

## Bank Runs in the Digital Economy: The Need for Stablecoin Regulation

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### I. INTRODUCTION

The images that come to mind for most Americans when they think of a “bank run” are set in a historical context. Images of Depression-era masses racing to withdraw their deposits from local savings and loan banks have been embedded in popular culture in movies such as Frank Capra’s *It’s a Wonderful Life*.<sup>1</sup> Most do not think of bank runs as a contemporary problem because we have effectively eliminated their risk with modern deposit insurance. However, the recent popularization of stablecoins, which are digital assets that act more like bank products than securities, has brought with it evidence that the risk of bank runs remains with us via the crypto economy.<sup>2</sup>

There has been much debate in the past decade in regard to what is the most appropriate regulatory framework for cryptocurrencies.<sup>3</sup> Like other financial instruments, cryptocurrencies should not be

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<sup>1</sup> *IT’S A WONDERFUL LIFE* (Paramount Pictures 1946).

<sup>2</sup> See, e.g., Song Jung-a, *Retail Investors Become Vigilantes in Hunt for Crypto’s Most Wanted Man*, FIN TIMES, <https://www.ft.com/content/1a7d82ff-9986-4890-99e8-048940ce8553> (Oct. 19, 2022) (describing the hunt for the creator of TerraUSD, a stablecoin that recently experienced a coin run, leaving depositors with a total loss).

<sup>3</sup> See, e.g., Aaron Klein, *The Future of Crypto Regulation: Highlights From the Brookings Event*, BROOKINGS (Aug. 11, 2022), <https://www.brookings.edu/2022/08/11/the-future-of-crypto-regulation-highlights-from-the-brookings-event/> (explaining that the question of “[w]hether crypto is a security or commodity remains unclear, as various subcomponents of the crypto ecosystem challenge existing regulatory divisions. For instance, the SEC recently argued that nine different crypto tokens were securities in an insider trading case while a federal judge ruled that virtual currency like Bitcoin constitutes a commodity.”).

regulated wholesale, but rather classified specifically based on the characteristics of the token in question. Stablecoins, the focus of this Comment, are cryptocurrencies without volatility. In order to be utilized as a predictable store of value and reliable medium of exchange, stablecoins aim to hold their peg to a consistent price regardless of market conditions.<sup>4</sup> This Comment first explores the characteristics of custodial stablecoins; then examines the largest stablecoin issuer, Tether, and its legal problems in the United States; and finally considers the potential application of banking regulation on custodial stablecoin issuers in the United States.

Cryptocurrencies have exploded in number and value in the past decade. At over nine hundred billion dollars, the combined value of crypto assets today exceeds the market capitalizations of most companies, commodities, and even the combined stock markets of many nations.<sup>5</sup> Like all crypto assets, stablecoins have flown under the regulatory radar. Recently, however, there has been growing support for the regulation of stablecoins using modern banking law as a model.<sup>6</sup>

Bank products—structurally similar to stablecoins—were historically susceptible to the “bank run,” in which depositors, fearful that their bank may fail and therefore lose their savings, withdraw their deposits *en masse*.<sup>7</sup> The phenomenon was in many ways a self-fulfilling prophecy: if the public withdrew their money from the bank, it may cause the bank to collapse, regardless of the bank’s financial well-being when the fear began.<sup>8</sup> A bank collapse was catastrophic to the economy beyond the failed institution itself, affecting businesses and individuals who rely on banks for capital, credit, and other financial services.<sup>9</sup> However, the risk of bank runs has nearly disappeared since the creation of the Federal Deposit Insurance Corporation (“FDIC”) in 1933.<sup>10</sup> Today, the public has little need to fear that they will lose their savings because the U.S. Federal Government insures their deposits. In exchange for this security, banks must adhere to stricter supervision

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<sup>4</sup> See *infra*, Section II.B.

<sup>5</sup> COINMARKETCAP, <https://coinmarketcap.com/> (last visited Mar. 3, 2023) (displaying cryptocurrency token prices in real-time) [hereinafter *CoinMarketCap*]; see *Market capitalization of listed domestic companies (current US\$)*, THE WORLD BANK, <https://data.worldbank.org/indicator/CM.MKT.LCAP.CD> (last visited Mar. 3, 2023) (listing the combined market capitalizations of many advanced economies, many of which (for example, Sweden, Singapore, and Russia), are valued at less than the combined crypto asset market capitalization of nine hundred billion dollars).

<sup>6</sup> See *infra*, Section IV.

<sup>7</sup> MICHAEL S. BARR, ET AL., *FINANCIAL REGULATION: LAW AND POLICY* 236 (2016).

<sup>8</sup> See BARR, ET AL., *supra* note 7, at 236.

<sup>9</sup> See BARR, ET AL., *supra* note 7, at 236.

<sup>10</sup> BARR, ET AL., *supra* note 7, at 240.

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and restrictions on their operations. The U.S. Government should require bank charters to issue stablecoins to avoid the mistakes of the past and mitigate the risk of bank runs resurfacing in the digital economy.

In the past two years alone, crypto assets have received regulatory interest from bank regulators including the Office of the Comptroller of the Currency (“OCC”),<sup>11</sup> the FDIC,<sup>12</sup> and the Federal Reserve (“The Fed”),<sup>13</sup> as well as from securities and derivatives regulators including the Securities and Exchange Commission (“SEC”)<sup>14</sup> and the Commodity Futures Trading Commission (“CFTC”).<sup>15</sup> There has also been controversy in courts, including enforcement actions by state attorneys general<sup>16</sup> and federal civil litigation.<sup>17</sup> While cryptocurrencies are subject to government oversight under current regulatory frameworks, it is an uncomfortable fit because of their unique characteristics. Additionally, businesses in the crypto industry have been immature at best and fraudulent at worst in compliance with existing laws and regulations. This innovative and rapidly growing sector of the economy demands greater clarity and new approaches from preexisting regulatory frameworks; but not all crypto assets are the same. Like traditional financial instruments, the specific kind of oversight a

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<sup>11</sup> Letter from Jonathan Gould, Senior Deputy Comptroller & Chief Couns., Off. of the Comptroller of the Currency (July 22, 2020) (available at <https://www.occ.gov/topics/charters-and-licensing/interpretations-and-actions/2020/int1170.pdf>).

<sup>12</sup> Press Release, Bd. of Governors of the Fed. Rsrv. Sys, Fed. Deposit Ins. Corp., Off. of the Comptroller of the Currency, Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps (Nov. 23, 2021) (available at <https://www.fdic.gov/news/press-releases/2021/pr21096a.pdf>).

<sup>13</sup> See *Fed’s Powell ‘Legitimately Undecided’ on Central Bank Digital Currency*, REUTERS (July 15, 2021), <https://www.reuters.com/business/finance/feds-powell-says-hes-undecided-central-bank-digital-currency-2021-07-15/#:~:text=%22I%20am%20legitimately%20undecided%20on,for%20the%20U.S.%20central%20bank>.

<sup>14</sup> See *SEC v. Ripple Labs, Inc.*, No. 20-CV-10832 (AT)(SN), 2021 U.S. Dist. LEXIS 69563, at \*2–3 (S.D.N.Y. Apr. 9, 2021).

<sup>15</sup> Matt Robinson, *Tether’s Latest Black Eye is CFTC Fine for Lying About Reserves*, BLOOMBERG NEWS (Oct. 15, 2021, 11:00 AM), <https://www.bloomberg.com/news/articles/2021-10-15/tether-bitfinex-to-pay-fines-totaling-42-5-million-cftc-says?srnd=cryptocurrencies>.

<sup>16</sup> See Press Release, N.Y. Atty. Gen., Attorney General James Ends Virtual Currency Trading Platform Bitfinex’s Illegal Activities in New York (Feb. 23, 2021) (available at <https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinex-illegal>).

<sup>17</sup> See, e.g., *In re Tether & Bitfinex Crypto Asset Litig.*, 576 F. Supp. 3d 55 (S.D.N.Y. Sept. 28, 2021).

cryptocurrency asset is subject to is dependent on its specific characteristics.

This Comment will explore attempts by regulators to construct a legal framework to supervise stablecoins within a crypto economy that is becoming an increasingly prevalent portion of the economy at large. Stablecoins, like bank deposits, can be subject to bank runs, which can have potentially serious effects on those holding the asset as well as on the larger economy. Tether, one of the first stablecoin issuers, has struggled to comply with U.S. law, and regulators have struggled to enforce it. The lack of clarity on this subject in current law can be detrimental to consumers, markets, and the issuers themselves.

The first section of this Comment will introduce the crypto-economy, stablecoins' place in it, and the largest stablecoin: Tether. The second section will provide detailed background regarding Tether's investigation and litigation with the Office of the Attorney General of the State of New York, showing the legal and financial challenges facing stablecoin issuers today. The third section will examine recent interest in adopting banking law as a framework for the potential regulation of stablecoins. The fourth section will explore banking regulation in the U.S. and potential issues that lawmakers and regulators may consider in attempting to apply it to stablecoin issuers.

## II. BACKGROUND

Growth in the field of blockchain technology has been exponential based on all measurable factors. For example, the market value of all crypto assets surpassed one trillion dollars at one point in 2021.<sup>18</sup> One nation has even adopted Bitcoin as its official state currency, and there is speculation about what country will be first to follow suit.<sup>19</sup> The following section will provide a brief introduction to blockchain technology in general, and stablecoins in particular, and also explore the characteristics and uses for stablecoins within this rapidly growing financial ecosystem. This section will conclude by delving deeply into the history, structure, and problems faced by the largest stablecoin, Tether.

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<sup>18</sup> COINMARKETCAP, *supra* note 5.

<sup>19</sup> See Caitlin Ostroff, *El Salvador Becomes First Country to Approve Bitcoin as Legal Tender*, WALL ST. J. (June 10, 2021, 6:10 PM), [https://www.wsj.com/articles/el-salvador-becomes-first-country-to-approve-bitcoin-as-legal-tender-11623234476?mod=Searchresults\\_pos7&page=1](https://www.wsj.com/articles/el-salvador-becomes-first-country-to-approve-bitcoin-as-legal-tender-11623234476?mod=Searchresults_pos7&page=1); see, e.g., Despina Karpathiou, *Which Country Will Follow El Salvador to Make Bitcoin Legal Tender?* YAHOO! FIN. (Dec. 26, 2021), <https://au.finance.yahoo.com/news/which-country-elsalvador-bitcoin-legal-tender-023003901.html>.

*A. Cryptocurrencies operate on blockchain technology, an inventive form of mass public accounting that was introduced by Bitcoin.*

Cryptocurrency was introduced in 2008 in the form of Bitcoin, a “peer-to-peer version of electronic cash [that] allow[s] online payments to be sent directly from one party to another without going through a financial institution.”<sup>20</sup> Unlike traditional financial transactions, cryptocurrency transactions are not run through a bank or other intermediary charged with verifying transactions. Crypto transactions occur and complete automatically via computer software and are verified on blockchains.<sup>21</sup> For purposes of this Comment—exploring the legal issues surrounding stablecoins—only a brief and general background follows.

Blockchains are shared digital ledgers that record every transaction across a peer-to-peer network.<sup>22</sup> Blockchains themselves are the long series of past transactions, linked together by the algorithm, but they also contain the source code of the network.<sup>23</sup> The essential innovation that blockchains introduced is that they maintain a trustworthy record of ownership rights, similar to how banks have traditionally maintained ledgers of their own. Blockchain ledgers, however, are replicated and distributed publicly, allowing all users to verify that everyone agrees on the balances of each user’s wallet without having to rely on a centralized institution.<sup>24</sup> Therefore, a crypto asset is, at its core, “nothing more than an entry in a ledger[,]” specifying that a particular user has ownership of the asset in question.<sup>25</sup>

Each group of transactions occurring within a specified time period is recorded as a “block” of data on these shared, chronological chains of past transactions, although methods for doing so vary by blockchain.<sup>26</sup> “The blocks confirm the exact time and sequence of transactions, and

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<sup>20</sup> SATOSHI NAKAMOTO, BITCOIN: A PEER-TO-PEER ELECTRONIC CASH SYSTEM 1 (2008).

<sup>21</sup> *See id.*

<sup>22</sup> *Making Sense of Bitcoin, Cryptocurrency and Blockchain*, PWC, <https://www.pwc.com/us/en/industries/financial-services/fintech/bitcoin-blockchain-cryptocurrency.html> (last visited Mar. 5, 2023).

<sup>23</sup> *See, e.g.*, Stuart D. Levi & Alex B. Lipton, *An Introduction to Smart Contracts and Their Potential and Inherent Limitations*, HARV. L. SCH. FORUM ON CORP. GOV. (May 26, 2018), <https://corpgov.law.harvard.edu/2018/05/26/an-introduction-to-smart-contracts-and-their-potential-and-inherent-limitations/>.

