

## StableCoins Are (Not Just Similar To) Money Market Funds

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Before TerraD and Luna tokens crashed and the FTX exchange imploded, Securities and Exchange Commission Chair Gary Gensler gave a speech laying out his views on the regulation of the digital asset markets. Among other things, he said: “When a new technology comes along, our existing laws don’t just go away.” He reiterated the position of his predecessor Jay Clayton: “Without prejudging any one token, most crypto tokens are investment contracts under the Howey Test” adopted by the U.S. Supreme Court in 1946. The SEC and other federal regulators have spent the past year bringing enforcement actions against digital platforms that ignored the regulators’ warnings.

This article discusses a correlate of the proposition that digital assets are investment contracts and therefore are securities, namely that pools of digital assets are investment companies as defined in the Investment Company Act of 1940 (the 1940 Act). That act was adopted because of abuses that arose approximately 100 years ago in the then relatively new “technology” of pooled investment vehicles. As it happened, some of these investment funds engaged in a variety of abuses: selling to unsophisticated investors, participating in self-dealing transactions to prop up failing entities, manipulating prices and providing benefits to affiliated parties, and using combined power with controlled funds to force combinations with competitors,

The 1940 Act defines “investment company” to mean an “issuer which ... holds itself out as being engaged primarily ... in the business of investing ... or trading in securities;” or “owns or proposes to acquire investment securities [i.e., not including government securities or certain majority-owned subsidiaries] having a value exceeding 40 per centum of the value of such issuer’s total assets ... .”

If digital assets or tokens are securities under the Howey Test, then they are certainly investment securities under the 1940 Act. Even if they are “investment securities,” most digital assets are not “investment companies” because the “business” of which they are tokens is simply the registration of their own ownership on a distributed ledger. There is no investing or trading by the platform itself. However, if a “platform” describes its business as investing or trading in tokens or ascribes more than 40% of its value to its ownership of such tokens, it would fit the definition of, and would be required to register as, an investment company, unless it was entitled to, or applied to the SEC for and received, an exemption from the 1940 Act.

This brings us to digital assets that present themselves as “StableCoins.” These assets have been defined as “digital assets that are designed to maintain a stable value relative to a national currency or other reference asset.” In order to do so, unlike other pure tokens that just identify their ownership and have an independent market value, StableCoins must develop and utilize a mechanism by which their intended stable value may be maintained. One way to do so would be to hold a fixed amount of the reference asset for every unit of the digital asset. Another way would be to maintain an asset base that parallels the reference asset and algorithmically sheds or builds value when the asset base fails to equal the intended stable value.

Some StableCoin platforms maintain opacity about their underlying assets, possibly because it would provoke doubts about the stated value. Even if a platform were to invest solely in U.S. Treasury securities, that would not be sufficient to maintain a stable value. Silicon Valley Bank suffered a mortal wound because its treasury holdings lost value as interest rates rose.

The asset bases of StableCoins have been seen to include other tokens, derivatives or other securities. If a platform were to identify what it actually traded to maintain value, that could confirm that it satisfies part of the definition of investment company in that it holds itself out as principally investing in securities. Note, however, that even if has not yet identified its portfolio, a StableCoin platform meets part of the definition in that it engages primarily in investing and trading in securities. What else does a StableCoin (as opposed to its holders) actually do besides hold investment assets?

Forty years ago, the Securities and Exchange Commission adopted a regime for investment companies both available to retail investors and with the objective of maintaining a stable value. It referred to them as “money market funds.” The SEC adopted Rule 2a-7 (which followed a limited number of private exemptive orders), which has been enhanced repeatedly over the decades to provide the highest probable assurance that a stable value could be approximated and maintained. In forty years, less than a handful of funds have failed to sustain their \$1 per share value every single day, and the few that failed to do so lost only two or three cents, unlike, say, banks that failed or StableCoins that crashed to lose almost all their value.

For all the creativity of the financial wizards who have arisen since the overturning of the Merlins of 1940 or 2008, nothing suggests that a magic formula has been found for maintaining a stable value that had not been evaluated during the forty-year development of Rule 2a-7. The primary lessons from money market fund protection have been diversification, transparency and policies and procedures for testing valuation.

The use of the word “coin” in Bitcoin or StableCoin is just a metaphor. Digital assets are stored in memory on devices that connect to peer-to-peer networks, not in a vault. The fact that ownership records are maintained in a database called a blockchain does not actually make each record a “token” or a “coin” or turn the distributed ledger into a “bank.” These are all just metaphors.

Whatever the underlying business of a standard “coin offering” turns out to be when you take the red pill and consider it in the context of existing regulation, a “StableCoin” is a rather different and more cultivated article. It actually needs a process not just for “mining” but for “refining” into a polished \$1 (or other standard) value. As outlined above, this requires identifying the underlying assets and if they are securities (including investment contracts under the Howey Test), admitting that the business principally involves investment in those securities, and that the pooling of those assets create an investment company under the 1940 Act. In that case, it requires a pre-existing exemption or receipt of an exemptive order to ignore some or all of the protective provisions of the 1940 Act, including registration, public financial and other reporting, avoidance of affiliated transactions, oversight and valuation mechanisms, and limitations on leverage and use of derivatives.

The SEC is not averse to financial innovations; in just the investment company area, it has approved money market funds, passive and active exchange-traded funds, and interval funds. It has provided exemptions for asset-based securitizations. Section 6(c) of the 1940 Act provides that the Commission can exempt persons, securities or transactions from any or all provisions of the 1940 Act.

Obtaining such an exemption, however, normally requires innovators to agree to conditions designed to achieve the same safeguards for investors as would exist in non-exempted investment products. The process of negotiating those protections could be a lengthy process and is not for the faint of heart, notwithstanding that the commission negotiates in good faith. It may, or may not, be more difficult to obtain a bank charter and to comply with the capital and other supervisory requirements of being a bank (possibly with a bank holding company above it). Another exemption exists for mutual insurance companies, where the policy holders are the shareholders and share excess returns. But the most obvious regulatory regime for a product intended to maintain a stable value is that of the money market fund. If a StableCoin is not following the same rules to achieve its purposes as other similar offerings do, then inquisitive regulators may want to know why.

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