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Centre of FinTech

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Secretariat to the Financial Stability Board
Bank for International Settlements
Centralbahnplatz 2 CH-4002 Basel
Switzerland

Submitted via Email: fsb@fsb.org

Re: Response to questions for consultation on the FSB's proposed framework for the International Regulation of Crypto-asset Activities.

Dear Secretariat

The Centre of FinTech welcomes FSB's on-going efforts to further enhance market stability and market integrity by addressing the regulatory, supervisory and oversight related challenges of crypto-assets. We acknowledge FSB's valuable work in this space aimed at building a truly robust framework for crypto-assets regulation. At the Centre of FinTech, we believe that strong regulation is needed to facilitate all dimensions of FinTech – a significant aspect being crypto-assets, which covers the remit of our current work. We, as such, believe that globally agreed standards on market integrity, investor protection, to achieve financial stability and safeguards against cybersecurity threats and financial crime (such as money laundering and terrorism financing) are essential. Crypto-assets transactions, whether on centralised or decentralised platforms, lend themselves to these vulnerabilities and the approach to regulation needs to take this on board.

The Centre of FinTech is also cognisant that the crypto-assets activities and transactions cuts across dimensions of existing traditional finance having features of banking, investment and payments and settlements features which, therefore, requires a coordinated approach to regulation. This approach would necessarily involve different international standards setters, as such the Centre is impressed to see that the FSB has been working closely with, the Basel Committee on Banking Supervision (BCBS), the Committee on Payments and Market Infrastructures (CPMI), the International Organization of Securities Commissions (IOSCO), the Financial Action Task force (FATF), the International Monetary Fund (IMF) and the World Bank to ensure that a robust and well-coordinated approach is taken in devising the framework for the regulation of crypto-asset activities.

Given the unique features of crypto-assets, we at the Centre of FinTech believe that a broad-brush approach to regulation, would not be sufficient in achieving a robust framework. So, in addition to considering / applying the "same business, same risks, same rules" approach, as applied to traditional finance institutions, the framework should take cognisance of the differences between this asset class and assets from traditional finance which necessitates a difference of approach to regulation. A unique feature is the cross-border dimensions of crypto-assets which any robust regulatory regime would need to cater for and without which regulation would be inadequate.

The dimensions, as such for this ranges from ensuring regulatory authorities understand and appreciate the need for cooperation; that they endorse robust regulation of the space; that they adopt a common approach in devising a regulatory framework; and most of all, that the infrastructure for supervision is built into this framework.

This is even more pertinent as we know, that between September 2019 and June 2021, the crypto-asset ecosystem expanded by 2,300% and according to estimates of ownership of these assets published by the UNCTAD in 2021, 75% of the top 20 crypto economies were emerging market and developing economies. Kenya, South Africa, and Nigeria were among them - this is a large percentage of emerging and developing markets. We also know that most of those countries lack the skill and infrastructure to adequately regulate the space – such as the infrastructure for approving licenses for those crypto-asset firms wishing to operate in their jurisdictions. Any weak regulation from such jurisdictions is likely to lead to regulatory arbitrage and / loopholes in the framework that may then jeopardise the strength of the regulation of the space.

So, we strongly support the FSB approach and believe that a robust global approach to regulation would be significant for the continued operation of both decentralised and centralised exchanges and platforms.

The Centre of FinTech also believes that any global framework would need to clearly outline specific areas for a coordinated approach to regulation - which have been highlighted in this response.

We, therefore, welcome this opportunity to comment on FSB's proposed set of recommendations on crypto-assets and global stablecoins as well as on the questions for consultation on the FSB's Proposed framework for the International Regulation of Crypto-asset Activities. If you have any questions about our comments, please do not hesitate to contact us.

Sincerely,



Dr Iwa Salami
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Co-Director, Centre of FinTech, University of East London

Response to Questions on FSB's proposed framework for the International Regulation of Crypto-asset Activities.

General

1. Are the FSB's proposals sufficiently comprehensive and do they cover all crypto-asset activities that pose or potentially pose risks to financial stability?