<sup>24</sup> Shaanan Cohney et al., *Coin-Operated Capitalism*, 119 COLUM. L. REV. 591, 603 (2019).

<sup>25</sup> *Id.* at 602.

<sup>26</sup> *See What is Blockchain Technology?*, IBM, <https://www.ibm.com/topics/what-is-blockchain> (last visited Mar. 5, 2023).

the blocks link securely together to prevent any block from being altered or a block being inserted between two existing blocks.”<sup>27</sup>

Different blockchains vary in how they handle the critical task of deciding which users will update the distributed ledger with new blocks and receive payment for doing so. This Comment only describes “proof-of-work” blockchains, but other structures exist to achieve the same end of a trusted public ledger that is continuously updated without the need for a central authority.<sup>28</sup>

The first blockchains were created based on proof-of-work technology. Proof-of-work is achieved by participating computers, or “nodes”, racing each other to solve complex cryptographic equations.<sup>29</sup> In proof-of-work, the network selects the fastest node to solve the problem to validate the previous block of data.<sup>30</sup> Cryptocurrency rewards incentivize the nodes, or “miners”, to expend their time and energy solving the puzzle and winning the block; today, the miner that wins the block receives 6.25 Bitcoin (or about \$122,000, at the time of writing).<sup>31</sup> On the Bitcoin blockchain, a new block is generated about every ten minutes.<sup>32</sup> Therefore, the winning node will be tasked with verifying the transactions of the past ten minutes and publishing them to the blockchain.<sup>33</sup> On the Ethereum network, in comparison, blocks are added to the chain an average of every twelve seconds.<sup>34</sup> While this process is valuable because it creates a decentralized ledger and can

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<sup>27</sup> *Id.*

<sup>28</sup> See, e.g., Brian Nibley, *Proof of Stake: A Process Used to Validate Crypto Transactions Through Staking*, BUS. INSIDER, <https://www.businessinsider.com/proof-of-stake> (Jul. 8, 2022) (discussing how proof of stake blockchains verify their ledgers through consensus, as opposed to competition).

<sup>29</sup> E. Napoletano, *Proof of Work Explained*, FORBES, <https://www.forbes.com/advisor/investing/cryptocurrency/proof-of-work/#:~:text=The%20%E2%80%9Cwork%E2%80%9D%20in%20proof%20of,or%20transactions%20to%20the%20blockchain> (last visited Mar. 3, 2023).

<sup>30</sup> See *id.*; Scott J. Shackelford & Steve Myers, *Block-by-Block: Leveraging the Power of Blockchain Technology to Build Trust and Promote Cyber Peace*, 19 YALE J. L. & TECH. 334, 346 (2017).

<sup>31</sup> Adam Hayes, *What Happens to Bitcoin After All 21 Million Are Mined?*, INVESTOPEDIA, <https://www.investopedia.com/tech/what-happens-bitcoin-after-21-million-mined/> (Mar. 5, 2022); see COINMARKETCAP, *supra* note 5 (listing Bitcoin as trading for \$19,480 on October 23, 2022).

<sup>32</sup> Kenny L., *The Blockchain Scalability Problem & the Race for Visa-Like Transaction Speed*, MEDIUM: TOWARDS DATA SCIENCE (Jan. 30, 2019), <https://towardsdatascience.com/the-blockchain-scalability-problem-the-race-for-visa-like-transaction-speed-5cce48f9d44>.

<sup>33</sup> *Proof of Work Explained*, *supra* note 29.

<sup>34</sup> Paul Wackerow (@wackerow), *Blocks*, ETHEREUM, <https://ethereum.org/en/developers/docs/blocks/#:~:text=Block%20time%20refers%20to%20the,is%20evaluated%20after%20each%20block> (last visited Mar. 3, 2023).

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provide banking services to anyone with access to an internet connection, transaction times are slow, and the process can use an outsized amount of energy.<sup>35</sup>

Bitcoin and all other tokens are today collectively referred to as “crypto assets.” While Bitcoin remains by far the largest cryptocurrency by market capitalization, thousands of other assets have been created since its establishment.<sup>36</sup> Some crypto assets act as their own independent network, while others function like applications within another network. For example, the stablecoin Tether is not a blockchain itself like Bitcoin, but a crypto asset originally built to run on the Bitcoin blockchain.<sup>37</sup>

Bitcoin represents only about forty percent of the total market capitalization of the over 21,000 crypto assets trading at the time of writing.<sup>38</sup> In contrast, at the start of 2016, Bitcoin accounted for over ninety percent of the value of all crypto assets.<sup>39</sup> These collective crypto assets are exchanged within blockchains without action by a centralized institution, but they are also bought and sold on centralized exchanges that facilitate trading between blockchains and between users. Centralized cryptocurrency exchanges (“CEX”) are platforms on which people can trade crypto assets and also exchange fiat currency (e.g., U.S. dollars for crypto assets, and vice versa).<sup>40</sup> Popular CEX platforms today include Coinbase, Robinhood, Binance, and Bitfinex.

Crypto assets initially aimed to act as traditional money and had similar functions: “a medium of exchange . . . a store of value . . . and a unit of account to compare the value of goods and services.”<sup>41</sup> One issue that has delayed widespread cryptocurrency adoption along these ambitious lines has been their volatility; cryptocurrencies have been

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<sup>35</sup> See John Huang et al., *Bitcoin Uses More Electricity Than Many Countries. How Is That Possible?* N.Y. TIMES (Sep. 3, 2021), <https://www.nytimes.com/interactive/2021/09/03/climate/bitcoin-carbon-footprint-electricity.html>.

<sup>36</sup> See, e.g., COINMARKETCAP, *supra* note 5 (listing many of the crypto assets available today).

<sup>37</sup> TETHER, FIAT CURRENCIES ON THE BITCOIN BLOCKCHAIN 4 [hereinafter *Tether Whitepaper*].

<sup>38</sup> *Market Cap BTC Dominance*, TRADING VIEW, <https://www.tradingview.com/symbols/CRYPTOCAP-BTC.D> (last visited Mar. 8, 2023); COINMARKETCAP, *supra* note 5 (Coinmarketcap keeps a real-time counter on its home page that tracks the number of unique crypto tokens in circulation, labeled “Cryptos”).

<sup>39</sup> *Market Cap BTC Dominance*, *supra* note 38.

<sup>40</sup> Robert Sistros, *Post-Etherdelta: Clarifying Liabilities for Cryptocurrency Exchanges and Market Participants*, 39 CARDOZO ARTS & ENT. L.J. 343, 346 (2021).

<sup>41</sup> Jess Cheng, *How to Build a Stablecoin: Certainty, Finality, and Stability Through Commercial Law Principles*, 17 BERKELEY BUS. L.J. 320, 322 (2020).

especially susceptible to large and sudden changes in value. For example, Bitcoin lost half its value between April and June of 2021, only to gain it back in October 2021.<sup>42</sup> It is not uncommon for Bitcoin to gain or lose more than ten percent of its value in a matter of hours.<sup>43</sup> As stability is a critical requirement for a successful currency, volatility has been a significant barrier to widespread adoption.<sup>44</sup> One answer to the problem of volatility and unpredictability in crypto markets is the stablecoin.

*B. Stablecoins aim to introduce certainty into volatile cryptocurrency markets.*

A stablecoin can be broadly defined as “a digital asset that has mechanisms to maintain a low deviation of its price from a target price” that represents the price of a physical asset such as a currency or a commodity.<sup>45</sup> Stablecoins are cryptocurrencies without volatility; they are digital assets that are pegged to a value and aim to forever be worth that amount. For example, one tether token (“USDT”) is pegged to the dollar and attempts to always be worth one U.S. dollar.<sup>46</sup> While in reality Tether’s USDT coin has fluctuated in value (trading as low as \$0.91 at times), thousands of USDTs are changing hands today for exactly one dollar each.<sup>47</sup> There are many iterations of these presumably “safe” and stable tokens existing today on blockchains throughout the world, for example Circle’s USDC, Binance’s BUSD, and MakerDAO’s DAI. While there are also many categories of stablecoin classifications that are based on stablecoins’ technical and economic structure, all stablecoins share the fundamental quality of being purportedly forever worth the same amount, whether that is one dollar, one ounce of gold sterling, or one “ether” per stablecoin.<sup>48</sup> While an investor may not be sure if one

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<sup>42</sup> See, e.g., COINMARKETCAP, *supra* note 5.

<sup>43</sup> See, e.g., MacKenzie Sigalos, *Bitcoin’s Wild Price Moves Stem From its Design—You’ll Need Strong Nerves to Trade it*, CNBC, <https://www.cnbc.com/2021/bitcoins-wild-price-moves-stem-from-its-design-youll-need-strong-nerves-to-trade-it/> (May 20, 2021, 12:49 PM) (covering the day that Bitcoin lost more than thirty percent of its value in one day).

<sup>44</sup> See Cheng, *supra* note 41, at 326.

<sup>45</sup> Joachim Zahnentferner et al., *Djed: A Formally Verified Crypto-Backed Pegged Algorithmic Stablecoin*, INPUT OUTPUT GLOBAL (2021), <https://eprint.iacr.org/2021/1069.pdf> [hereinafter *Djed Whitepaper*].

<sup>46</sup> Tether Whitepaper, *supra* note 37.

<sup>47</sup> Djed Whitepaper, *supra* note 45, at 2; see also *Tether*, COINMARKETCAP, <https://coinmarketcap.com/currencies/tether/> (last visited Mar. 8, 2023) (depicting the current and past trading prices of USDT).

<sup>48</sup> See, e.g., TETHER OPERATIONS LTD., TETHER GOLD A DIGITAL TOKEN BACKED BY PHYSICAL GOLD 1 (Jan. 28, 2022).

bitcoin will be worth, for example, \$20,000 or \$40,000 in the near future, stablecoin holders presume that their stable crypto assets will remain the same value regardless of market forces. While the value of one bitcoin has swung between \$20,000 and \$40,000, one tether is always worth \$1.<sup>49</sup>

There are multiple uses for stablecoins in today's market, including as a form of payment, but their main function is typically to be used as a safe haven for cryptocurrency traders in times of wider market volatility.<sup>50</sup> If a speculator believes that their crypto asset will decrease in value in the near term, they can exchange it for stablecoins whose value they expect to remain stable. Additionally, stablecoins serve economic functions within decentralized finance ("DeFi") by acting as the critical stable half of an asset pairing when users provide liquidity on certain decentralized exchanges ("DEX").<sup>51</sup> Providing liquidity to a DEX pool allows exchanges to operate without market makers or broker-dealers, and allows holders of crypto assets to earn a percentage of transaction fees incurred by the DEX as it fills orders from users, earning yield for liquidity depositors on their otherwise idle crypto assets but often locking them from withdrawal for a period of time.<sup>52</sup> The future value of a stablecoin is supposed to be easily calculated, and this certainty allows investors to make less risky asset pairs when they deposit into a DEX liquidity pool. The specifics of DEXs and the role of stablecoins within them are complex; it is important to note that stablecoins serve crucial functions within decentralized systems aside from being a stable store of value.

Stablecoins can be organized into two categories: custodial and non-custodial.<sup>53</sup> Custodial stablecoins are by far the most prolific based on both total value and transaction volume. The three most valuable stablecoins by market capitalization are custodial, initially designed as fiat-backed and one-to-one pegged to the U.S. Dollar.<sup>54</sup> At the time of

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<sup>49</sup> See COINMARKETCAP, *supra* note 5.

<sup>50</sup> See John M. Griffin & Amin Shams, *Is Bitcoin Really Un-Tethered?* SSRN, Oct. 2019 at 1.

<sup>51</sup> Alex Behrens, *USD Coin and AMMs: The Role of USDC in DeFi Trading*, CIRCLE BLOG (June 11, 2021), <https://www.circle.com/blog/usd-coin-and-amms-the-role-of-usdc-in-defi-trading> ("Stablecoins play a significant role in decentralized finance (DeFi), allowing investors and liquidity providers to mitigate volatility risk while gaining exposure to various digital assets and generating yields.").

<sup>52</sup> See *id.*

<sup>53</sup> Ariah Klages-Mundt et al., *Stablecoins 2.0: Economic Foundations and Risk-based Models*, 2ACM CONF. ON ADVANCES IN FIN. TECH. 59 (Oct. 2020) [hereinafter *Stablecoins 2.0*].

