Crypto-assets market: Regulators keeping a watchful eye

The impact of crypto-assets on the global financial system continues to be a subject of debate for regulatory and supervisory authorities. **Julia Smithers Excell** and **Laura Kitchen** provide a summary of the latest publications.

On 14 May 2019, the European Central Bank's (ECB) Crypto-Assets Task Force added to the growing body of published work on crypto-assets in the financial markets. Its paper, entitled "Crypto-Assets: Implications for financial stability, monetary policy, and payments and market infrastructures," follows similar publications by the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA). Shortly afterwards, the Financial Stability Board (FSB) published a report entitled "Crypto-assets: Work underway, regulatory approaches and potential gaps," and the International Organization of Securities Commissions (IOSCO) separately published its own consultation paper on "Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms".

An evolving crypto-asset market

What is most striking about the ECB paper is its assessment that the risks and potential implications of crypto-assets in the current market are limited and/or manageable within the existing regulatory and oversight frameworks in the euro area. This conclusion may be surprising given the level of regulatory scrutiny surrounding crypto-assets in recent months. But, while acknowledging that the current regulatory framework may be sufficient in managing known risks (excluding AML and consumer protection risks), the Crypto-Assets Task Force is clear that this assessment is not, and cannot be, static. It recommends that the ECB continues to monitor, raise awareness and develop preparedness for an evolving crypto-assets market. This message echoes the call made by G20 Ministers of Finance and Central Bank Governors in March 2018 for international standard setting bodies to continue monitoring crypto-assets and their risks, and assess the need for multilateral responses (as referenced in the IOSCO report).

The IOSCO report identifies eight priority areas based on the core issues and risks related to crypto-asset trading platforms (CTPs) highlighted during its consultation:

- Access to CTPs and participant on-boarding
- Safeguarding participant assets, including custody arrangements
- Identification and management of conflicts of interest
- Transparency of operations
- Market integrity, including the rules governing trading on the CTP, and how those rules are monitored and enforced
- Price discovery mechanisms
- Technology, including resilience and cyber security
- Clearing and settlement

Equally importantly, the IOSCO report also sets out corresponding toolkits for supervisory authorities to consider when seeking to regulate CTPs.

IOSCO adds that the eight key considerations depend on the operational model of the CTP and may already be mitigated or addressed by existing regulatory frameworks. The IOSCO report focuses on secondary market trading of crypto-assets on CTPs and does not discuss issues related to initial coin offerings (ICOs).

ECB publishes its report on "Crypto-Assets: Implications for financial stability, monetary policy, and payments and market infrastructures"

Emerging regulatory approaches

While it is clear from the ECB paper that the ECB considers the regulation of the crypto-asset market on a European level to be broadly functional and adequate, IOSCO recognizes that other global jurisdictions are considering new or tailored requirements to account for the novel and unique characteristics of CTPs. For example, the IOSCO report points out that some jurisdictions have established, or are in the process of establishing, a specific framework for CTPs that offer trading of crypto-assets that fall within their regulatory remit. Annex A of the IOSCO report provides a list of information published by key jurisdictions regarding their regulatory frameworks applicable to CTPs. Some jurisdictions such as Canada and Hong Kong are considering creating a new regime or adapting the existing one by tailoring requirements and/or exemptions. In certain jurisdictions, such as Japan, the payment services framework applies to the trading of crypto-assets whereas in other jurisdictions, such as China, engaging in ICO activities is prohibited.

> **"It is important to ensure that the evolution of business models in crypto-assets does not circumvent the regulatory framework or compromise its effectiveness in the future**

Differences in prudential treatment

The FSB addresses this developing global divergence in regulatory frameworks, and the potential risks and challenges that it poses. The FSB report provides an update on the work of the following international organizations: the Basel Committee on Banking Supervision (BCBS), Committee for Payments and Market Infrastructures (CPMI), IOSCO, Financial Action Task Force (FATF) and the Organisation for Economic Co-operation and Development (OECD).

The FSB recognizes that, at a national level, supervisory authorities have chosen varying approaches, reflecting differences in national market developments and underlying legal and regulatory frameworks. The FSB report also highlights the challenges in assessing the significance of potential gaps that may arise from an absence of international standards or recommendations, given the rapidly evolving nature of the crypto-asset ecosystem and related risks. It argues that adopting a forward-looking approach in monitoring crypto-assets can help provide a basis for identifying potential gaps and areas to prioritize and focus on.

In fact, the ECB, FSB and IOSCO all allude to the difficulties supervisory authorities face globally in attempting to clarify the prudential treatment of crypto-assets across the various sets of risk categories (counterparty risk, credit risk, market risk, liquidity risk, etc.). They acknowledge that there is no international agreement on how to define crypto-assets and no common taxonomy, which results in variations in the legal status of crypto-assets globally. The ECB points out that the European regulation on capital requirements for credit institutions and investment firms (CRR) is not tailored to crypto-assets given their high volatility. It suggests that crypto-assets should be deducted from common equity tier one (CET1) capital by way of a conservative prudential treatment, similarly to other assets classified as "intangible assets" under the accounting framework.

The importance of regulatory collaboration

The ECB paper expresses concern that disjointed regulatory initiatives could trigger regulatory arbitrage and ultimately hamper the resilience of the financial system to crypto-asset market-based shocks.

To mitigate this risk, the FSB states in its report that one of its two focus areas is the preparation of a directory of regulators on crypto-assets (the other focus area being the monitoring of risks to financial stability). The FSB delivered this directory to G20 Finance Ministers and Central Bank Governors in April 2019. The aim of the directory is to provide information on the relevant regulators and other authorities in FSB jurisdictions that are dealing with crypto-asset issues and the aspects covered by them.

Information sharing is also integral to IOSCO's work on crypto-assets, and the purpose of its report is to set out the approaches taken or being considered by regulatory authorities in IOSCO members' jurisdictions to allow authorities to consider (and possibly benchmark) their own efforts.

What's next?

The FSB shares the ECB's view that crypto-assets do not currently pose a material risk to global financial stability. However, the FSB, ECB and IOSCO all recognize the importance of keeping a watchful eye on the crypto-asset market, particularly as new products and services develop. In terms of next steps, IOSCO intends to continue to monitor the situation, with a view to ensuring the risks, issues and key considerations identified continue to be appropriate and relevant. The FSB intends to submit a monitoring note to its Standing Committee on Assessment of Vulnerabilities (SCAV) in September 2019, including developments in stablecoins and tokenization. The ECB intends to address any risks relating to crypto-assets that are not covered by Pillar 1 (i.e., should CET1 deductions not apply to crypto-assets) via supervisory assessment. The ECB also states that it is in a position to impose ring-fencing segregation for the European financial market infrastructures that it owns and controls, subject to risk considerations. The ECB regards such supervision as important in ensuring that the evolution of business models in crypto-assets does not circumvent the regulatory framework or compromise its effectiveness in the future.

FSB to submit a monitoring note to SCAV on the development of stablecoins and tokenisation

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