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Stablecoins come under increased scrutiny

For an asset type often regarded as a "safer" corner of the crypto world, stablecoins have attracted a surprising degree of regulatory scrutiny. While stablecoins are designed to maintain a stable value, their underlying structures and use cases vary, meaning not all stablecoins are created equal. Regulators are concerned about the potential for stablecoins to pose systemic risks, particularly given their intersection with traditional financial systems.

Stablecoins are a type of crypto asset that – as the name implies – are designed to maintain a stable value by being pegged to a stable asset such as a fiat currency. Perhaps the best-known stablecoin is Tether (USDT), which is pegged to the US dollar. The idea is to shield investors from the extreme volatility that has characterized many crypto assets.

Stablecoins seen as posing threat to financial stability

Nevertheless, the touted safety of stablecoins has not insulated them from growing attention from national regulators and the global standard-setting bodies – such as the Financial Action Task Force (FATF) – that help to shape the emerging regulatory framework.

An obvious concern regarding stablecoins is their widespread use in money laundering. However, anti-money laundering (AML) is arguably the most "standardized" area of regulation. For all the lack of cohesion that still hampers crypto asset regulation, supervisory bodies across the board have long been aligned when it comes to AML. Further, money laundering is a risk that applies to all crypto assets, not just stablecoins.

The reason stablecoins have attracted special attention therefore goes beyond AML. In fact, the primary concern for regulators seems to be the perceived threat they pose to financial stability, given their size and their intersection with the regulated financial system.

EU redefines “stablecoin”

The EU’s Markets in Crypto Assets Regulation (MiCA) is the most comprehensive emerging crypto asset regulatory framework among major jurisdictions. Following the guidance of standard-setting bodies such as the FATF, the Financial Stability Board (FSB), and the International Organization of Securities Commissions (IOSCO), MiCA includes a detailed and strict set of rules for stablecoins. Redefining this asset subtype on its own terms, MiCA has introduced new categories and terms not previously used by market practitioners, effectively ditching “stablecoin” from its lexicon. Instead, MiCA identifies two other asset types:

- **E-Money Tokens (EMTs):** Pegged directly to a single fiat currency (like the euro or US dollar), an EMT essentially operates as a digital representation of the currency to which they are pegged.
- **Asset-Referenced Tokens (ARTs):** Pegged to a basket of assets, including commodities, other currencies, other digital assets, or some combination thereof, an ART is designed to be widely used as a store of value or medium of exchange.

Tough requirements strike blow to crypto industry

The requirements MiCA has imposed on these newly defined asset categories are far-reaching and strict. Some of the key rules relate to:

- **E-money licenses:** Any EMT operating in the EEA must have an e-money license from at least one EU member.
- **Reserve and redemption requirements:** EMT issuers are required to maintain adequate reserves fully backing their tokens and ensure convertibility. This means holders have a clear legal claim to redeem these tokens at face value from reserves.
- **Market cap and transaction limits:** ARTs with a large market capitalization or high transaction volumes may be subject to transaction volume caps if regulators deem them a systemic risk.
- **Investor protection:** EMT and ART issuers must disclose detailed information regarding token mechanics, risk factors, and redemption rights, leading to additional administrative and compliance requirements.
- **DeFi and cross-border use:** EMTs and ARTs used in decentralized finance (DeFi) or cross-border transactions may face various regulatory restrictions, particularly around jurisdictional requirements and oversight.
- **Interest:** MiCA prohibits EMTs and ARTs from offering interest on holdings, making them less appealing to investors compared to traditional interest-bearing accounts.

Aimed at upholding core principles such as transparency and investor protection, as well as mitigating systemic risk, these rules are also exacting a heavy toll on the crypto industry. Coinbase, for instance, has preemptively delisted some stablecoins in anticipation of these requirements coming into force, presumably in the knowledge they won’t meet the classification criteria for EMTs or ARTs.

Implications for USDT

While USDT may be the most well-known stablecoin, its treatment by MiCA is not yet clear. Despite its US dollar peg, the reserve holdings that back USDT have historically included a mix of assets, including commercial paper, loans, and other investments, which would effectively disqualify it from EMT classification. At the same time, given the single-asset peg, it may not qualify as an ART or may, in any case, fail to meet other requirements listed above.

USDT's ongoing woes

Meanwhile, USDT continues to be plagued by its association with illicit activity and controversy surrounding its reserves. According to the Wall Street Journal, Tether (the company) is under investigation by the US Department of Justice, given extensive alleged use of USDT in illicit activity, including money laundering, drug trafficking, terrorism, and cybertheft – allegations that are refuted by Tether executives.

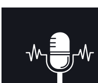
Compounding Tether's difficulties are lingering concerns regarding the transparency of the reserve assets that are supposed to back the stablecoin. They are claimed to be a mix of Bitcoin, gold, and US T-bills covering some USD120 billion USDT in circulation, but these reserves have not been audited.