<sup>54</sup> See *Top Stablecoin Tokens by Market Capitalization*, COINMARKETCAP, <https://coinmarketcap.com/view/stablecoin/> (last visited Mar. 8, 2023) (noting the market capitalizations of USDT, USDC, and BUSD).

writing the major custodial stablecoins include Tether's USDT, Circle's USDC and Binance's BUSD.<sup>55</sup> Of the seventy-five stablecoins tracked by CoinMarketCap.com as of the start of 2022, these three coins represent over eighty percent of the value.<sup>56</sup>

A custodial stablecoin is one that requires trust in a third party to maintain reserves.<sup>57</sup> Tether Holdings Limited ("Tether Limited" or "Tether"), for example, is the entity that issues USDTs in exchange for dollars and claims to hold those dollars in reserve.<sup>58</sup> A person who wishes to exchange one tether for one dollar can do so by giving Tether Limited one tether and will receive in exchange their one dollar from Tether's reserves.<sup>59</sup> This exchange requires trust in the custodial stablecoin issuer to maintain sufficient liquidity to perform these transactions, which are much like withdrawal of a bank demand deposit.

While a custodial stablecoin reintroduces the traditional idea of trust in a centralized institution, in contrast a non-custodial stablecoin aims to have no entity controlling it and can be characterized as one which "replace[s] this trust with economic mechanisms."<sup>60</sup> While the variety and innovation in this field are abundant, this Comment is restricted to discussion of custodial stablecoins.

Tether is a ripe example of a custodial stablecoin because it was among the first stablecoins, has the widest adoption, and has faced the most scrutiny. In addition, Tether has uniquely embodied a caricature of what would make regulators nervous. Throughout a global race to find banking institutions to work with, Tether has been alleged to have committed acts that modern financial regulation is aimed to prevent, including opaque financial disclosure and conflicted lending and trading practices.<sup>61</sup> Through the lens of Tether's troubles, it is clear that the U.S. Government must act to regulate custodial stablecoin issuers to protect not only the U.S. consumer, but also the global financial system.

*C. Tether was the first stablecoin to achieve widespread use under the custodial stablecoin issuer model but encountered early*

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<sup>55</sup> *Id.*

<sup>56</sup> *Id.* (depicting total stablecoin market capitalization in the high one-hundred-billion-dollar range).

<sup>57</sup> Stablecoins 2.0, *supra* note 53, at 1.

<sup>58</sup> Tether Whitepaper, *supra* note 37, at 4.

<sup>59</sup> Tether Whitepaper, *supra* note 37, at 4.

<sup>60</sup> Stablecoins 2.0, *supra* note 53, at 1.

<sup>61</sup> *Infra* Section III.

*problems.*

Tether was created in 2014 with the merging of two distinct companies: a Santa Monica startup called Realcoin,<sup>62</sup> and a stablecoin project run by Giancarlo Devasini, who was an executive at an offshore Bitcoin exchange called Bitfinex.<sup>63</sup> Devasini is a controversial figure, as a former plastic surgeon and early Bitcoin advocate, who helped build Bitfinex, one of the world's largest cryptocurrency exchanges.<sup>64</sup> Eventually, Devasini and a select group of others at Bitfinex would buy the others' entire stake in Tether.<sup>65</sup>

Tether was first issued "as a solution to a problem plaguing the crypto market: banks didn't want to open accounts for virtual-currency exchanges because they feared touching funds tied to drug trafficking, cyberattacks and terrorism."<sup>66</sup> By accepting Tether, exchanges were able to provide users with a stable asset and means to move funds between exchanges without utilizing traditional banks.<sup>67</sup> There is some evidence, however, that the actual motivations were more basic. The original Bitfinex stablecoin, which partnered with and ultimately absorbed Realcoin to become Tether, was allegedly created because engineers at Bitfinex wanted to increase profits from arbitrage between exchanges, according to Bitfinex's current CTO.<sup>68</sup> The creators likely required an asset nimble enough to be quickly transferred on blockchains but stable enough to hold value between Bitcoin trades, and Bitfinex's original Tether was born.<sup>69</sup>

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<sup>62</sup> Michael J. Casey, *Dollar-Backed Digital Currency Aims to Fix Bitcoin's Volatility Dilemma*, WALL ST. J., <https://www.wsj.com/articles/BL-MBB-23780> (July 8, 2014, 5:42 PM).

<sup>63</sup> Zeke Faux, *Anyone Seen Tether's Billions?*, BLOOMBERG BUSINESSWEEK (Oct. 7, 2021, 5:00 AM), <https://www.bloomberg.com/news/features/2021-10-07/crypto-mystery-where-s-the-69-billion-backing-the-stablecoin-tether#:~:text=There%20are%20now%2069%20billion,not%20an%20unregulated%20offshore%20company>.

<sup>64</sup> Kadhim Shubber & Siddharth Venkataramakrishnan, *Tether: The Former Plastic Surgeon Behind the Crypto Reserve Currency*, FIN. TIMES (July 15, 2021), <https://www.ft.com/content/4da3060c-8e1a-439f-a1d7-a6a4688ad6ca>.

<sup>65</sup> Faux, *supra* note 63.

<sup>66</sup> Tom Schoenberg et al., *Tether Executives Said to Face Criminal Probe into Bank Fraud*, BLOOMBERG NEWS (July 26, 2021), <https://www.bloomberg.com/news/articles/2021-07-26/tether-executives-said-to-face-criminal-probe-into-bank-fraud>.

<sup>67</sup> *Id.*

<sup>68</sup> *Stablecoin Innovation, Regulation, and Mainstream Potential with Paolo Ardoino*, RELAY CHAIN, at 7:30-9:30 (Mar. 2021), <https://relaychain.fm/31-tether-stablecoin-paolo-ardoino> (current Tether CTO speaking).

<sup>69</sup> *See id.*

The combination of Realcoin and Tether adopted the name of the latter, already in development at Bitfinex.<sup>70</sup> Within a year of the creation of Tether, the Realcoin team became concerned about potential liability, including, for example, anti-money-laundering laws that had already alienated traditional banks from the cryptocurrency exchanges.<sup>71</sup> As a result, they sold their stake completely to the Bitfinex executives, including Bitfinex CEO Jean-Louis van der Velde as well as Bitfinex's *de facto* leader, CFO Giancarlo Devasini.<sup>72</sup>

Bitfinex is a company that runs the offshore cryptocurrency exchange of the same name. The leak of the so-called "Paradise Papers" in 2017 revealed that Bitfinex and Tether are owned and operated by the same small group of individuals, including Giancarlo Devasini and Jean-Louis van der Velde.<sup>73</sup> Following Bitfinex's complete acquisition of Tether from the Realcoin team in 2015, the modern Tether began accepting fiat currency in exchange for USDT and trading on Bitfinex.<sup>74</sup>

1. Tether's design has become the model for subsequent custodial stablecoin issuers to follow.

Tether Limited had marketed its stablecoin product, from inception until recently, as "always backed one-to-one, by traditional currency held in our reserves."<sup>75</sup> According to Tether's Whitepaper, there are five steps in the lifecycle of a tether. First, "users deposit fiat currency into Tether Limited's bank account."<sup>76</sup> Second, Tether Limited generates USDT coins and credits the user's tether account on the blockchain.<sup>77</sup> The third step in the lifecycle is users interacting with each other by exchanging tethers on "a [peer-to-peer] open-source, pseudo-anonymous, Bitcoin based platform."<sup>78</sup> In the fourth step in the lifecycle, according to Tether in 2015, the end-user holding the USDT "deposits tethers with Tether Limited for redemption into fiat currency."<sup>79</sup> Fifth, "Tether destroys the tethers and sends fiat currency

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<sup>70</sup> Faux, *supra* note 63.

<sup>71</sup> Faux, *supra* note 63.

<sup>72</sup> Faux, *supra* note 63.

<sup>73</sup> *Tether Holdings Limited, Offshore Leaks Database*, INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS, <https://offshoreleaks.icij.org/nodes/82024464> (last visited Mar. 8, 2023) [hereinafter *Paradise Papers*].

<sup>74</sup> Faux, *supra* note 63.

<sup>75</sup> *Tether*, WEB ARCHIVE (Feb. 19, 2019) <https://web.archive.org/web/20190219054619/https://tether.to/>.

<sup>76</sup> Tether Whitepaper, *supra*, note 37, at 7.

<sup>77</sup> Tether Whitepaper, *supra*, note 37, at 7.

<sup>78</sup> Tether Whitepaper, *supra*, note 37, at 8.

<sup>79</sup> Tether Whitepaper, *supra*, note 37, at 8.

to the user's bank account."<sup>80</sup> According to the Whitepaper, "the main concept to be conveyed . . . is that Tether Limited is the only party who can issue tethers into circulation (create them) or take them out of circulation (destroy them)."<sup>81</sup> This lifecycle naturally results in Tether holding a lot of cash in reserve, to "back" its issued tether tokens.

Tether did not begin publicly reporting on the state of these reserves until 2017 when it hired Friedman LLP ("Friedman"), a New York-headquartered accounting and consulting firm to conduct an audit.<sup>82</sup> Friedman concluded, in a preliminary Memo, that Tether had cash reserves to back all of its issued tethers, which at the time amounted to \$442,481,760.<sup>83</sup> The auditor compared the number of tether tokens issued to the dollars held in Tether's bank accounts, but notes that "[Friedman] did not evaluate the terms of the above bank accounts and makes no representations about the Client's ability to access funds from the accounts or whether the funds are committed for purposes other than Tether token redemptions."<sup>84</sup> The Memo is six pages long, including a two-page background section.<sup>85</sup> In short, the Friedman audit was the lowest level of transparency that Tether thought would be necessary to ensure continued confidence in the USDT token.

Friedman was supposed to continue auditing Tether's reserves, but the two parted ways in January of 2018, at which time a Tether spokesman told Coindesk that "[g]iven the excruciatingly detailed procedures Friedman was undertaking for the relatively simple balance sheet of Tether, it became clear that an audit would be unattainable in a reasonable time frame."<sup>86</sup> It appears that Friedman needed more information to provide an assurance than Tether was willing or able to deliver. While it is not known what caused the bad blood between Friedman and Tether, it is clear that Tether had hit a roadblock in its first attempt at having a third party support its claims of fully backed reserves.

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<sup>80</sup> Tether Whitepaper, *supra*, note 37, at 8.

<sup>81</sup> Tether Whitepaper, *supra*, note 37, at 8.

<sup>82</sup> *Auditor Engagement*, BITFINEX (May 5, 2017), <https://www.bitfinex.com/posts/202>.

<sup>83</sup> Memorandum Regarding Consulting Services Performed, Friedman LLP (Sept. 28, 2017) (available at [https://blog.bitmex.com/wp-content/uploads/2018/02/Final-Tether-Consulting-Report-9-15-17\\_Redacted.pdf](https://blog.bitmex.com/wp-content/uploads/2018/02/Final-Tether-Consulting-Report-9-15-17_Redacted.pdf)).

<sup>84</sup> *Id.*

<sup>85</sup> *See id.*

<sup>86</sup> Marc Hotchstein, *Tether Confirms Its Relationship with Auditor has 'Dissolved'*, COINDESK (Jan. 27, 2018, 6:43 PM), <https://www.coindesk.com/markets/2018/01/27/tether-confirms-its-relationship-with-auditor-has-dissolved/>.

2. Tether encountered early hurdles in securing access to traditional banking.

Tether Limited does a lot of business with cash, and therefore requires access to traditional banking networks; but from its launch in 2015 until 2018 Tether existed largely in the world of offshore cryptocurrency exchanges, and did its banking with progressively less reputable institutions in nations with more relaxed banking regulation.<sup>87</sup> In this same period, the number of USDTs issued and outstanding exploded from under one million tethers in 2015 to over two billion tethers in 2018, an increase of 2,000 percent.<sup>88</sup> Each tether in circulation is supposed to represent one dollar deposited to Tether Limited in the first step of a tether's lifecycle. Therefore, the bank accounts of Tether Limited, now known to be interconnected to the owners of Bitfinex, should have amassed over two billion dollars in reserves by 2018.

During this same period between 2015 and 2018, Bitfinex and Tether owners reportedly began having banking problems.<sup>89</sup> Tether Limited and Bitfinex initially did their banking with four Taiwanese banks, with Wells Fargo in the U.S. acting as a correspondent bank that processed international wire transfers for Tether from the Taiwanese banks.<sup>90</sup> According to a lawsuit filed by Bitfinex and Tether against Wells Fargo, the U.S. bank had ceased accepting transfers for Bitfinex and Tether through the Taiwanese banks as of March, 2017.<sup>91</sup> During this period of public uncertainty for Bitfinex and Tether, USDT hit its lowest price to-date, trading as low as \$0.91 per tether in April, 2017.<sup>92</sup> Subsequently, Bitfinex and Tether reportedly partnered with a new bank in Puerto Rico called Noble Bank International, LLC ("Noble Bank"), which allowed the company to continue accepting deposits and issuing tethers; the news stabilized the price back to \$1.<sup>93</sup>

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<sup>87</sup> See Faux, *supra* note 63.