Yes, the FSB proposals are comprehensive, covering dimensions of crypto-asset activities that pose financial stability risk. They advocate for regulation to be proportionate to the financial stability risk crypto-assets activities pose in line with the principle "same activity, same risk, same regulation" as exists in traditional financial services and transactions. So focusing on: international cooperation (R3); corporate governance (R4); effective risk management framework (R5); robust frameworks for collecting, storing, safeguarding, and the timely and accurate reporting of data (R6); disclosure (R7); identify and monitor the relevant interconnections both within the crypto-asset ecosystem, as well as between the crypto-asset ecosystem and the wider financial system (R8) and ensuring that crypto-asset service providers that combine multiple functions and activities are adequately regulated (R9), they provide a good basis for regulators to build on and flesh out regulation. However, they assume that authorities across the world have access to regulatory tools and infrastructure to supervise crypto-assets activities.

Authorities would need to be equipped to adequately perform supervisory functions. Therefore, bearing in mind that authorities have varying financial regulatory and supervisory tools and strengths, adhering to R1 (highlighting that authorities should have the power, resources and tools to regulate) would require, among other things, the upskilling of a good numbers of regulatory authorities across the world; and equipping them with the right tools and infrastructure to enable them perform their function. This necessarily requires cooperation among all countries; where those with stronger crypto-regulatory frameworks can lead the way and provide technical assistance to those countries without. A good forum for this could be the Regulator Knowledge Exchange Programme (RKE) of the Cambridge Centre for Alternative Finance (CCAF). The RKE is a peer-led and community-driven digital platform for financial services regulators, supervisors and policymakers to enable effective peer-learning, seamless knowledge exchange and collaborative problem-solving. It is necessary that global mechanisms for equipping and strengthening regulatory capacity of authorities is built into any plan to strengthen the crypto-assets regulatory framework in order to effectively achieve R1.

Also, although the FSB recommendations - as are most international standards - are recommendations as to the result to be achieved and leaving it to countries' discretion as to how to achieve the result, due to the significant potential risks posed to financial stability and the challenge of regulating crypto-assets, their wide scope for implementation would result in varying degrees of implementation across countries. This would weaken the effectiveness of a globally coordinated regulatory framework;

facilitating regulatory arbitrage and risk to financial stability and retail investors. Clearer and more specific standards set for crypto-asset transactions at global levels would be useful without taking away States' power to consider/assess the implications of the implementation of these provisions in their jurisdictions.

2. Do you agree that the requirements set out in the CA Recommendations should apply to any type of crypto-asset activities, including stablecoins, whereas certain activities, in particular those undertaken by GSC, need to be subject to additional requirements?

Yes, the requirements set out in the CA Recommendations should apply to any type of crypto-asset activities. It is also agreed, as the FSB further highlights, that since crypto asset activities continue to evolve rapidly, there is a high potential for financial stability risks to increase and authorities should be ready to regulate whether activities occur on decentralised platforms or other platforms where transacting parties are not easily identified. Authorities should have in place a regulatory framework that aims to protect all relevant parties, including consumers and investors, in line with the principle of "same activity, same risk, same regulation".

This is so significant especially as there needs to be in place adequate risk management provisions relating to trading, lending and borrowing of crypto-asset. This is more so as prior to the collapse of Terra Luna in May 2022, crypto-asset lending and borrowing grew rapidly. Many trading or lending platforms promised high returns to attract investors' crypto-asset deposits. It became clear from the fall outs of the Terra's collapse that service providers engaged in and lent assets to complex and risky investment strategies to generate these high returns. This created, among other things this, maturity mismatches and liquidity risk. Liquidity/maturity mismatch are risks typical to traditional finance and hence their strict regulation. Despite the same activities were occurring in the crypto-asset space, they have not been regulated by standards equivalent to banking regulations, nor are they regulated as licensed lending activities, permitting these providers to engage in unrestricted risk-taking without sufficient resources or appropriate safeguards. As such, they engaged in risky trading and business ventures, operated with little or no capitalisation, they had concentrated exposures to risky entities and were vulnerable to runs - all of which materialised in spring 2022; resulting in the failure of a number of crypto-asset lenders and significantly impacting numerous retail investors.

