earlier, Ethan, during our discussion is about treatment under the BSA. This is one of the primary reasons I don't think algorithm stablecoins will ever be kind of formally legitimized in the US because it's very difficult to. Because those stablecoins are run entirely by smart contracts, it would be very difficult to comply with certain requirements under the BSA like, for example, suspicious activity reports, CTRs, et cetera.

Here, it says that payment stablecoin issuers will be treated as financial institutions under the BSA, meaning that all of the kind of activities that traditional financial institutions have to engage in to comply with the BSA, those activities now apply to their issuance of stablecoins as well.

Ethan Ostroff:

Got you. Very interesting stuff. Thanks for going through all that, Addison. Really appreciate your time and joining me today. One, I also want to thank our audience for listening to today's episode. Don't forget to visit our blogs and subscribe, so you can get the latest updates. Make sure to subscribe to this podcast via Apple Podcasts, Google Play, Stitcher, or whatever platform you use. Until next time.

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