<sup>88</sup> See COINMARKETCAP, *Tether Historical Data*, <https://coinmarketcap.com/currencies/tether/historical-data/> (last visited Mar. 8, 2023).

<sup>89</sup> See Michael Volkov, *The New York Attorney General's Office Reaches Settlement with Bitfinex and Tether*, JD SUPRA (Mar. 15, 2021), <https://www.jdsupra.com/legalnews/the-new-york-attorney-general-s-office-9385268/>.

<sup>90</sup> Complaint at 7, *iFinex Inc. et al v. Wells Fargo & Co. et al*, Case 3:17-cv-01882-MMC, No. 17 Civ. 1882 (N.D. Cal. Apr. 5, 2017) (withdrawn Apr. 11, 2017).

<sup>91</sup> *Id.* at 8.

<sup>92</sup> COINMARKETCAP, *Tether Historical Data*, *supra* note 88 (reflecting tethers trading as low as \$.9135 on April 26, 2017).

<sup>93</sup> In the Matter of the Inquiry by Letitia James, Att'y Gen. of the State of New York, Petitioner, Pursuant to Article 23-A of the New York Gen. Bus. L. in regard to the acts and

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The New York Attorney General's Office later found that for this three month period in the summer of 2017, tethers were not fully backed by dollars.<sup>94</sup> Instead, tethers on the blockchain were backed by "an account under the control of its General Counsel, with the balance accounted for as a 'receivable' from Bitfinex."<sup>95</sup> Tether knew that it was funneling cash away to Bitfinex, and concurrently displaying its "one-to-one" promise on all public media. The company knew of this misrepresentation because the company made a payment from that same Bitfinex account to Noble Bank on the morning of Friedman LLP's first Tether audit.<sup>96</sup> The relationship with Noble Bank eased immediate concerns of losing access to the banking system, including a potential situation similar to a bank run developing, if the public were to discover that Tether could not fulfill its obligations of redeeming tethers for dollars.

It was not long, however, before Bitfinex began having banking trouble of its own, separate from its Tether affiliate. Bitfinex had been utilizing the banking services of Crypto Capital Corporation ("Crypto Capital"), a Panamanian institution.<sup>97</sup> Bitfinex requires access to liquidity in its exchange business because it can only function if users are able to trade crypto assets for dollars.

By May of 2018, Crypto Capital was under investigation by multiple countries for breaching anti-money-laundering laws.<sup>98</sup> Therefore, Bitfinex had a liquidity problem because Crypto Capital was allegedly holding \$850 million of Bitfinex's cash.<sup>99</sup> Bitfinex executives, including Giancarlo Devasini and Jean-Louis van der Velde, found their Bitfinex business low on cash but had billions of dollars sitting in their bank accounts: the Tether reserves.

Bitfinex and Tether continued to move quickly through banking relationships (and their alleged \$850 million with Crypto Capital remained frozen) throughout the summer of 2018.<sup>100</sup> By the fall of 2018, however, Tether "announced publicly that it had 'established a

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practices of, v. iFINEX INC., et al, 2019 WL 2176835 (N.Y.Sup.) [hereinafter *Whitehurst Affirmation*].

<sup>94</sup> Settlement Agreement at 5–6, In the Matter of Investigation by Letitia James of iFINEX Inc., et al. (Feb. 18, 2021).

<sup>95</sup> *Id.* at 6.

<sup>96</sup> *Id.*

<sup>97</sup> Volkov, *supra* note 89, at 3.

<sup>98</sup> Konrad Krasuski & Olga Kharif, *Crypto Capital Official Nabbed in Polish Money Laundering Probe*, BLOOMBERG NEWS (Oct. 15, 2018), <https://www.bloomberg.com/news/articles/2019-10-25/crypto-capital-official-nabbed-in-polish-money-laundering-probe>.

<sup>99</sup> See *Whitehurst Affirmation*, *supra* note 93, at ¶¶ 58–61.

<sup>100</sup> See *Whitehurst Affirmation*, *supra* note 93, at ¶¶ 58–61.

banking relationship with Deltec Bank & Trust Limited,' with headquarters in the Bahamas."<sup>101</sup>

Tether is alleged to have used funds that were supposed to be dollar-for-dollar reserves of its stablecoin to prop up its Bitfinex business partner.<sup>102</sup> While Tether's problems began with trying to locate a bank to work with, they were compounded by the company's subsequent actions.

III. WITHOUT FEDERAL GUIDANCE, STATE ATTORNEYS GENERAL HAVE BEEN ON THE FRONT LINES OF THE REGULATORY ENFORCEMENT OF STABLECOIN ISSUERS, INCLUDING TETHER.

The CFTC has investigated and fined Tether, but the most notable regulatory enforcement of Tether to-date is the investigation by the Office of the Attorney General of the State of New York ("OAG").<sup>103</sup>

Like other crypto asset regulatory enforcement in the United States, Tether is subject to regulation by being classified as a security or commodity. There has been recent interest, however, in constructing a regulatory framework for stablecoins that applies bank regulation, rather than securities regulation.<sup>104</sup> The troubling allegations that arose during the investigations into Bitfinex and Tether in recent years, coupled with an ultimately unsatisfactory OAG settlement, shows that Congress and regulators such as the OCC and FDIC must act to better classify and provide a regulatory architecture for stablecoins.

*A. The Office of the Attorney General for the State of New York's litigation with Tether sheds light on stablecoin issuer financial practices and supports the need for federal stablecoin-specific regulation.*

The New York Attorney General's office under Eric T. Schneiderman began the Virtual Markets Integrity Initiative ("VMII") on

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<sup>101</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 56.

<sup>102</sup> *See infra*, at III.A.

<sup>103</sup> *See* Matt Robinson, *Tether's Latest Black Eye is CFTC Fine for Lying About Reserves*, BLOOMBERG NEWS (Oct. 15, 2021), <https://www.bloomberg.com/news/articles/2021-10-15/tether-bitfinex-to-pay-fines-totaling-42-5-million-cftc-says?srnd=cryptocurrencies>.

<sup>104</sup> *E.g.*, PRESIDENTS WORKING GROUP ON FINANCIAL MARKETS, THE FEDERAL DEPOSIT INSURANCE CORPORATION, AND THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS 2 (Nov. 2021), [https://home.treasury.gov/system/files/136/StableCoinReport\\_Nov1\\_508.pdf](https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf).

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April 17, 2018.<sup>105</sup> The initiative was “part of a broader effort to protect cryptocurrency investors and consumers.”<sup>106</sup> New York is a favorable jurisdiction for state regulators of crypto assets because of its broad state securities laws (“blue sky laws”) and its status as a financial capital. On the same date, the OAG sent a three-page questionnaire to thirteen cryptocurrency exchanges, including Bitfinex, requesting an extensive amount of detailed information and documentation pertaining to each platform’s specific activities, rules, policies, and customer terms.<sup>107</sup>

In September of 2018, the OAG under Barbara Underwood released a thirty-two-page VMII report.<sup>108</sup> The report’s findings were not favorable to the crypto asset exchanges that voluntarily participated in the initiative by affirmatively responding to the April 17th letter and questionnaire. Of particular concern to Bitfinex, and interest to future Attorney General Letitia James, was likely a key finding that outlined the reality that cryptocurrency exchanges operate with significant conflicts of interest. The report states that:

[v]irtual asset trading platforms often engage in several lines of business that would be restricted or carefully monitored in a traditional trading environment. Platforms often serve (i) as venues of exchange, operating the platform on which buyers and sellers trade virtual and fiat currencies; (ii) in a role akin to a traditional broker-dealer, representing traders and executing trades on their behalf; (iii) as money-transmitters, transferring virtual and fiat currency and converting it from one form to another; (iv) as proprietary traders, buying and selling virtual currency for their own accounts, often on their own platforms; (v) as owners of large virtual currency holdings; and, in some cases, (vi) as issuers of a virtual currency listed on their own and other platforms, with a direct stake in its performance.<sup>109</sup>

The office of Letitia James, then newly elected as Attorney General of the State of New York, launched its investigation of Tether less than two months later, in November 2018. James “began the investigation as a result of her concern that [Tether] lacked sufficient liquidity to permit

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<sup>105</sup> Press Release, N.Y. Att’y Gen, A.G. Schneiderman Launches Inquiry Into Cryptocurrency “Exchanges” (Apr. 17, 2018), <https://ag.ny.gov/press-release/2018/ag-schneiderman-launches-inquiry-cryptocurrency-exchanges>.

<sup>106</sup> *Id.*

<sup>107</sup> STATE OF N.Y. OFFICE OF THE ATT’Y. GEN, VIRTUAL MARKETS INTEGRITY INITIATIVE QUESTIONNAIRE (2018).

<sup>108</sup> See generally, OFFICE OF THE N. Y. STATE ATT’Y GEN. BARBARA UNDERWOOD, VIRTUAL MARKETS INTEGRITY INITIATIVE REPORT (Sept. 18, 2018) [hereinafter *VMII Report*].

<sup>109</sup> *Id.* at 5 (emphasis added).

customers to redeem tether at the represented value.”<sup>110</sup> Given the timing of James’s investigation, it is likely that information provided to the OAG by Bitfinex in its VMII questionnaire responses raised some of these concerns.

Attorney General James first served subpoenas on third-party entities, including banks and audit firms that had worked with Tether in the past, seeking information regarding Tether’s activities.<sup>111</sup> Shortly after, in November 2018, Bitfinex and Tether’s attorneys accepted service of subpoenas on their clients’ behalf requesting “information and documents from January 1, 2015 forward.”<sup>112</sup> The OAG’s jurisdiction in their investigation and subsequent litigation is derived from the Martin Act, a New York state law that “gives the New York Attorney General broad law-enforcement powers to conduct investigations of suspected fraud in the offer, sale, and purchase of securities and commodities within or from New York.”<sup>113</sup> Tether is encompassed within the broad Martin Act definition of a commodity.<sup>114</sup>

During its investigation, the OAG discovered that Crypto Capital, the Panamanian entity that was processing Bitfinex’s payments, was declining Bitfinex access to \$851 million of its funds.<sup>115</sup> During the period directly following the OAG’s subpoenas, according to communication logs Bitfinex and Tether produced, the companies were facing a severe liquidity crisis.<sup>116</sup> In these logs, a Bitfinex executive messaged a Crypto Capital executive stating that “the situation looks bad. [W]e have more than 500 withdrawals pending and they keep coming in[.]”<sup>117</sup>

In addition, the OAG uncovered evidence of Bitfinex misleading its customers regarding the company’s access to banking and the transmittal of funds for customer withdrawals. On October 15, 2018, a Bitfinex executive began messaging Crypto Capital requesting urgent access to funds.<sup>118</sup> On the same day, Bitfinex posted to its website that

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<sup>110</sup> James v. iFinex Inc., 185 A.D.3d 22, 25 (N.Y. 2020).

<sup>111</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 41.

<sup>112</sup> *James*, 185 A.D.3d at 26.

<sup>113</sup> ENFORCEMENT PROCEEDINGS UNDER NEW YORK’S MARTIN ACT, PRACTICAL LAW PRACTICE NOTE 4-582-1925 (2022), Westlaw Practical Law; *see also* N.Y. GEN. BUS. LAW § 352 (McKinney).

<sup>114</sup> *James*, 185 A.D.3d 22, at 28 (holding that “even if the court were to consider respondents’ argument on the merits, the Martin Act’s definition of commodities as including ‘any foreign currency, any other good, article, or material . . . is broad enough to encompass *tether*”).

<sup>115</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 68.

<sup>116</sup> *See Whitehurst Affirmation*, *supra* note 93, at ¶ 67.

<sup>117</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 67.

<sup>118</sup> *See Whitehurst Affirmation*, *supra* note 93, at ¶ 66.

“[a]ll fiat (USD, GBP, JPY, EUR) withdrawals are processing, and have been, as usual.”<sup>119</sup> This inconsistency between Bitfinex’s public statements and their internal records likely concerned OAG attorneys, who requested a meeting with Bitfinex representatives to discuss the investigation.<sup>120</sup>

Attorneys representing Bitfinex and Tether met with OAG attorneys on February 21, 2019.<sup>121</sup> In this meeting, counsel for Bitfinex and Tether explained that their clients were “in the process of contemplating a transaction that would permit Bitfinex to draw upon Tether’s cash reserves on an as-needed basis.”<sup>122</sup> According to a scathing petition that an Assistant Attorney General, who was present at the February meeting, filed in the Supreme Court of the State of New York, the firm’s plan to borrow from Tether to satisfy Bitfinex’s financial obligations “raised serious questions about the viability of Bitfinex as an ongoing concern, the possibility that Tether’s cash reserves would be dissipated and unrecoverable, and whether Bitfinex and Tether have misled their clients[.]”<sup>123</sup> On February 26, the OAG sent a letter to Bitfinex and Tether requesting detailed information about USDT issuance, the \$851 million that Crypto Capital allegedly held, and other internal documents related to the companies’ financial status and ownership “to be provided no later than March 7, 2019.”<sup>124</sup>

March of 2019 was a turning point for Tether, and both regulators and lawmakers should view Tether’s actions during this time as evidence in support of the need for regulation of stablecoin issuers. On March 4, lawyers representing Bitfinex and Tether sent an email to OAG stating, “it is not possible to get this information by March 7.”<sup>125</sup> Shortly afterward, Tether updated its website, reversing its claim of one-to-one backing.<sup>126</sup>

From Tether’s creation in 2014 until March 14, 2019, Tether’s website proclaimed an essential promise, which the company also made

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<sup>119</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 65.