Conclusion

The regulatory focus on stablecoins shows no sign of abating. The UK, for instance, is expected to adopt measures similar to MiCA in the coming months. In an emerging global framework that aims for cohesion but still shows notable divergences across jurisdictions, could stablecoins be one area where a regulatory consensus is forming – akin to AML? A key difference is that whereas AML is an obvious priority for regulators, the level of scrutiny shown toward stablecoins has taken many market participants by surprise.

Intuition Know-How has a number of tutorials relevant to the content of this article:

- *Digital Assets*
- *Crypto Assets – An Introduction*
- *Regulation – An Introduction*
- *Markets Regulation – An Introduction*
- *Anti Money-Laundering (AML) (2024)*
- *Blockchain*
- *Tokenization*
- *Crypto Derivatives*
- *DeFi*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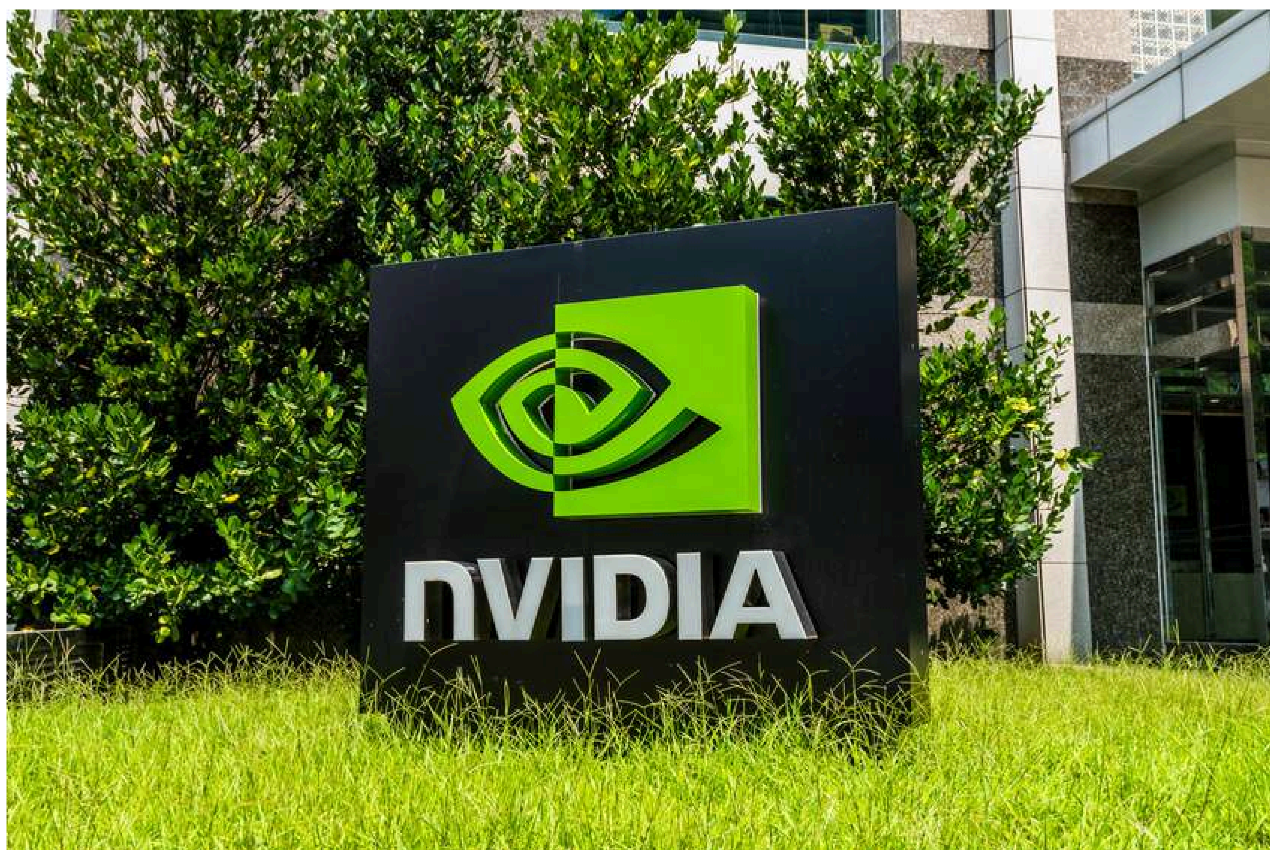
Heavy stock concentration poses indexing problems

The relentless secular bull market in tech stocks has led to structurally high index concentration. While this is an age-old market phenomenon, it still poses a challenge for fund managers and index designers, particularly with passive investing having added fuel to the debate around index concentration.

