

Newsletter No.

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Understanding stablecoins and their regulatory challenges:

On 26 July 2024, the Swiss Financial Market Supervisory Authority (FINMA) published a new guidance on stablecoins. This newsletter highlights the key elements that are relevant for issuers of stablecoins as well as for banks that offer default guarantee solutions for stablecoin projects.

FINMA publishes a new guidance on stablecoins



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In this newsletter, the authors delve into FINMA's recent guidance on stablecoins, offering an overview of the legal classification of stablecoins and the legal requirements that apply to issuers of stablecoins. In addition, this newsletter summarizes the minimal requirements formulated by FINMA that banks and issuers of stablecoins need to fulfill when projects rely on default guarantees.

The issuance of stablecoins triggers financial market law requirements

Stablecoins have taken off to meet the demand for crypto currencies with low volatility in prices. The price stability may be achieved through various mechanisms, including linking their value to underlying assets such as traditional FIAT currencies or commodities. For such purpose, issuers of stablecoins keep an equal amount of underlying assets as issued in stablecoins. Generally, stablecoin holders have a claim against the issuer.

FINMA in its recent guidance 06/2024 "Stablecoins: risks and challenges for issuers of stablecoins and banks providing guarantees"¹ published on 26 July 2024 assesses the claims of stablecoin holders under Swiss banking and collective investment schemes regulations:

- **Banking Act:** If the issuer manages the underlying assets for its own account and at its own risk, the claims of the stablecoin holders are considered deposits from the public under banking regulations. This classification subjects the issuer to the regulations of the Banking Act (the BankA) which is designed to protect the depositors and ensure financial stability (while FINMA assumes that stablecoin holders

would have a direct claim against the issuer which, in our experience, is rarely the case).

- **Collective Investment Schemes Act:** In contrast, if the underlying assets are managed for the account and risk of the stablecoin holders, a collective investment scheme in the sense of the Collective Schemes Act (the CISA) is given. As a consequence, the issuer is required to fulfill regulatory requirements on the product and on the point-of-sale level.

In addition to the above, the issuance of stablecoins as a means of payment is a financial intermediation activity and falls into the scope of the Anti-Money Laundering Act (the AMLA). The AMLA imposes extensive compliance requirements on issuers to prevent a misuse for money laundering and terrorist financing purposes. In detail, stablecoin issuers are required to implement robust identity verification processes and maintain comprehensive records to comply with AMLA obligations. In this context, FINMA also reminds of its supervisory practice of its 2021 Annual Report (p. 19 et seq.) based on which issuers of stablecoins or supervised financial intermediaries must verify the identity of all holders of stablecoins (i.e., also acquirers which

¹ https://www.finma.ch/en/~media/finma/dokumente/dokumentencenter/myfinma/4dokumentation/finma-aufsichtsmittelungen/20240726-finma-aufsichtsmittelungen-06-2024.pdf?sc_lang=en&hash=03D675C1247EAFAE0C391363A2F18B9A.

received the stablecoins from a holder other than the issuer according to our reading of the FINMA publication). Lastly, FINMA states that anonymous transfers of stablecoins are prohibited in view of the AMLA regulations. In other words, FINMA intends to prevent the use of stablecoins in a similar way than cash.

Stablecoins carry inherent risks for money laundering and terrorist financing

FINMA highlights in its guidance the risks associated with stablecoins and repeats the Financial Action Task Force's (the FATF) emphasis on the inherent risks of cryptocurrencies, including stablecoins, for money laundering and terrorist financing. FINMA notes that the stability and widespread acceptance of stablecoins make them particularly appealing to illicit actors.

FINMA also points out the need for sound AMLA processes and the potential risks for the Swiss financial center as a whole in view of the increased risks of money laundering, terrorist financing and the circumvention of sanctions.

FINMA has formulated minimal requirements for default guarantees

Over the last years various stablecoin issuers in Switzerland have used default guarantees from banks on the basis of art. 5 para. 3 let. f of the Banking Ordinance to avoid prudential license requirement in Switzerland. FINMA has formulated minimum requirements that issuers need to meet when they wish to benefit from such an exemption:

- If a stablecoin issuer goes bankrupt, each stablecoin holder must have its own claim against the bank issuing the default guarantee. Stablecoin holders must be informed about the default guarantee.
- The default guarantee must cover all public deposits, including any earned interest.
- The total deposits covered should never exceed the upper limit of the default guarantee.
- The default guarantee should allow the stablecoin holders to assert their claim in a swift and simple manner. The provisions of the guarantee must be drafted accordingly. According to FINMA practice, the claim must be due at the time of insolvency, i.e., at the latest with the adjudication of bankruptcy over the issuer.
- Legal defenses and objections by the bank are allowed as provided by law.
- In case of multiple default guarantees, issuers of stablecoins require to implement coordination measures to manage the resulting operational risks and they need to inform the stablecoin holders accordingly.
- Reputational Damage: The failure of stablecoin issuers to comply with AMLA regulations may expose the guarantor banks to significant reputational damage. An association with non-compliant stablecoin issuers can tarnish a bank's reputation. Maintaining a robust due diligence process and ongoing monitoring of issuers is essential to mitigate this risk.
- Legal Risks: Banks may face legal challenges from dishonest claimants. These challenges can increase compliance costs and necessitate a proactive approach to risk management.

Moving forward with caution

FINMA's new guidance underscores the importance of rigorous compliance and risk management for stablecoin issuers and guarantor banks. As the crypto landscape continues to evolve, stakeholders must stay informed and proactive in addressing the regulatory challenges associated with stablecoins.

Ensuring compliance with AML regulation, maintaining transparent and secure customer relationships and being prepared to manage legal and reputational risks are crucial steps for sustainable operation in this dynamic sector. In particular, issuers of stablecoins should assess their existing bank guarantee, client identification and client information setups to ensure compliance with FINMA's requirements. Moreover, as for planned stablecoin projects, alternative structures should be explored that would allow an issuance of stablecoins without triggering a banking license, e.g., the issuance of stablecoins based on a prospectus.

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