<sup>120</sup> *See Whitehurst Affirmation*, *supra* note 93, at ¶ 47.

<sup>121</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 72.

<sup>122</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 72.

<sup>123</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 76.

<sup>124</sup> *See Whitehurst Affirmation*, *supra* note 93, at ¶ 78.

<sup>125</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 81.

<sup>126</sup> William Suberg, *Cryptocurrency Community Eyes Tether After Website Dilutes USD Backing Claims*, COINTELEGRAPH, <https://cointelegraph.com/news/cryptocurrency-community-eyes-tether-after-website-dilutes-usd-backing-claims> (Mar. 14, 2019) (reporting that “[d]evelopers behind stablecoin Tether (USDT) have drawn scrutiny today, March 14, after social media users noticed they had removed previous claims that the altcoin was fully backed by United States dollars”).

in its whitepaper, that every tether was backed by a U.S. dollar held in reserve and that any holder of tether may redeem it for one dollar at any time.<sup>127</sup> On that later date, however, the language on the Tether website changed without notice to state that “[e]very tether is always 100 [percent] backed by our reserves, which include traditional currency and cash equivalents and, from time to time, may include other assets and receivables from loans made by Tether to third parties, which may include affiliated entities[.]”<sup>128</sup> This was a dramatic change, and represented Bitfinex’s and Tether’s first public disclosure that their promise of one-to-one reserves was no longer true. As USDT’s value is derived from users’ trust that their tethers can always be exchanged for equivalent dollars held in reserve, the admission that the company no longer held adequate reserves should be seen as a breach of trust. Further, the intermingling of funds between the stablecoin issuer and its affiliated exchange business, which engages in proprietary trading activities, creates significant conflicts of interest because proprietary trading activity for Bitfinex involves speculating with money that belongs to USDT holders. If a chartered bank were to engage in similar activity, it would be in violation of federal banking law.<sup>129</sup>

On March 29th, Bitfinex and Tether responded with a letter to the OAG’s requests for information related to their proposed line of credit transaction from Tether to Bitfinex.<sup>130</sup> In the letter, a copy of which was provided to the Supreme Court of New York, Bitfinex and Tether disclosed not only that the transaction in question had already occurred, but also that the entities had previously undertaken additional transactions of the same kind.<sup>131</sup> According to the letter, Bitfinex had been borrowing from Tether’s reserves since November 2018, and owed Tether \$700 million.<sup>132</sup> The transaction documents “were signed on behalf of Bitfinex and Tether by the same two individuals.”<sup>133</sup>

The OAG filed an application with the Supreme Court of New York requesting an ex parte order pursuant to General Business Law § 354 requesting production of documents and information as well as seeking injunctive relief to prevent Bitfinex and Tether from “taking any further

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<sup>127</sup> *Id.*

<sup>128</sup> *Tether*, WEB ARCHIVE (Mar. 4, 2019), <https://web.archive.org/web/20190304165618/https://tether.to/>; see also *James v. iFinex Inc.*, 185 A.D.3d 22, 25 (N.Y. App. Div. 2020).

<sup>129</sup> See 12 C.F.R. § 351(a) (current through the Oct. 11, 2022, issue of the Federal Register).

<sup>130</sup> See *Whitehurst Affirmation*, *supra* note 93, at ¶ 85.

<sup>131</sup> See *Whitehurst Affirmation*, *supra* note 93, at ¶ 85.

<sup>132</sup> See *Whitehurst Affirmation*, *supra* note 93, at ¶ 85.

<sup>133</sup> *Whitehurst Affirmation*, *supra* note 93, at ¶ 86.

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action to access, loan, extend credit, encumber, pledge, or make any other similar transfer or claim between Bitfinex and Tether.”<sup>134</sup> According to the statute, it is a court’s duty to compel production of certain documents, and the court may issue injunctive relief when necessary and proper.<sup>135</sup>

The Court ordered production of a significant number of documents, set a date to appear, and preliminarily enjoined Bitfinex and Tether from “(1) taking any further action to ‘make any . . . claim . . . on the U.S. dollar reserves held by Tether [Holdings]’; (2) making any payments to any individual associated with respondents ‘from the U.S. dollar reserves held by Tether [Holdings]’; and (3) altering or destroying any documents related to the investigation.”<sup>136</sup> Bitfinex and Tether later successfully argued for an amended preliminary injunction that narrowed the scope of the initial injunction and limited its effects to ninety days.<sup>137</sup> The Supreme Court, Appellate Division of New York, however, ultimately denied their motion to dismiss.<sup>138</sup>

*B. Facing the possibility of potentially protracted, expensive, and intrusive litigation, Tether settled with New York State, agreeing to significant financial transparency initiatives.*

Bitfinex and Tether settled the matter of *James v. iFinex, Inc.* on February 23, 2021.<sup>139</sup> Tether agreed to pay a monetary penalty of \$18,500,000 (made by wire transfer).<sup>140</sup> In exchange, the OAG agreed to withdraw its Martin Act application for relief, *In re: James v. iFinex*, and to not further pursue the companies regarding their misleading statements about Tether’s backing or any other act that came to light as a result of the investigation.<sup>141</sup> Additionally, Bitfinex and Tether agreed

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<sup>134</sup> See Ex Parte Order Pursuant to Gen. Bus. L. § 354 at 4, In the Matter of the Inquiry by Letitia James, Att’y Gen. of the State of New York, Petitioner, Pursuant to Article 23-A of the New York Gen. Bus. L. in regard to the acts and practices of, v. iFINEX INC., et al, No. 450545/2019, 2019 WL 3891172 (N.Y. Sup. Ct. 2019).

<sup>135</sup> See N.Y. GEN. BUS. § 354 (McKinney 2022).

<sup>136</sup> *James v. iFinex Inc.*, 185 A.D.3d 22, 26–27 (N.Y. App. Div. 2020).

<sup>137</sup> See Decision and Order, In the Matter of the Inquiry by Letitia James, Att’y Gen. of the State of New York, Petitioner, Pursuant to Article 23-A of the New York Gen. Bus. L. in regard to the acts and practices of, v. iFINEX INC., et al, No. 450545/2019, 2019 WL 2142297 (N.Y. Sup. Ct. 2019).

<sup>138</sup> See *James*, 185 A.D.3d at 25.

<sup>139</sup> Press Release, N.Y. Atty. Gen., Attorney General James Ends Virtual Currency Trading Platform Bitfinex’s Illegal Activities in New York (Feb. 23, 2021) (available at <https://ag.ny.gov/press-release/2021/attorney-general-james-ends-virtual-currency-trading-platform-bitfinexs-illegal>).

<sup>140</sup> Settlement Agreement, *supra* note 94, at 9.

<sup>141</sup> Settlement Agreement, *supra* note 94, at 10.

to continue to improve their reserve reporting and both provide OAG with written reports each quarter and publish them to the public for a period of two years.<sup>142</sup> Bitfinex and Tether further agreed to not do business in the State of New York and that for Bitfinex and Tether to resume business in New York in the future, “they will do so in accordance with applicable law, including any applicable licensing requirements.”<sup>143</sup>

The most notable of the terms of the settlement agreement is the reserve reporting requirement, which may have been an OAG condition to come to the table to discuss settlement in the first place. After Bitfinex and Tether’s motion to dismiss was denied by the New York Supreme Court’s Appellate Division,<sup>144</sup> Bitfinex and Tether likely began feeling pressure to settle, and therefore complied. Before these negotiations, Tether was not in the practice of disclosing very much information about the composition of its reserves.<sup>145</sup>

*C. The adequacy of Tether’s reserves today remains the subject of debate, but its transparency is unquestionably improving.*

From the start of the New York Attorney General’s investigation to the present day, Tether’s market capitalization continued its extraordinary growth, growing from four billion tethers in 2017 to over seventy billion tethers at the time of writing.<sup>146</sup> Today, Tether releases daily accounting balances as well as quarterly financial reports on the transparency page of its website.<sup>147</sup> As these practices were presumably agreed upon by the OAG, one would expect that they provide more detailed information regarding Tether’s reserves, but they do not.

The first reports since the OAG settlement were issued by an accounting firm called Moore Cayman, which is a “five employee” outfit for which there is very little public information available.<sup>148</sup> The “Independent Accountant’s Reports” prepared by Moore Cayman

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<sup>142</sup> Settlement Agreement, *supra*, note 94, at 10–11.

<sup>143</sup> Settlement Agreement, *supra*, note 94, at 13.

<sup>144</sup> See *James*, 185 A.D.3d at 25.

<sup>145</sup> See *Transparency*, TETHER (last visited Mar. 9, 2023), <https://tether.to/en/transparency/#reports> (providing links to all of Tether’s reserve reporting in chronological order).

<sup>146</sup> *Tether*, COINMARKETCAP (last visited Mar. 9, 2023), <https://coinmarketcap.com/currencies/tether/>.

<sup>147</sup> See *Transparency*, TETHER (last visited Mar. 9, 2023), <https://tether.to/en/transparency>.

<sup>148</sup> Nikhilesh De & Marc Hochstein, *Tether’s First Reserve Breakdown Shows Token 49% Backed by Unspecified Commercial Paper*, COINDESK (May 13, 2021, 8:00 AM), <https://www.coindesk.com/markets/2021/05/13/tethers-first-reserve-breakdown-shows-token-49-backed-by-unspecified-commercial-paper/>.

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appeared on letterhead suggesting that Moore Cayman is affiliated with Moore Global, a global accounting and advisory conglomerate.<sup>149</sup> The quarterly reports were not signed by any professional individual who claims to be responsible for the results and provide very little in terms of assurances of Tether's reserves.<sup>150</sup> A typical Tether Limited financial disclosure report consists of four to five pages, a few pages from Tether attesting to its reserves and a few pages from Moore Cayman reiterating those attestations.<sup>151</sup> The Tether attestations were signed by Jean-Louis van der Velde.<sup>152</sup>

In 2022, Tether took another step towards improving their public disclosure practices by engaging the Italian office of the accounting firm BDO to produce their reserve reports moving forward, and also to increase their frequency from quarterly to monthly.<sup>153</sup> A BDO Partner named Andrea Mezzadra signed the first BDO audit report, an encouraging step in the right direction for Tether.<sup>154</sup> Additionally, Tether's holdings of U.S. Treasury Bills, a traditionally safe use of fractional reserves, appear to be progressively larger with each report.<sup>155</sup> U.S. Treasury Bills are viewed favorably by bank regulators due to their risk-free backing by the federal government, and banks in

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<sup>149</sup> MOORE GLOBAL, <https://www.moore-global.com/regional-hubs/north-america/firms?cid=0456898e-08f5-4fd4-9794-5507c03707a9> (last visited Mar. 9, 2023).

<sup>150</sup> See Independent Accountant's Report to Board of Directors and Management Tether Holdings Limited from Moore Cayman (Feb. 28, 2021) (available at <https://assets.ctfassets.net/vyse88cgwfb/3QH0mpzRBghZuLKa0hLw9c/2c41698f4bffc9fd91fa611ab04915b/tether-assurance-feb-2021.pdf>) (signed on behalf of the auditor with the words "Moore Cayman" alone) [hereinafter *Feb. 2021 Moore Cayman Report*].

<sup>151</sup> See Independent Accountant's Report to Board of Directors and Management Tether Holdings Limited from Moore Cayman (Sept. 30, 2021) (available at <https://assets.ctfassets.net/vyse88cgwfb/011ZdtaNYx7jZ4jU5xmlYO/90aa0d5b1e3559c393ff135f987ddb0/tether-assurance-sept-30-2021.pdf>) [hereinafter *Sept. 2021 Moore Cayman Report*].

<sup>152</sup> *Feb. 2021 Moore Cayman Report*, *supra* note 150, at 5; Sept. 2021 Moore Cayman Report, *supra* note 151, at 6.

<sup>153</sup> Elizabeth Howcroft, *Stablecoin Tether Hires BDO Italia for Monthly Proof-of-Reserves Reports*, REUTERS (Aug. 18, 2022, 11:59 AM), <https://www.reuters.com/technology/stablecoin-tether-hires-bdo-italia-monthly-proof-of-reserve-reports-2022-08-18/>.