There can be little doubt that index concentration in the US stock market is high. In 2024, the five largest tech giants – Apple, Alphabet, Microsoft, NVIDIA, and Meta – make up over 30% of the Nasdaq 100, while the top ten constituents of the Russell 1000, consisting mainly of tech stocks, account for over 30% of that index, the highest concentration level in its 45-year history. The US technology industry's weight in the Russell 1000 hit an all-time high in July over three times the aggregate weight of the basic materials, consumer staples, energy, and utilities industries (the exact opposite of the situation in 2007/08).



At the same time, this is nothing new. FTSE Russell Insights (affiliated with FTSE Russell Indexes) has identified some striking examples of extreme concentration. For example, Nokia accounted for 70% of Finland's stock market index in 2000, while Volkswagen had a 27% weight in Germany's DAX30 in 2008, albeit on the back of an unprecedented short squeeze triggered by Porsche acquiring a stake in the company.

Diversification/correlation

The problems with excess index concentration are well-known. To start with, it diminishes diversification, which is one of the main reasons to invest in an index in the first place. Diversification is a founding principle of modern portfolio theory and underpins asset allocation and portfolio construction. A key benefit is that it reduces "unsystematic risk," which describes the risks unique to a single stock or sector – as opposed to systemic (or overall market) risk – by combining them with other assets that, optimally, have weak or even negative correlations. This then reduces portfolio volatility, as sharp declines in one asset or sector should theoretically be shielded or offset elsewhere.

By the same token, excessive concentration makes an index disproportionately vulnerable to moves in the relevant sector, and this increases volatility. High concentration can also give rise to other distortions, such as an index being an inaccurate barometer of the underlying economy.

Passive investing's amplification effect

While index concentration itself may be nothing new, there's a reason why it continues to be hotly discussed – the rise of passive investing and its growing dominance of market flows through index trackers and passive ETFs over the years. In crude terms, the problem many fund managers and analysts see is that this ongoing wave of "dumb" – or valuation-insensitive – flows into equity markets causes the stock market to move increasingly in lockstep. In other words, it amplifies the above mentioned problem of suboptimal diversification/excessive correlation. A virtuous cycle takes shape, where money naturally flows to the same outperforming stocks (as passive strategies use capitalization-weighted indices like the S&P 500) and those stocks go even higher, causing yet more flows into those stocks. The ultimate concern for market participants is that this eventually ends in a proper bear market, inflicting unrecoverable losses on investors, with spillover into other markets and the real economy.

Some analysts have identified other issues with passive investing, such as its impact on market structure. For example, with an ever-larger portion of stock held by passive funds, the free floats of stocks may be lower than the official numbers suggest. A fund manager who wishes to buy stock on the market can only really buy from other active investors. This may help to explain some of the outsized daily moves seen in mega-cap stocks that used to be rare but are common today, particularly during earnings season.

Other analysts have weighed in on the other side of the argument. A recent article in the FT called *"Slaying some of the biggest passive investing bogeymen"* references research by Goldman Sachs analysts that dismisses many of these claims. For example, their research suggests that passive investing has had a limited impact on correlations and valuations.

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Regulators alert to risks

Whether the risks are overblown or not, they are not lost on regulators who look to protect investors – in particular retail investors.

In the US, investment companies such as mutual funds that market themselves as "diversified" must follow what is known as the "75-5-10" rule, requiring that the fund:

- Must have at least 75% of the fund's assets invested in the securities of other issuers
- Cannot invest more than 5% of its assets in any one company
- Cannot own more than 10% of a single company's outstanding stock

The EU has a roughly equivalent measure called the "5/10/40" rule, which means that funds can only invest up to 10% of assets in a single issuer, and any positions worth 5% or more of the fund must not exceed 40% on aggregate.

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Index designers look to limit concentration risk

Many mutual funds track indices, and it might be thought that index designers would have to reflect the fund diversification rules in their design. In fact, because regulators recognize that index trackers are less likely to incur stock-specific risk, they have granted index tracker fund providers a degree of flexibility.

Index providers such as FTSE Russell design indices to tackle concentration risk. One such method is capped indices where individual index constituents are capped on a quarterly basis – a variant on the standard market-cap weighted index.

While overconcentration typically unwinds eventually (no bull market lasts forever), as long as the current "winner takes all" age of mega-cap domination persists, concentration risk promises to remain topical. Taken in tandem with fund concentration regulations, index providers hope to ensure that their modified index offerings can adequately limit concentration risk while protecting fund investors.

Intuition Know-How has a number of tutorials relevant to the content of this article:

- *Equity Markets – An Introduction*
- *Equity Indices*
- *Asset Allocation – An Introduction*
- *Risk & Return – Efficient & Optimal Portfolios*
- *Portfolio Management – Passive vs. Active Approaches*
- *Mutual Funds (US) – An Introduction*
- *Mutual Funds (US) – Investing*
- *Mutual Funds (US) – Types*
- *ETFs – An Introduction*

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