Also, the requirements set out in the CA recommendations, should apply to stablecoins to the extent that they perform the activities covered by issuers of crypto-assets. However, as stablecoins also perform the quite critical role of maintaining stability to a very volatile eco-system, and have not yet been required to be backed on a 1:1 ratio of stablecoin to a dollar in a bank account (in the case of fiat backed stable coins) but instead is backed by other assets such as commercial paper with inbuilt risk to the wider financial system; as well as the risks to retail investors in the heavily collateralised crypto-backed stablecoins, they should be subject to additional scrutiny.

3. Is the distinction between GSC and other types of crypto-assets sufficiently clear or should the FSB adopt a more granular categorisation of crypto-assets (if so, please explain)?

Yes, the distinction between GSC and other types of crypto-assets is clear, however, the differences in regulatory classifications of crypto-assets results in regulatory, supervisory and enforcement challenges. The same crypto-asset may be classified differently in different jurisdictions, or may be regulated in some jurisdictions but not in others. In jurisdictions where crypto-assets are not or cannot be categorised as financial instruments, custodial wallets may be unregulated unless offered by a regulated financial institution, subject to trust provisions under the general law, or captured by a specific regulation. This may result in regulatory arbitrage in which some players may be incentivised to structure their businesses to circumvent the application of certain jurisdictions' more stringent regulatory requirements. This may also make cross-border cooperation arrangements difficult to achieve. A globally accepted taxonomy and classifications for digital-assets is, as such, necessary both to achieve consistency of approaches to regulation among authorities as assumed in R3 on 'Cooperation among regulators' which states that: 'Authorities should cooperate and coordinate with each other, both domestically and internationally, to foster efficient and effective communication, information sharing and consultation in order to support each other as appropriate in fulfilling their respective mandates and to encourage consistency of regulatory and supervisory outcomes.'

4. Do the CA Recommendations and the GSC Recommendations each address the relevant regulatory gaps and challenges that warrant multinational responses?

Yes, however, with respect to disclosure relating to crypto-assets activities, accurate data on crypto-asset activities are largely still unavailable to regulators or to the public because these activities are carried out by unregulated entities that are not subject to any reporting requirements or because the service provider fails to collect and report reliable data in compliance with existing requirements, or because of the lack of specific reporting requirements for traditional regulated entities of their participation in crypto-asset activities. As the FSB has highlighted, the lack of available and reliable data poses challenges for regulators when monitoring and assessing the financial stability risks of crypto-asset activities. For example, while the recent crypto-asset market strain has not significantly impacted the wider financial system, regulators face challenges in assessing potential spillovers of a similar event in the future due to a lack of reliable data.

Also, as the FSB further points out, although many crypto-asset market participants claim that their activities are fully transparent and reliable because they are stored and accessible on public blockchains, certain activities can be disguised using privacy enhancing technologies. Many activities and processes are also conducted "off-chain", particularly by centralised trading platforms, meaning that there will not be a public or accessible record of such activities. The FSB further highlights that a recent study conducted by the BIS published in May 2022 '*Banking in the shadow of Bitcoin? The institutional adoption of cryptocurrencies*', indicates that disclosures by crypto-asset trading platforms may not be reliable. The study indicates that the total number of Bitcoin holdings by Coinbase inferred from on-chain records significantly varies from the amount disclosed by the trading platform. Furthermore, even on-chain data provides only limited information into a transaction, as details are often

pseudonymised or anonymised. Thus, it is a challenge to assess and analyse on-chain data due to its complexity and opacity. Many regulatory authorities do not have adequate resources to verify their accuracy and reliability to support monitoring and policy considerations. Similarly, when crypto-asset issuers and service providers are not subject to disclosure requirements, users and investors lack the tools to assess the risk of their participation. Investors may have very limited information about the product structures or operations. Many crypto-asset service providers (e.g., trading platforms, lending platforms and custodians) do not disclose sufficient information to understand their financial conditions and risk profiles. This means that it is necessary to enhance the transparency and reliability of data on crypto-asset activities to address the data gaps.