<sup>154</sup> See Independent Auditors' Report on The Consolidated Reserves Report To the Board of Directors of Tether Holdings Limited from BDO (Aug. 10, 2022) (available at [https://assets.ctfassets.net/vyse88cgwfb/2xJyKdUKicdRUWpC9buRWR/6fe2987698dbbf39b947af718d736ddb/Std\\_ISAE\\_3000R\\_Opinion\\_30-6-2022\\_RC134792022BD0303.pdf](https://assets.ctfassets.net/vyse88cgwfb/2xJyKdUKicdRUWpC9buRWR/6fe2987698dbbf39b947af718d736ddb/Std_ISAE_3000R_Opinion_30-6-2022_RC134792022BD0303.pdf)) [hereinafter *Aug. 2022 BDO Report*].

<sup>155</sup> Compare *Sept. 2021 Moore Cayman Report*, *supra* note 151 (reporting 19 of 69 billion of Tether holdings as U.S. Treasury Bills), with *Aug. 2022 BDO Report*, *supra* note 154 (reporting 28 of 66 billion of Tether holdings as U.S. Treasury Bills).

the U.S. can have more Treasury Bills than private corporate notes (also referred to as “commercial paper”) and still remain below their capital ratio requirements.<sup>156</sup> It is easy to equate Tether’s reserves to those of a traditional bank because Tether holds fractional reserves of customer deposits, much like a bank, but thus far Tether has eluded the cumbersome requirements that the U.S. government places on banks.<sup>157</sup> However improved Tether’s transparency has become since the OAG settlement, even the most recent BDO Report remains based only on a five-page statement signed by Mr. van der Velde without independent auditor confirmation of the underlying facts.<sup>158</sup>

The best snapshot of Tether’s reserves can be found in these short pages written by Tether and marked as appendices to Tether’s reserve accounting reports. Starting in the third quarterly report provided by Tether and Moore Cayman, Tether began disclosing the breakdown of its reserves by asset class.<sup>159</sup> The September 2021 report states that Tether is holding over seventy-five percent of its reserves in “Cash & Cash Equivalents & Other Short-Term Deposits & Commercial Paper,” which seems positive until closer inspection, which reveals that over sixty-five percent of that figure is held in commercial paper.<sup>160</sup> This was more than half of all of Tether Limited’s reserve holdings, and nothing is publicly known about whose commercial paper Tether was or is holding. In the appendix to the September 2021 report, Tether does claim that the vast majority of this commercial paper is rated “A-1” or “A-2”, but no further information or independent verification is available.<sup>161</sup> Not only is Tether’s commercial paper unconfirmed in its rating by professionals, but also its maturation timeframe is not disclosed. This, however, seems to be improving in recent quarters. In the August 2022 BDO Report, for example, Tether claims that it has

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<sup>156</sup> See Risk Management Manual of Examination Policies, Federal deposit insurance corporation, Capital, Section 2.1 (available at <https://www.fdic.gov/regulations/safety/manual/section2-1.pdf>) (last visited Mar. 13, 2023). (explaining that “risk-weightings [in calculating capital ratios] can vary across asset classes and exposures depending on their inherent risk. For instance, U.S. Treasury securities have a 0 percent risk weight, while a commercial loan to a private business would generally receive a risk-weight of 100 percent under the Standardized Approach.”).

<sup>157</sup> See *infra* Section V.A (explaining the federal U.S. banking regulatory scheme).

<sup>158</sup> *Aug. 2022 BDO Report, supra* note 154, at 4 (“Scope Limitations [BDO’s] opinion is limited solely to the [attached report from Tether].”).

<sup>159</sup> See *Transparency, TETHER* (last visited Mar. 13, 2023), <https://tether.to/en/transparency>.

<sup>160</sup> *Sept. 2021 Moore Cayman Report, supra* note 151, at 5.

<sup>161</sup> *Sept. 2021 Moore Cayman Report, supra* note 151, at 5.

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reduced its commercial paper exposure to less than twenty percent of its holdings.<sup>162</sup>

While Tether has been taking steps to improve transparency, its financial disclosure practices remain insufficient. There is too much trust being placed in the same individuals who have overseen Tether from the start. Even if Tether's attestations about its reserves are true, their composition, notably the large holdings in commercial paper, is troubling because it remains unclear whether they have sufficient capital reserves to survive a crisis.

If trust is lost in the ability of stablecoin issuers to maintain the price of their coin during a crisis, a run on the coin could occur.<sup>163</sup> While the OAG may feel that their settlement and imposed reporting requirements are sufficient to insulate New Yorkers from the risk of losing their "deposits," there likely will be much more oversight of custodial stablecoins in the future.<sup>164</sup>

Tether's entanglement with the OAG should be heeded as a warning to anyone investing in stablecoin infrastructure. Tether flourished partially because U.S. regulators were glad that crypto companies were operating "offshore." Because stablecoins work on blockchains, however, they are very difficult to keep out of the world's largest economy. The U.S. has an opportunity to be a leader in this industry and should accordingly take proactive regulatory measures. It may be possible to regulate stablecoin issuers under current law, but new legislation could also be required. Either way, it would be socially, economically, and legally prudent to move forward with one, or both, of these measures in a timely fashion.

#### IV. THE CURRENT REGULATORY ENVIRONMENT IS RIPE FOR THE CREATION OF A COMPREHENSIVE FEDERAL REGULATORY FRAMEWORK FOR THE SUPERVISION OF STABLECOINS.

When it comes to crypto assets, similar to other financial instruments, the question of whose regulatory jurisdiction an asset falls under should be determined by the characteristics of the asset. There has been debate about how cryptocurrencies should be classified. A few

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<sup>162</sup> Aug. 2022 BDO Report, *supra* note 154, at 7.

<sup>163</sup> *Stablecoins Could Pose New Short-Term Credit Market Risks*, FITCH RATINGS (July 21, 2021), <https://www.fitchratings.com/research/fund-asset-managers/stablecoins-could-pose-new-short-term-credit-market-risks-01-07-2021> (claiming that "[a] sudden mass redemption of USDT could affect the stability of short-term credit markets if it occurred during a period of wider selling pressure in the [Corporate Paper] market, particularly if associated with wider redemptions of other stablecoins that hold reserves in similar assets").

<sup>164</sup> See generally *infra* Section V.

crypto assets (like Bitcoin and Ethereum) have generally been classified by the CFTC as commodities because they have derivatives.<sup>165</sup> Concurrently, the SEC has classified most cryptocurrencies as securities because they qualify under the *Howey* test.<sup>166</sup> The IRS classifies cryptocurrency as property for federal tax purposes.<sup>167</sup>

Custodial stablecoins, unlike most other crypto assets, may be simpler to classify because they do not have the added layer of complexity associated with having no centralized institution for regulators to supervise. Since custodial stablecoins have issuers who hold the reserves in trust, and because there is no expectation of profit for holders of stablecoins, their characteristics mirror a bank product more than a security or commodity.

*A. There is recent governmental interest in the regulation of stablecoins, and the executive branch has signaled support for bank-like regulation of stablecoins.*

The executive branch under President Joe Biden has shown an interest in the regulation of stablecoins by bank regulators. In November 2021, the Treasury Department released a Report on Stablecoins (the “Report”) authored by the President’s Working Group on Financial Markets (“PWG”), which includes the FDIC and OCC.<sup>168</sup> The Report concludes that stablecoins could pose systemic risk to the economy.<sup>169</sup> It further 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.”<sup>170</sup> Specifically, the Report

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<sup>165</sup> Order Institution Proceedings Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, Making Findings and Imposing Remedial Sanctions, In the Matter of Coinflip, Inc., CFTC Docket No. 15-29 (Sep. 17, 2015); *see, e.g.*, Press Release, Commodity Futures Trading Commission, Release Number 8051-19 (Oct. 10, 2019) (available at <https://www.cftc.gov/PressRoom/PressReleases/8051-19>).

<sup>166</sup> SEC v. Ripple, No. 20-10832, 2021 U.S. Dist. LEXIS 69563, at \*3; *see also* SEC v. W. J. Howey Co., 328 U.S. 293, 301 (1946) (holding that, for determining whether an instrument is a security, “[t]he test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”).

<sup>167</sup> I.R.S. Notice 2014-21, 2014-16 I.R.B. 938.

<sup>168</sup> PRESIDENTS WORKING GROUP ON FINANCIAL MARKETS, THE FEDERAL DEPOSIT INSURANCE CORPORATION, AND THE OFFICE OF THE COMPTROLLER OF THE CURRENCY, REPORT ON STABLECOINS 2 (Nov. 2021) [https://home.treasury.gov/system/files/136/StableCoinReport\\_Nov1\\_508.pdf](https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf).

<sup>169</sup> *See id.* at 1 (“If stablecoin issuers do not honor a request to redeem a stablecoin, or if users lose confidence in a stablecoin issuer’s ability to honor such a request, runs on the arrangement could occur that may result in harm to users and the broader financial system.”).

<sup>170</sup> *Id.* at 2.

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recommends that “[t]o address risks to stablecoin users and guard against stablecoin runs, legislation should require stablecoin issuers to be insured depository institutions, which are subject to appropriate supervision and regulation, at the depository institution and the holding company level.”<sup>171</sup>

The Report highlights the risk of coin runs, writing that “[c]onfidence in a stablecoin may be undermined by factors including: (1) use of reserve assets that could fall in price or become illiquid; (2) a failure to appropriately safeguard reserve assets; (3) a lack of clarity regarding the redemption rights of stablecoin holders; and (4) operational risks related to cybersecurity and the collecting, storing, and safeguarding of data.”<sup>172</sup> As seen through Tether’s history, some of these risks have already occurred. Tethers have fallen below their \$1 peg, going as low at \$.91 in 2017 upon users’ fears of potentially being unable to redeem their tokens for dollars, and the composition of their reserve assets is unclear.

Custodial stablecoin issuers have been operating in a regulatory vacuum. As shown through Tether’s past false disclosures and questionable financial activities, there is a risk that those who deposit with stablecoin issuers will face an inability to redeem their stablecoins for dollars. If stablecoin issuers face circumstances where their depositors rush to redeem their tokens for dollars *en masse*, they are likely to fail in their current state.

In addition, there is risk to the larger economy because, if a stablecoin fails, its potential ripple effects could have negative consequences for the price of other crypto assets and could even put undue stress on the unknown corporations whose commercial paper Tether holds in place of pure cash reserves, which it could have to attempt to liquefy quickly in such a scenario. It is unclear whether such a situation could apply to Tether’s commercial paper specifically, because the terms of Tether’s notes are also unknown. As stablecoins’ balance sheets grow, these risks intensify. The acting Comptroller of the Currency, Michael J. Hsu (“acting Comptroller Hsu”), confirmed the same in a January 2022 speech, stating that, “[t]he growth and mainstreaming of crypto means that a stablecoin run would not just impact those directly invested in it. There would be collateral damage. And the potential scope of that damage will continue to grow as long as crypto expands.”<sup>173</sup> Given the rapid growth and widespread use of

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<sup>171</sup> *Id.*

<sup>172</sup> *Id.* at 12.

<sup>173</sup> Michael J. Hsu, Executive Roundtable: Remarks before the British American Business Transatlantic Finance Forum 4 “The Future of Crypto-Assets and Regulation,”

cryptocurrency as well as the increased public interest—manifested in the form of the President’s Working Group Stablecoin Report, as well as the O.C.C.’s comments—it appears that the likelihood is increasing for some kind of federal bank regulation of custodial stablecoins.

Acting Comptroller Hsu noted that in addition to mitigating the risks that stablecoin runs could pose on the economy, enforcing bank regulation on stablecoins could also benefit the larger crypto economy.<sup>174</sup> Namely, he argues that proper regulatory safeguards on stablecoins would allow for more confident innovation in the non-stable crypto economy, similar to the value-add that the introduction of a regulated national currency had on the U.S. economy in the 1860s.<sup>175</sup>

V. MODERN BANKING LAW PROVIDES A REGULATORY FRAMEWORK TO SUPERVISE STABLECOIN ISSUERS THAT WOULD INCREASE TRANSPARENCY AND LOWER THE RISK OF MORAL HAZARD; BUT THE APPROACH SHOULD BE TAILORED FOR STABLECOINS BASED ON THEIR UNIQUE CHARACTERISTICS.

