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# Alert | Blockchain & Digital Assets

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## Digital Assets: Financial Stability Oversight Council Risk Report Assesses Regulatory Gaps; Offers Recommendations

On Oct. 3, the Financial Stability Oversight Council (FSOC) took another step in identifying, assessing, and responding to the risks various types of digital assets pose to the financial system by releasing its *Report on Digital Asset Financial Stability Risks and Regulation* (Report) in response to President Biden's March 2022 Executive Order on "Ensuring Responsible Development of Digital Assets."

The Report reviews the specific financial stability risks and regulatory gaps digital assets pose and provides recommendations to address such risks. This GT Alert summarizes the Report.

*Financial stability risks* have amplified within the crypto-asset ecosystem largely due to participants' failure to implement appropriate risk controls and create effective governance.

- Some crypto-asset activities lack basic risk controls to protect against run risk or to help ensure leverage is not excessive.
- Crypto-asset prices primarily appear driven by speculation rather than grounded in current fundamental economic use cases, and prices have recorded significant and broad declines.
- Some crypto-asset firms or activities have sizable interconnections with crypto-asset entities with 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.

*Regulatory gaps* were observed and discussed at length. They include:

- Limited direct federal regulation of spot markets[1] for crypto-assets that are not securities results in weaker rules.
- Inconsistent or incomprehensive regulatory frameworks that allow for regulatory arbitrage.

Some crypto-asset trading platforms have proposed offering retail customers direct access to markets by vertically integrating the services provided by intermediaries. 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. The FSOC made *recommendations* that include:

- 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 stablecoins pose, legislation relating to regulators' authorities to have visibility into, and otherwise supervise, the activities of all affiliates and subsidiaries of crypto-asset entities, and appropriate service provider regulation; and
- study of potential vertical integration by crypto-asset firms.

Finally, the Report highlights the existence of a regulatory framework that is effective when enforced but sometimes obfuscated by firms. The Report suggests that compliance with and enforcement of existing regulations is the key to addressing financial stability risks. The Report may help guide lawmakers in crafting legislation that addresses the concerns raised therein, specifically around regulatory arbitrage, spot markets, and implementation of appropriate risk controls by vertically integrated crypto-asset firms.

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[1] The spot market is where financial instruments, such as commodities, currencies, and securities, are traded for immediate delivery.

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