A workable approach to assist regulatory authorities in tackling this data gap is ensuring they are able to access SupTech solutions — SupTech is the use of technology such as AI, machine learning and blockchain for regulatory, supervisory and oversight purposes. Blockchain could provide opportunities for both prudential and conduct supervisors, as well as facilitating RegTech solutions (the use of technology to facilitate efficient regulatory compliance by firms) e.g. in regulatory reporting. The combination of smart contracts and blockchain could help to automate regulatory reporting and make it more efficient and transparent, improve consistency and data quality across undertakings, and allow regulators to get data on new areas of interest with real-time access to signed contracts and information they contain (real-time regulatory monitoring), reducing compliance costs and making the whole insurance sector more transparent. As the Bank of International Settlements (BIS) has identified, SupTech solutions are now emerging for a wide range of regulatory focus areas. A December 2021 BIS paper (BIS innovation hub and monetary authority of Singapore develop prototype supervisory analytics platform) reviewed 71 SupTech tools used for prudential supervision in 20 jurisdictions during the pandemic. It found that Limited data science skills of supervisors, data quality issues that underpin SupTech models and settling on an appropriate calibration of SupTech parameters, hamper broader adoption of SupTech tools.

Also, significant, due to the cross-border nature of crypto-assets transactions, is the interoperability of SupTech solutions. This is important as globally, many regulators are demonstrating a preference, or at least a default, towards building SupTech tools in-house to help deliver their existing regulatory model. This approach risks producing an architecture with limited interoperability between different regulators or between the tools used by regulators and those used by the financial services firms they regulate. The global interoperability of SupTech solutions is so essential to facilitate a globally coordinated approach to regulating crypto-assets. Perhaps what is very critical for the adoption of these SupTech solutions is the upskilling of regulators. Regulators may be facing deficits in both technology skillsets (staffing and training) and core technology capacity. Some are impeded in hiring and can find themselves unable to compete financially for available talent in a market where demand materially outstrips supply. Dr Iwa Salami, of the Centre of FinTech had highlighted this and put a forward-thinking approach for regulators as they think about regulating the crypto space at the 2022 Point Zero Forum of global leaders in Web 3 and sustainable finance in the digital economy. She called on regulatory authorities to think about

significant investment in their staff particularly in building technology skillsets and offering competitive remunerations packages for regulators. The latter will ensure that increased remuneration would not be the reason for a career move from a regulatory body to a 'more lucrative' crypto-asset firm.

So as highlighted, whilst there are variations in regulatory progress across jurisdictions, many regulators may lack holistic technology and digital transformation strategies and not fully perceive the need to leverage different types of technologies (open-source technologies, cloud computing, interoperability, interagency coordination, big data and AI-based tools) in strengthening the overall financial regulatory regime of which crypto-assets regulation is a part of. Developing countries, in particular, may not fully realize that lagging technology could rapidly create risks to consumer protection, financial inclusion, systemic stability, and anti-money-laundering (AML). More needs to be done at the global level to upskill regulators across the globe and as stated above, this could be in the context of the Cambridge Centre for Alternative Finance (CCAF) Regulators Knowledge Exchange programme. It has also been suggested that, just the same way regulatory sandboxes have been put in place for the market to experiment and test innovative solutions, business models and products in a real-world (but controlled environment) to allowed regulators to gain real-world experience in innovation although primarily market-led; there is now a need for a dedicated sandbox for regulators themselves, to help them explore, compare and gain a deeper understanding of the technologies that they may need to use themselves or that they may need to evaluate and supervise going forward. This can also fit within the context of the CCAF RKE, since a few key regulators are already engaged with the RKE programme and it is anticipated that a few others would engage with the programme.

5. Are there any financial stability issues that remain unaddressed that should be covered in the recommendations?

These appear to have been covered extensively. However, as mentioned above, there should be an outlined approach for upskilling regulators especially in developing countries, particularly as they would need support to adequately regulate an industry where strong technical regulatory expertise is required. Also, due to the significant cross-border feature of crypto-assets, regulation would only be as strong as its weakest link. As such, upskilling and equipping regulators across the world, as discussed above, is key.

Also, whilst a lot can be said for the need for regulatory cooperation along the lines existing in traditional finance, without upskilling and equipping regulatory authorities across the world with tools such as for ensuring robust reporting standards are in place for CASPs, the effectiveness of multilateral cooperation in supervision is likely to be limited. In the case of reporting requirements, for example, there is the need to build strong domestic reporting requirements frameworks for CASPs across jurisdictions and to ensure that regulatory authorities are equip to monitor, review and assess compliance with reporting requirements and be able to assess violations by service providers. As such, the upskilling of regulators across the world that would make both the development of common standards and multinational / global cooperation in

supervision meaningful, is so needed. This would ensure that host and home country rules / standards operate seamlessly to prevent regulatory arbitrage and secure a stable global crypto-asset eco-system.