Because of the outsized financial importance of banks in the wider economy and the financial incentives for bankers to take outsized risks with their fractional reserves, banking is subject to a higher level of regulatory scrutiny than many other industries.<sup>176</sup> For example, to guard against the risk of moral hazard associated with public insurance of the funds that banks invest, their actions and investment decisions are subject to close supervision by government agents.<sup>177</sup> Additionally, federal regulators establish capital requirements to ensure that banks maintain a liquidity ratio sufficient to withstand stress in times of economic turmoil.<sup>178</sup>

Custodial stablecoin issuers like Tether, Circle, and Binance have largely avoided such oversight because they have not sought banking charters nor complied with banking regulations. By providing services that compete with demand deposits, however, they may be subject to state and federal banking law.

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(Jan. 13, 2022) (available at <https://www.occ.treas.gov/news-issuances/speeches/2022/pub-speech-2022-2.pdf>).

<sup>174</sup> *See id.* at 6.

<sup>175</sup> *Id.*

<sup>176</sup> *See* BARR, ET AL., *supra* note 7, at 72 (“The nature of [banking] services, it is generally assumed, warrants a degree of regulatory control and oversight substantially more intrusive and expensive than legal rules governing other business enterprises.”).

<sup>177</sup> BARR, ET AL., *supra* note 7, at 247 (“Moral hazard refers to situations where one actor is incentivized to take on risk because another party is set up to absorb the costs of the first actor’s bad behavior.”).

<sup>178</sup> 12 C.F.R. § 3.10 (The OCC minimum capital requirements.); 12 C.F.R. § 324.10 (The FDIC minimum capital requirements.).

A strong historical rationale for tight regulation of banks is the risk of a bank run. This risk is not merely theoretical. In 1933, President Franklin D. Roosevelt's administration declared a moratorium on banking by proclaiming a week-long bank holiday to keep fearful depositors from being able to continue withdrawing their money from the banks of the United States.<sup>179</sup> It was during this same time that modern bank regulation was born, with the creation of the Federal Deposit Insurance Corporation, which has largely erased the risk of bank runs in the U.S..<sup>180</sup> The government's insurance of demand deposits has been so successful because bank runs are fueled by public panic. The knowledge that individuals' deposits are safe removes the necessary condition for a bank run to begin: fear.

Under the National Banking Act ("NBA"), the enumerated powers of a chartered bank include "all such incidental powers as shall be necessary to carry on the business of banking," including receiving deposits, loaning money, and issuing and circulating notes.<sup>181</sup> A national bank may commence such business only after "[the prospective bank] has complied with all the provisions required to be complied with before commencing the business of banking, and that such association is authorized to commence such business."<sup>182</sup>

State law controls the creation of business associations, including banks, and requires an entity be chartered before engaging in banking.<sup>183</sup> All U.S. territories have bank regulators and the power to issue state charters, although the federal government can issue national bank charters that supersede state banking laws.<sup>184</sup> Case law holds whether various activities are engaged in banking, but there is little debate on whether taking demand deposits constitutes banking.<sup>185</sup> The taking of deposits from the public, redeemable on demand at par,

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<sup>179</sup> See Robert Jabaily, *Bank Holiday of 1933*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), <https://www.federalreservehistory.org/essays/bank-holiday-of-1933>.

<sup>180</sup> See CHARLES W. CALOMIRIS & GARY GORTON, FINANCIAL MARKETS AND FINANCIAL CRISES 109 (R. Glenn Hubbard ed. (1991)).

<sup>181</sup> 12 U.S.C.S. § 24.

<sup>182</sup> 12 U.S.C.S. § 27.

<sup>183</sup> See *Noble State Bank v. Haskell*, 219 U.S. 104, 111 (1911) (holding states have the right under their police powers to "enforce[e] the primary conditions of successful commerce.").

<sup>184</sup> 12 USCS § 27(b)(2).

<sup>185</sup> See, e.g., *Lacewell v. Off. Of the Comptroller of the Currency*, 999 F.3d 130, 136 (2d Cir. 2021) (analyzing whether entities that do not take deposits engage in banking); see also *Warren v. Shook*, 91 U.S. 704, 710 (1875) ("Having a place of business where deposits are received and paid out on checks, and where money is loaned upon security, is the substance of the business of a banker.").

unquestionably meets the criteria.<sup>186</sup> Therefore, companies taking demand deposits are required to be chartered.<sup>187</sup>

The practice that stablecoin issuers engage in when issuing tokens arguably qualifies as the taking of demand deposits, which is the most basic function of banks. Demand deposits are defined as “a deposit that is payable on demand, or a deposit issued with an original maturity or required notice period of less than seven days. . . .”<sup>188</sup> In fact, courts have held that “the term ‘business of banking,’ as used in the NBA, unambiguously requires receiving deposits as an aspect of the business.”<sup>189</sup>

As the New York Attorney General’s investigation brought to light, Tether has not been holding its demand deposits in cash reserves, but instead has been investing deposits in interest-bearing instruments and holding fractional reserves.<sup>190</sup> It is not surprising that Tether does so because holding large amounts of cash reserves leaves too much potential revenue on the table in the form of interest.

The traditional bank business model relies on fractional reserves. The fractional reserve banking model refers to a “system in which a bank’s reserves are only a fraction of its outstanding deposits.”<sup>191</sup> Without the fractional reserve system, banks would not have the liquidity required to make profitable loans, which is what they are in business to do.

Fractional reserves, however, add to the financial risk during bank runs because banking institutions very likely do not hold sufficient liquidity to honor withdrawal requests from depositors if the requests happen simultaneously. Such bank runs have ripple effects beyond the institution itself. Due to the fractional reserve model, banks that are under pressure to honor withdrawal requests may have to begin calling in their loans to access liquidity, which can place strain on the businesses and other entities to which the banks have credit on their balance sheets. Therefore, *en masse* withdrawals from a bank will have

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<sup>186</sup> *Warren*, 91 U.S. 704 at 710.

<sup>187</sup> *See, e.g.*, *First Nat’l Bank v. Hartford*, 273 U.S. 548, 558 (1927) (implying, through dicta, that engaging in activities within the business of banking subjects unchartered state entities to bank regulation).

<sup>188</sup> 12 C.F.R. § 204.2(b)(1).

<sup>189</sup> *See* *Vullo v. Off. of the Comptroller of the Currency*, 378 F. Supp. 3d 271, 292 (S.D.N.Y. 2019).

<sup>190</sup> *See* *Transparency*, TETHER (last visited Mar. 9, 2023), <https://tether.to/en/transparency>.

<sup>191</sup> BARR, ET AL, *supra* note 7, at 236.

negative effects not just on that bank, but on all entities in business with the bank.<sup>192</sup>

Holding fractional reserves is not in itself a necessary practice for custodial stablecoin issuers. For example, before Tether began lending its reserves to Bitfinex and other entities, it did not have fractional reserves. Currently, the financial disclosures from Circle (USDC) and Binance (BUSD) regarding their stablecoin reserve compositions are clearer than Tether's and state that their reserves are held exclusively in cash and short-term U.S. treasuries.<sup>193</sup> Both of these stablecoins, however, derive their value solely from their reserves. Therefore, there is an increased need for stablecoin issuers to ensure liquidity, certainly more than that of a chartered bank, whose deposits are insured by the federal government.<sup>194</sup>

As previous bank runs have made clear, the loss of public trust in banks can have catastrophic consequences for the national and global economy.<sup>195</sup> As stablecoins become larger by market capitalization, the risks that they pose not only to their users but to the overall economy, grows substantially. The United States can ease the risk to depositors and to the larger economy with legislation classifying custodial stablecoin issuers as depository banks, requiring that they be chartered and regulated by the OCC to ensure that issuers meet capital requirements, comply with banking laws, and provide deposit insurance for depositors under the FDIC.

Stablecoin issuers and those investing in their infrastructure should welcome this potential regulation. If stablecoin users were protected by deposit insurance, their value would no longer be tied solely to trust in one-to-one reserves, but to the promise of government insurance. Therefore, issuers would be able to invest their reserves without risking coin runs. In exchange, they would subject their companies to significant but potentially burdensome supervision.

Today, bank regulators "establish capital requirements, conduct onsite examinations and off-site monitoring to assess a bank's financial

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<sup>192</sup> See generally Jon. R. Moen & Ellis W. Tallman, *The Panic of 1907*, FED. RSRV. HIST. (Dec. 4, 2015), <https://www.federalreservehistory.org/essays/panic-of-1907> (explaining how a bank run on trust banks in New York City operating with fractional reserves helped cause a recession).

<sup>193</sup> See Report of Independent Certified Public Accountants, Grant Thornton (July 31, 2022) (available at <https://www.centre.io/usdc-transparency?hsLang=en>); see also Reserve Acct. Rep., PAXOS, <https://paxos.com/wp-content/uploads/2022/08/USDP-Examination-Report-July-29-2022.pdf> (last visited Mar. 13, 2023).

<sup>194</sup> *Infra* Section V.A.

<sup>195</sup> See Gary Richardson, *Banking Panics of 1930-31*, FED. RSRV. HIST. (Nov. 22, 2013), <https://www.federalreservehistory.org/essays/banking-panics-1930-31>.

condition, and monitor compliance with banking laws.”<sup>196</sup> Bank regulators have the power to grant charters to new banks, make rules in regard to their activities, oversee and supervise their activities, and enforce applicable rules and law.<sup>197</sup> While there are many state and federal regulators of banks, two organizations are potentially relevant to a proposal for stablecoin regulation: the Office of the Comptroller of the Currency (“OCC”) and the Federal Deposit Insurance Corporation (“FDIC”).

*A. The OCC and FDIC are the two agencies most likely to be tasked with chartering and supervising stablecoin issuers under the framework proposed by the Biden Administration.*

As custodial stablecoin issuers take demand deposits redeemable at par and are subject to state and federal bank regulations, and because the federal government has taken an interest in ensuring that stablecoins are properly classified as bank products requiring a charter to operate, the main federal regulators of stablecoins will likely be the OCC and FDIC.

The OCC is the principal federal regulator of national banks and the only organization that can approve a federal bank charter.<sup>198</sup> It is “an independent bureau of the U.S. Department of the Treasury and is led by the Comptroller of the Currency.”<sup>199</sup> The OCC’s primary function is to charter, supervise, and regulate national banks.<sup>200</sup> The OCC was created in 1863 by Abraham Lincoln’s administration and codified into law in 1864 under the National Bank Act, which, albeit amended repeatedly, remains the principal framework of national bank law in the United States today.<sup>201</sup>

The first responsibility of the OCC is to charter national banks. The purpose of the chartering process is to both “regulate entry into the banking industry on the basis of economic considerations and to assure

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<sup>196</sup> BARR, ET AL., *supra* note 7, at 79.

<sup>197</sup> CRS Rep., *Who Regulates Whom? An Overview of the U.S. Financial Regulatory Framework*, CONG. RSCH. SERV. 2–3, <https://sgp.fas.org/crs/misc/R44918.pdf> (last updated Mar. 10, 2020) [hereinafter *Who Regulates Whom*].

<sup>198</sup> 12 U.S.C § 27(a).

<sup>199</sup> *Organization*, OFF. OF THE COMPTROLLER OF THE CURRENCY, <https://www.occ.treas.gov/about/who-we-are/organizations/index-organization.html> (last visited Mar. 18, 2023).

<sup>200</sup> *Id.*

<sup>201</sup> *Founding of the OCC & the National Banking System*, OFF. OF THE COMPTROLLER OF THE CURRENCY, <https://www.occ.treas.gov/about/who-we-are/history/founding-occ-national-bank-system/index-founding-occ-national-banking-system.html> (last visited Mar. 18, 2023).

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that national banks are competently and honestly operated.”<sup>202</sup> Banks are granted charters by the OCC only if they meet certain prerequisites. The NBA’s Section 27 instructs that:

If, upon a careful examination of the facts so reported, and of any other facts which may come to the knowledge of the Comptroller . . . it appears that such association is lawfully entitled to commence the business of banking, the Comptroller shall give to such association a certificate . . . that such association has complied with all the provisions required to be complied with before commencing the business of banking, and that such association is authorized to commence such business.<sup>203</sup>

The key phrase in Section 27 is “lawfully entitled to commence the business of banking”, which has been interpreted by some courts to limit OCC chartering powers to institutions that “receiv[e] deposits as an aspect of the business.”<sup>204</sup> Although the language of the NBA appears on its face to require that the OCC grant charters to banks that meet these prerequisites, in practice the OCC has some discretion on whether to issue a charter for a new bank based on supervisory concerns with respect to the filer, or if approval of the filing is inconsistent with applicable law, regulation, or OCC policy.<sup>205</sup> In order to overturn the denial of a bank charter by the Comptroller, “the inquiry is whether the Comptroller’s adjudication was ‘arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.’”<sup>206</sup> The OCC, therefore, wields significant power in making the determination of whether to grant or deny a national bank charter application.

