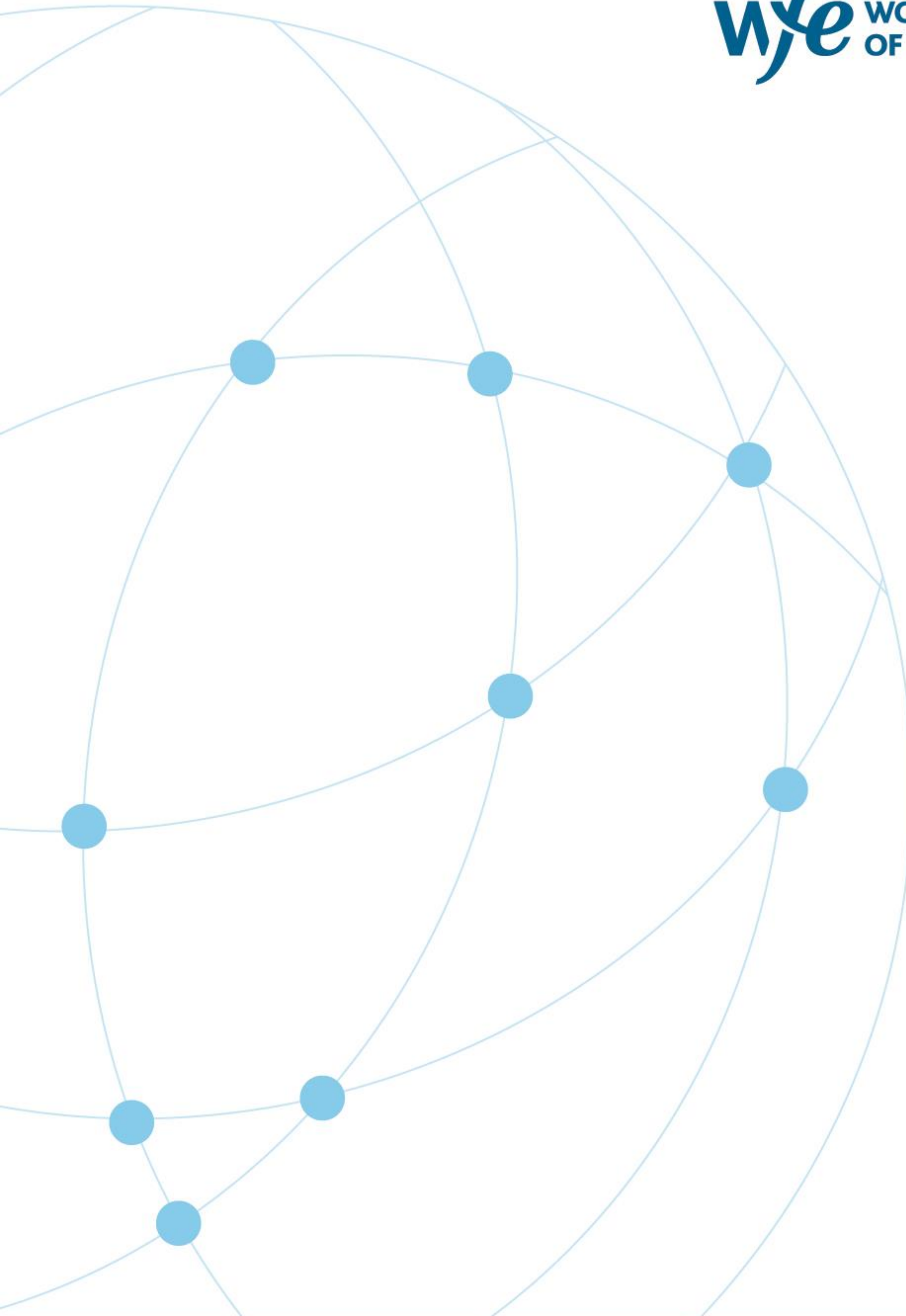

WORLD FEDERATION OF EXCHANGES

WFE Response: HM Treasury Consultation and call for evidence - Future financial services regulatory regime for cryptoassets