Crypto-assets and markets (CA Recommendations)

6. Does the report accurately characterise the functions and activities within the crypto-ecosystem that pose or may pose financial stability risk? What, if any, functions, or activities are missing or should be assessed differently?

Yes, however, this could be further strengthened such as strengthen disclosure requirements. So, for instance R7 on disclosure can be strengthened. It states, 'Authorities should require that crypto-asset issuers and service providers disclose to users and relevant stakeholders comprehensive, clear and transparent information regarding their operations, risk profiles and financial conditions, as well as the products they provide and activities they conduct.' The strengthening of disclosure requirement would be useful, particularly as a key feature of the crypto-asset market structure is that service providers often engage in a wide range of functions. As the FSB highlights, some trading platforms, in addition to their primary functions as exchanges and intermediaries, also engage in custody, brokerage, lending, deposit gathering, market-making, settlement and clearing, issuance distribution and promotion. Some trading platforms also conduct proprietary trading or allow proprietary trading on the platform by affiliated entities. Similar to a financial conglomerate, these service providers have complex risk profiles. Risks originating from individual functions may be transmitted across functions.

As the FSB highlights, when a trading platform combines the functions of marketplace trading with lending, offering of derivatives, structural products and collective investment vehicles, it may be incentivised to provide products with high risks and leverage as has been seen from the case of the collapse of the FTX exchange. The combination of multiple functions may also give rise to conflicts of interest. For example, a crypto-asset trading platform might conduct market-making on its own platform and impede the fair access of competing market makers. Such conduct may give rise to investor protection, market integrity and conflict of interest issues, again seen played out in the case of FTX and Alameda Research.

The FSB also clearly highlights that traditional financial institutions have incentives to expand and combine multiple functions. However, existing prudential regulation of financial conglomerates seeks to comprehensively address the corresponding risks, segregate particular functions, and ensure the consolidated group is sufficiently resilient to maintain its operations under stressful conditions. More generally, existing market regulation seeks to mitigate the inherent conflicts of interest and investor risks arising from the combination of services and functions. Similar to the regulatory approach to financial conglomerates, it may be important to address the risks arising from the combination of multiple crypto-asset related functions within a single entity. In some instances and jurisdictions, it may be appropriate to disallow the provision of certain combination services or functions by a single entity.

This is so as a very fragmented regulatory framework currently applies to crypto exchanges such as those around transparency, market fairness and operational resilience. It is vital that global and common standards are developed around these. So, for example, with respect to transparency, some exchanges lack corporate, financial, product and legal transparency or at the very basic level offer no information about how they protect either crypto or fiat holdings. This is critical as lack of transparency is a widespread concern for a good number of crypto exchanges because the availability and quality of key information is unsatisfactory. Lack of information does not help to create trust and confidence either that these exchanges are determined to be open and put investors' interest first. Closely linked to this is the area of market fairness. There needs to be credible information about any restriction applied to crypto exchanges on proprietary trading (beyond legitimate market making activity aimed at ensuring liquidity) and also how these restrictions are monitored and enforced. If proprietary trading by crypto exchanges is tolerated in any form, this might create serious conflict of interest issues and might question the fairness of their entire operation - as seen in the case of FTX and Alameda Research. This is particularly concerning for the bigger exchanges. With respect to operational resiliency, there are hardly any business continuity disaster recovery plan or policy monitored by regulators which would be followed by crypto-exchanges in case of extreme market conditions – again as seen in the case of FTX. This means that investors do not know when and how the service will be restricted and/or maintained during a serious market turmoil. This, as such, leaves investors at the mercy of exchanges and hoping that exchanges are always truthful and will put investors' interest before their own, even during a market downturn.

Disclosure requirements for crypto-asset service providers and issuers is key and as discussed above, would require bringing on board RegTech and SupTech solutions that, amongst other things, facilitate real-time regulatory monitoring.

7. Do you agree with the analysis of activity patterns and the associated potential risks?

Yes, see response to question 6 above.