The charter application process for a national bank is often arduous and complex, involving massive disclosure in regard to both the financial state of the institution and the fitness of its managers to engage in the business of banking. Stablecoin issuers seeking a bank charter under current law would be required to submit to an OCC and concurrent FDIC investigation to determine whether the proposed institution is financially viable and whether its officers are fit to

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<sup>202</sup> *City Nat’l Bank v. Smith*, 513 F.2d 479, 481 (D.C. Cir. 1975).

<sup>203</sup> 12 U.S.C. § 27(a).

<sup>204</sup> *Vullo v. Office of the Comptroller of the Currency*, 378 F. Supp. 3d 271, 279, 292 (S.D.N.Y. 2019).

<sup>205</sup> Comptroller’s Handbook 1.1, *Bank Supervision Process*, OFFICE OF THE COMPTROLLER OF THE CURRENCY 52 (Sept. 2019) [hereinafter *Bank Supervision Process*].

<sup>206</sup> *Bank of Com. v. City Nat’l Bank*, 484 F.2d 284, 289 (5th Cir. 1973) (quoting 5 U.S.C. § 706(2)(A)).

implement the business plan.<sup>207</sup> This investigation can involve meetings with regulators, background investigations, and field inspections.<sup>208</sup>

Regulators will then either issue a preliminary approval or deny the application.<sup>209</sup> Preliminary approvals may also contain “standard and special conditions” that must be met by the institution.<sup>210</sup> If stablecoin issuers come to rely on federal charters under the current statutory framework, the OCC and FDIC should develop specific conditions attached to such charter approval tailored for stablecoin issuers. Furthermore, given the relative youth of stablecoins as an asset class and to avoid stifling innovation in this field, the issuance of preliminary approval should be more freely given, but also be more easily revoked.

The second responsibility of the OCC is to supervise national banks. Section 481 of the NBA “authorize[s] OCC examiners to make a thorough examination of a bank, which includes prompt and unrestricted access to a bank’s officers, directors, and employees as well as to a bank’s books, records, or documents of any type.”<sup>211</sup> Regulations require that banks receive a “full-scope, on-site examination” every twelve or eighteen months, a timetable referred to as the “supervisory cycle.”<sup>212</sup> Additionally, the OCC has the authority to require ongoing or targeted supervision.<sup>213</sup> The OCC assigns ratings to banks following their supervisory duties based on “capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk.”<sup>214</sup>

During each examination, the OCC may engage in “correction” practices when areas of concern arise.<sup>215</sup> The most common action taken by OCC is the issuance of a Matter Requiring Attention (“MRA”), which is an process in which bank examiners communicate criticisms to a bank’s management or board of directors.<sup>216</sup> The OCC, however, has

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<sup>207</sup> See Comptroller’s Licensing Manual, *Charters*, OFFICE OF THE COMPTROLLER OF THE CURRENCY 40 (Dec. 2021) [hereinafter *Charters*]; 12 U.S.C. § 1816.

<sup>208</sup> See *Charters*, *supra* note 207, at 40–41.

<sup>209</sup> *Charters*, *supra* note 207, at 41.

<sup>210</sup> *Charters*, *supra* note 207, at 42.

<sup>211</sup> *Bank Supervision Process*, *supra* note 205, at 12; see also 12 U.S.C. § 481.

<sup>212</sup> 12 C.F.R. § 4.6 (Lexis Advance through the Oct. 12, 2022 issue of the Federal Register, with the exception of the amendments appearing at 87 FR 61152, 87 FR 61465, and 87 FR 61660.); *Bank Supervision Process*, *supra* note 205, at 12.

<sup>213</sup> *Bank Supervision Process*, *supra* note 205, at 16.

<sup>214</sup> *Bank Supervision Process*, *supra* note 205, at 23.

<sup>215</sup> *Bank Supervision Process*, *supra* note 205, at 38.

<sup>216</sup> See *Bank Supervision Process*, *supra* note 205, at 46.

multiple options including “MRAs, citations of violations of laws or regulations, or enforcement actions to address banks’ deficiencies.”<sup>217</sup>

The third responsibility of the OCC is to regulate national banks. While chartering and supervision of banks fall under the generic term regulation, this aspect of the OCC’s responsibility generally refers to administrative rulemaking and enforcement. Enforcement actions taken against a bank “require a bank’s board and management to take timely actions to correct a bank’s deficiencies.”<sup>218</sup> Enforcement can range from informally notifying bank managers of violations to the issuance of a Civil Money Penalty (“CMP”) that can be enforced through litigation.<sup>219</sup>

The OCC, therefore, acts as a watchdog of nationally chartered banks, ensuring banks “operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations.”<sup>220</sup> As the OCC would be responsible for chartering, supervising, and regulating stablecoin issuers under the framework proposed by the Treasury Department, stablecoin issuers would have to undergo these processes with the OCC. Compliance with federal banking law, however, would allow for government insurance of stablecoin deposits through the FDIC.

Chartered institutions with FDIC insurance of their deposits enjoy a maximum deposit insurance amount of \$250,000 per depositor, per institution, and per account category.<sup>221</sup> The Deposit Insurance Fund (“DIF”) is funded by assessments on insured institutions on an *ex-ante* basis.<sup>222</sup> Today, “any depository institution which is engaged in the business of receiving deposits . . . upon application to and examination by the [FDIC] and approval by the Board of Directors, may become an insured depository institution.”<sup>223</sup> The application process typically runs concurrently with the charter application process with OCC.<sup>224</sup> Furthermore, as part of the ongoing supervisory process by the FDIC following approval, member banks “shall make to the [FDIC] reports of condition which shall be in such form and shall contain such information

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<sup>217</sup> *Bank Supervision Process*, *supra* note 205, at 38.

<sup>218</sup> *Bank Supervision Process*, *supra* note 205, at 49.

<sup>219</sup> See OFF. OF THE COMPTROLLER OF THE CURRENCY BULL. 2018-41, ATTACHMENT PPM 5000-7, CIVIL MONEY PENALTIES (Nov. 13, 2018), <https://www.occ.gov/news-issuances/bulletins/2018/ppm-5000-7.pdf>.

<sup>220</sup> *Bank Supervision Process*, *supra* note 205, at 1.

<sup>221</sup> BARR ET AL., *supra* note 7, at 244.

<sup>222</sup> BARR ET AL., *supra* note 7, at 244.

<sup>223</sup> 12 U.S.C. § 1815(a)(1).

<sup>224</sup> Charters, *supra* note 207, at 39, (“The OCC and the FDIC encourage simultaneous submission of the interagency application to each agency to expedite processing.”).

as the Board of Directors may require.”<sup>225</sup> Failure to comply with FDIC reporting requirements, whether through delay or misrepresentation, can result in large fines starting at \$20,000 per day for delays and \$1,000,000 for misrepresentations.<sup>226</sup>

OCC supervision of custodial stablecoins like USDT, USDC and BUSD would ensure that issuers are exercising proper risk management practices. FDIC insurance of deposits to custodial stablecoin issuers would work in concert to ensure that public trust is not lost in the issuer, further insulating these assets from runs. Congress should create an OCC department, a Department of Stablecoin Supervision, that could responsibly charter, supervise and regulate custodial stablecoin issuers. In such a structure, entities issuing stablecoins demand-redeemable at par would have to undergo a chartering process similar to that undertaken by *de novo* banks. The application process by a company like Tether would require extensive disclosure and a level of supervisory scrutiny never before experienced in this industry. With that in mind, the government should tailor charters to ensure abstention from unnecessarily burdening crypto asset companies and potentially stifling innovation.

*B. Although bank regulation appears to be an attractive regulatory scheme, applying current banking law to stablecoin issuers without tailoring the rules for the asset class would be an uncomfortable fit.*

Stablecoin issuers will have significant hurdles to actually obtaining a charter even if lawmakers or regulators decide to make laws and regulations granting the explicit framework for stablecoin issuers to be able to receive them. Further, rules instituted specifically for traditional banking products do not directly apply to stablecoins, including but not limited to capital ratio requirements and FDIC guidelines that may not apply to stablecoin issuers. Further research and guidance from lawmakers are needed to tailor a regulatory framework for stablecoin issuers to lawfully operate within. Although stablecoin issuers engage in the business of banking by taking demand deposits, there are differences between stablecoins and deposits. Most significantly, stablecoins differ from bank deposits because their use only requires interaction with the issuer for issuance and retirement.<sup>227</sup> After the issuer creates a stablecoin token on the blockchain and issues

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<sup>225</sup> 12 U.S.C. § 1817(a)(1).

<sup>226</sup> *Id.*

<sup>227</sup> See Tether Whitepaper, *supra* note 37, at 7 (depicting the “Flow of Funds Process”).

it to the depositor, that user can readily transfer that token to any third party without the issuer's involvement, and the transaction is recorded on the blockchain.<sup>228</sup> In contrast, assets in a bank deposit account, such as checking or savings, cannot be readily transferred from one account owner to another without action by the bank.

This additional layer of action by traditional banks results in banks having to comply with anti-money-laundering laws and regulations, as well as factoring this need for liquidity into their capital assessments. Stablecoins, on the other hand, can be transferred between users on secondary markets without involvement from the issuer. In practice, a company like Tether might actually need a lower level of reserves than a traditional bank to remain healthy because the stablecoin issuer requires liquidity far less often than the traditional bank. Further primary research is required to properly analyze the frequency in which stablecoin holders request to exchange their stablecoins for dollars directly with the issuer, as opposed to selling them on a third-party exchange or using them to buy volatile cryptocurrencies.

Stablecoin issuers have far less oversight and control over the flow of money through the economy because of the limited relationship between a stablecoin issuer and the user. Therefore, regulations should consider the specific characteristics of stablecoins, fund research into the effects of these differences in contrast to a traditional bank or holding company, and tailor the regulatory approach based on the findings. For example, it might be prudent to more easily grant preliminary charter approval but carry stricter conditions on final approval, and stablecoin issuers may be able to safely survive a crisis with lower capital ratio requirements than a bank, assuming FDIC insurance.

Additionally, traditional DIF funds would have to be created and FDIC insurance rules restructured because stablecoin issuers do not actively hold accounts for each stablecoin holder—they issue tokens and have no further interaction with the user until redemption. Therefore, it would be impractical to set maximum insurance amounts per customer, per account type. New research and innovative thinking will be required to tailor insurance funds and rules for stablecoins.

The promulgation of regulations tailored to stablecoins would likely result in wider public adoption of the technology. As Acting Comptroller Hsu noted in his January 2022 speech, proper regulation of

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<sup>228</sup> See Tether Whitepaper, *supra* note 37, at 7.

stablecoins would create trust in their value and could conceivably act as a foundation for further growth throughout the crypto economy.<sup>229</sup>

#### VI. CONCLUSION

Stablecoins are an important and rapidly growing subsection of the crypto economy. While there are differences between custodial stablecoin issuers and banks, and between stablecoins and demand-deposit accounts, their similarities carry more weight. Regulatory bodies have been giving more attention to cryptocurrencies in general, and on stablecoins specifically, in recent years. Due to the functional similarities between custodial stablecoin issuers and banks, the entities most equipped to supervise these new companies are bank regulators including the OCC and FDIC.

It is possible that regulators can take action within current law, or new legislation may be required. Either way, the government should attempt to specifically tailor regulation to stablecoins. The best way to do so would be to invest in targeted research, with a focus on identifying the areas most in need of government supervision as well as areas that may require less regulation than a traditional bank.

It would be difficult for Tether in particular to satisfy the standard requirements of bank charter approval and associated supervision, given its reluctance towards transparency to date. There are numerous benefits, however, that Tether and other custodial stablecoin issuers would reap if they could navigate the scrutiny placed on national bank charter applicants and holders.

First and foremost, a charter would allow a stablecoin issuer to do business as a bank in the United States. For example, access to the global payments system and short-term credit markets would likely bring some relief for Tether, which has been almost frantically seeking a new banking partner every few years.

Most importantly, FDIC insurance would replace dollar-for-dollar reserves as the reason a stablecoin's value would hold to its one-dollar peg. This would be crucial for issuers because laws regulating their liquidity ratios would provide implied government consent to operate a fractional reserve system. Stablecoin issuers should therefore welcome increased scrutiny from lawmakers and assist the government in better understanding the technological and economic innovations that these assets bring to the table.

Finally, stablecoin holders would enjoy security in the knowledge that their deposits were insured by the FDIC, which would nearly erase

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<sup>229</sup> Hsu, *supra* note 173.

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the risk that issuers face of users requesting withdrawals *en masse*. If tethers were backed by FDIC insurance up to \$250,000, USDT likely never would have fallen to \$0.91 in 2017. The government's reassurance of the public's deposits would then allow stablecoin issuers to make more informed, and therefore profitable investments with their reserves.

If stablecoin issuers like Tether could bring a level of responsibility and transparency to their business practices, it is possible that U.S. regulators will allow them to apply for and receive charters as national banks, with all the rights and responsibilities that follow.