FACT SHEET: The Financial Stability Oversight Council's Report on Digital Asset Financial Stability Risks and Regulation

October 3, 2022

The Financial Stability Oversight Council (Council) today released its *Report on Digital Asset Financial Stability Risks and Regulation*. In March 2022, the Secretary of the Treasury convened the Council to produce the report in response to Section 6 of President Biden's Executive Order 14067 on "Ensuring Responsible Development of Digital Assets." The report reviews the specific financial stability risks and regulatory gaps posed by various types of digital assets and provides recommendations to address such risks.

Financial stability risks

Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure.

The scale of crypto-asset activities has increased significantly in recent years. Although interconnections with the traditional financial system are currently relatively limited, they could potentially increase rapidly. Participants in the crypto-asset ecosystem and the traditional financial system have explored or created a variety of interconnections. Notable sources of potential interconnections include traditional assets held as part of stablecoin activities. Crypto-asset trading platforms may also have the potential for greater interconnections by providing a wide variety of services, including leveraged trading and asset custody, to a range of retail investors and traditional financial institutions. Consumers can also increasingly access crypto-asset activities, including through certain traditional money services businesses.

Some characteristics of crypto-asset activities have acutely amplified instability within the crypto-asset ecosystem.

- Many crypto-asset activities lack basic risk controls to protect against run risk or to help ensure that leverage is not excessive.
- Crypto-asset prices appear to be primarily driven by speculation rather than grounded in current fundamental economic use cases, and prices have repeatedly recorded significant and broad declines.
- Many crypto-asset firms or activities have sizable interconnections with crypto-asset entities that have risky business profiles and opaque capital and liquidity positions.
- In addition, despite the distributed nature of crypto-asset systems, operational risks may arise from the concentration of key services or from vulnerabilities related to distributed ledger technology.

These vulnerabilities are partly attributable to the choices made by market participants, including crypto-asset issuers and platforms, to not implement or refuse to implement appropriate risk controls, arrange for effective governance, or take other available steps that would address the financial stability risks of their activities.

Enforcement of the existing regulatory structure

Many nonbank firms in the crypto-asset ecosystem have advertised themselves as regulated. Firms often emphasize money services business regulation, though such regulation is largely focused on anti-money laundering controls or consumer protection requirements and does not provide a comprehensive framework for mitigating financial stability vulnerabilities arising from other activities that may be undertaken, for example, by a trading platform or stablecoin issuer. While some firms in the crypto-asset ecosystem have attempted to avoid the existing regulatory system, other firms have engaged with the existing regulatory system by obtaining trust charters or special state-level crypto-asset-specific charters or licenses.

Compliance with and enforcement of the existing regulatory structure is a key step in addressing financial stability risks. For example, certain crypto-asset platforms may be listing securities but are not in compliance with exchange or broker-dealer registration requirements. In addition, certain crypto-asset issuers have offered and sold crypto-assets in violation of federal and state securities laws, because the offering and sale were not registered or conducted pursuant to an available exemption. Regulators have taken enforcement actions over the past several years to address many additional instances of non-compliance with existing rules and regulations, including illegally offered crypto-asset derivatives products, false statements about stablecoin assets, and many episodes of fraud and market manipulation. In addition, false and misleading statements, made directly or by implication, concerning availability of federal deposit insurance for a given product, are violations of the law, and have given customers the impression that they are protected by the government safety net when they are not. Further, misrepresentations by crypto-asset firms about how they are regulated have also confused consumers and investors regarding whether a given crypto-asset product is regulated to the same extent as other financial products.

Regulatory Gaps

Though the existing regulatory system covers large parts of the crypto-asset ecosystem, this report identifies three gaps in the regulation of crypto-asset activities in the United States.

- First, the spot markets for crypto-assets that are not securities are subject to limited direct federal regulation. As a result, those markets may not feature robust rules and regulations designed to ensure orderly and transparent trading, prevent conflicts of interest and market manipulation, and protect investors and the economy more broadly.
- Second, crypto-asset businesses do not have a consistent or comprehensive regulatory framework and can engage in regulatory arbitrage. Some crypto-asset businesses may have affiliates or subsidiaries operating under different regulatory frameworks, and no single regulator may have visibility into the risks across the entire business.

- Third, a number of crypto-asset trading platforms have proposed offering retail customers direct access to markets by vertically integrating the services provided by intermediaries such as broker-dealers or futures commission merchants. Financial stability and investor protection implications may arise from retail investors' exposure to certain practices commonly proposed by vertically integrated trading platforms, such as automated liquidation.

Recommendations

The Council notes that large parts of the crypto-asset ecosystem are covered by the existing regulatory structure. In applying these existing authorities, the Council recommends that its members take into consideration a set of principles and emphasizes the importance of continued enforcement of existing rules and regulations.

To address regulatory gaps, the Council recommends:

- the passage of legislation providing for rulemaking authority for federal financial regulators over the spot market for crypto-assets that are not securities;
- steps to address regulatory arbitrage including coordination, legislation regarding risks posed by stablecoins, legislation relating to regulators' authorities to have visibility into, and otherwise supervise, the activities of all of the affiliates and subsidiaries of crypto-asset entities, and appropriate service provider regulation; and
- study of potential vertical integration by crypto-asset firms.

Finally, the Council recommends bolstering its members' capacities related to data and to the analysis, monitoring, supervision, and regulation of crypto-asset activities.

The full report can be viewed here.