May 17, 2022

Fundamental Safeguards for Stablecoins and the Cryptoasset Market

The recent collapse of the UST "stablecoin" and associated Luna tokens is but the latest of several shocks to the cryptoasset market. Despite this grave incident, the market capitalization of cryptoassets still exceeds $1.3 trillion, and over 10% of Americans are estimated to own cryptoassets. It is incumbent on U.S. policymakers and agencies to adopt appropriate regulation, tailored to the overall market risk and relevant participants. Several months ago, we highlighted certain deficiencies and risks associated with the cryptoasset market. The UST/Luna situation merits further commentary on these matters, as new laws and regulations are being considered under President Biden's Executive Order on Digital Assets.

UST and Luna tokens were functionally exchangeable. UST tokens are so-called "algorithmic" stablecoins designed to maintain a constant market price of $1 by incentivizing arbitrage with $1 worth of Luna, which is another token — with a floating price — created by the same developers. When this arrangement functioned as intended, if the price of a UST token dropped below $1, traders would be incentivized to purchase UST for the lower price and reduce UST supply by surrendering a unit of it for $1 worth of Luna; and if the price of a UST token exceeded $1, traders would be incentivized to buy Luna and increase UST supply by surrendering $1 worth of Luna for a unit of UST. Importantly though, neither UST nor Luna was backed by fiat currency reserves (although an entity associated with their developer acquired partial bitcoin reserves). Unfortunately, beginning May 9, 2022, the algorithm was unable to cope when the value of UST and Luna tokens *both* sharply dropped in a self-reinforcing manner, likely spurred by one or more investors with a large short position. This exact risk had been publicly identified by some market observers. But UST and Luna tokens were available on centralized exchanges for purchase by U.S. retail investors, who did not have the benefit of risk disclosure regarding the structural vulnerabilities that ultimately contributed to the crash.

These events highlight pressing challenges in the cryptoasset market that warrant immediate attention:

- *Clear lines of regulatory authority*. Reform in this arena must begin with the identification or creation of a federal regulatory agency with clear responsibility for oversight of centralized cryptoasset markets. Currently, even where cryptocurrency exchanges are chartered by state financial authorities and subject to bank-like supervision, they are not subject to broader market controls and reporting. The SEC does not regulate market activities involving nonsecurities, and the CFTC does not regulate spot markets in commodities. Consequently, despite the SEC's assertions that some cryptoassets available on centralized exchanges are securities, at bottom those cryptocurrency exchanges are currently operating under the active supervision of neither the SEC nor the CFTC. The practice of regulation by enforcement, or accounting bulletins, is not sustainable. To be in the position to foster market integrity and prevent further risks to both retail and institutional investors, there must first be action — legislative or otherwise — to allocate regulatory authority clearly.

- *Define stablecoin requirements*. In addressing stablecoin risks, any cryptoasset used as a medium of exchange and with a purportedly stable value peg to a fiat currency should be subject to heightened regulation. Similar to any consumer financial product, there should be a clear set of standards for stablecoins regardless of their specific design, including whether they may be digital representations of deposits solely issued by banks and eligible for federal deposit insurance, registered money market funds subject to all of the related obligations, or products issued by licensed money transmitters or nondepository trust companies and subject to the relevant federal and state regulations and specific reserve requirements. Also, similar to any consumer financial product, there should be clear, advance disclosure of both the risks related to the stablecoin and the rights of holders in the event of an issuer's failure. We acknowledge that such strict regulation may be at odds with an orthodox vision of decentralized finance — but the manifest risks are too great to abide, and it is possible to protect privacy in connection with broader stablecoin adoption (as proposed, for instance, in a recent Senate bill).

- *Promotion of market integrity*. To promote an efficient and fair market, the appropriate regulatory body should consider implementing trading controls and a new regulation akin to Regulation NMS (the SEC's regulation that modernized the national market system for equity securities). While the cryptoasset market is global and much trading activity occurs on decentralized exchanges, the bulk of U.S. retail investors trade through domestic centralized exchanges — retail investors doing so should have the benefit of best price execution and similar protections. And while burgeoning collective efforts from within the crypto industry have contributed meaningfully to the conversation on selected issues, these efforts have yet to coalesce into holistic industry-driven solutions on par with the self-regulatory organizations within traditional financial markets. Any such regulation should be tailored to foster market innovation and technological progress, while prioritizing investor protection.

- *Enhanced disclosure to protect investors*. Setting aside the ongoing vigorous debate about whether particular assets available on some centralized exchanges constitute securities, none, as a practical matter, are presently registered with the SEC (or any other agency) with the attendant investor protection disclosures. Without prejudice to any issuer disclosure obligations that may apply in relevant circumstances, a regulator could require that centralized exchanges provide customers with regimented disclosure for the cryptoassets in which they make markets, including with respect to the known individualized risks associated with a particular token project. While any such mandated disclosure by exchanges should not be tantamount to SEC registration statements or carry the equivalent of issuer or underwriter disclosure liability, investors should have ready access to the information necessary to make informed investment decisions, without bearing the full onus of doing their own research.

Appropriately applied, blockchain technology has potential to remake significant aspects of the economy, offer efficiencies, and generate bottom-up wealth, all with the U.S. at the vanguard. While the path of technological progress is always paved with incremental failures, this must not include failure to adopt an appropriately balanced regime that can ensure fair and orderly markets and protect investors.

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