8. Have the regulatory, supervisory and oversight issues and challenges as relate to financial stability been identified accurately? Are there other issues that warrant consideration at the international level?

Yes regulatory, supervisory and oversight issues and challenges relating to financial stability have been identified accurately. No other issues warrant consideration than the need for an action plan for: upskilling regulators; regulators across the world particularly in developing countries to adopt and implement digital transformation strategies, realizing that lagging technology could rapidly create risks to consumer protection, financial inclusion, systemic stability, and anti-money-laundering (AML).

9. Do you agree with the differentiated requirements on crypto-asset issuers and service providers in the proposed recommendations on risk management, data management and disclosure?

Yes – both classes should have unique responsibilities as different actors in the space. However, both should be subject to regulation and disclosure requirements as retail investors are exposed to both their activities.

10. Should there be a more granular differentiation within the recommendations between different types of intermediaries or service providers in light of the risks they pose? If so, please explain.

Not for now. The recommendations can be broadly applied to service providers as they exist today, however, the FSB should be open to monitoring the development of things given the ever-evolving services available in the crypto space. A differentiation of services on centralised and decentralised platforms may be necessary in future and the FSB should review the current position as and when things change.

Global stablecoins (GSC Recommendations)

11. Does the report provide an accurate analysis of recent market developments and existing stablecoins? What, if anything, is missing in the analysis or should be assessed differently?

Yes, R 8 and R 9, in particular address the major concerns around the absence of a 1:1 backing of stablecoin to dollar in an account. R 9 states that there is a coordinated approach to strengthening standards for stablecoin arrangements. This is seen through FSB members' support for standards set by other standards setting bodies such as CPMI and IOSCO in their guidance on *Application of the Principles for Financial Market Infrastructures to Stablecoin Arrangements*, which significantly paves the way for the application of the "same activity, same risk, same regulation" principle to systemically important stablecoins that are used for payments. FSB members also support BCBS's ongoing work on the prudential treatment of banks' crypto-asset exposures and IOSCO's ongoing work on DeFi and crypto-assets through its FinTech Taskforce, including the published IOSCO *Decentralized Finance Report*.

12. Are there other changes or additions to the recommendations that should be considered?

No

13. Do you have comments on the key design considerations for cross-border cooperation and information sharing arrangements presented in Annex 2? Should Annex 2 be specific to GSCs, or could it be also applicable to crypto-asset activities other than GSCs?

The key design considerations for cross-border cooperation and information sharing are reasonable and whilst multilateral and bilateral information sharing arrangements among authorities / between participating countries can be useful in curbing regulatory arbitrage in the space, however, they are limited as regulators across the world have varying regulatory strengths and skills as well as regulatory tools to check adequate compliance and disclosure may not be as effectively implemented or enforced against non-compliant stablecoin issuers in certain jurisdictions. Hence, response to question 4 is reiterated here, that there would be a need for a robust mechanism for regulatory

cooperation in upskilling and supporting regulators in jurisdictions which lack the tools and infrastructure to regulate crypto-asset issuers and transactions.

Multilateral and bilateral information sharing arrangements among authorities are also limited where countries are slow to respond to them or unwilling to engage with them, as seen in the Global Financial Crisis of 2007/8. Even when these are implemented, the keenness of regulatory authorities across the world to implement and enforce provisions can be a challenge, as seen in the case of the FATF's travel rule. Of the 98 jurisdictions that responded to FATF's March 2022 survey, only 29 jurisdictions have passed relevant Travel Rule laws. A smaller subset, just 11 of these jurisdictions, have started enforcement related to the Travel Rule. This demonstrates an urgent need for jurisdictions to accelerate implementation and enforcement of R.15/INR.15 to mitigate criminal and terrorist misuse of virtual assets.

As to the second part of this question on whether Annex 2 should be specific to GSCs, or whether it could also be applicable to crypto-asset activities other than GSCs, it is believed that Annex 2 should be applied to all crypto-asset activities including issuers and CASPs.

14. Does the proposed template for common disclosure of reserve assets in Annex 3 identify the relevant information that needs to be disclosed to users and stakeholders?

Yes.

15. Do you have comments on the elements that could be used to determine whether a stablecoin qualifies as a GSC presented in Annex 4?

No, it appears to cover current potential vulnerabilities of global stable coins.