30 April 2023

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent the operators of over 250 market infrastructures, spread across the Asia-Pacific region (25%), EMEA (58%) and the Americas (17%), with everything from local entities in emerging markets to international groups based in major financial centres. In total, member exchanges trade around $100 trillion (equivalent) in securities a year and are home to over 55,000 companies, with an aggregate market capitalisation of around $140 trillion. In addition, the 90 distinct central counterparty (CCP) clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1.3 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of companies and market participants wishing to raise capital, invest, trade, and manage financial risk.

Established in 1961, the WFE seeks outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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General Comments

The World Federation of Exchanges (WFE) welcomes the opportunity to comment on this consultation. As representatives of established, regulated, and trusted exchanges we wanted to offer our views on the formation of a new regime for the purposes of crypto-assets. Naturally, we focus on those questions that are most relevant to our membership, principally relating to trading venues and trading.

We know that technological innovation, such as that related to distributed ledgers, can enhance financial markets. DLT has the potential to deliver lower costs, faster execution of transactions, improved transparency, auditability of operations, and other benefits. Nevertheless, there have been a number of notable incidents involving the crypto-sector, with the biggest being the demise of FTX.

The recent experiences point to the need for regulation. Rather than particularly new or novel failures, the majority of issues around the crypto-sector remind us of failures in traditional finance. By introducing regulation, HM Treasury and the UK authorities can mitigate and minimise the risk of failures. Therefore, the WFE is a strong supporter of the internationally established principles of 'same risk, same regulation.'

Specific Comments

Chapter 3: Overview of the current regulatory landscape for cryptoassets

6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

The phased approach that the UK is proposing to regulate crypto-assets could create potential challenges for market participants and consumers. As different types of crypto-assets may be subject to different regulatory regimes, it may be difficult for market participants and consumers to understand the regulatory landscape and comply with the various requirements. Additionally, the regulatory framework for crypto-assets may be different from the existing regulatory frameworks for traditional financial products, leading to compliance difficulties for market participants who are already operating in the traditional financial services sector.

Nevertheless, we recognise the difficulty in developing such wide-ranging legislation so understand the reasoning behind the phased approach. Moreover, we welcome the careful and considered approach.

Chapter 4: Cryptoasset Activities

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

The proposed territorial scope that would capture crypto-asset activities provided in or to the United Kingdom seems appropriate and consistent with the goal of protecting consumers. This is because, as the consultation recognises, consumers can (and frequently do) easily access crypto-asset products and services which are provided by overseas companies.

Nevertheless, regulators around the world understand that there are substantial difficulties in supervising firms based in foreign jurisdictions. In particular, it is difficult to get regulatory "grip" on these firms.

Therefore, HM Treasury could consider some sort of equivalence/mutual recognition/substituted compliance mechanism that would permit firms to provide services into the UK from firms based in jurisdictions with similar regulatory standards as domestic firms. This would alleviate the pressures on the FCA and should deliver good outcomes for consumers.

10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?

Vertically integrated business models can create conflicts of interest, present operational risks, and pose challenges for ensuring market integrity and protecting consumers. For these reasons, in traditional finance regulators and governments often focus on ensuring that different stages of a vertically integrated business model are separated and subject to appropriate controls, oversight and regulation. This helps to minimize risks and promote fairness, transparency, and market stability.

For exchanges, this means that, broadly speaking, investors must go through intermediaries to access the marketplace. This system recognises the differing motivations of differing actors, with exchanges being a neutral platform between them. This helps to ensure a trusted trading environment – you know who is participating and on what basis.

Certain commercial activities that are frequently carried out by what HM Treasury calls crypto-asset trading venues would not be allowed on an exchange or would be closely regulated as it could impair neutrality. Crypto-asset trading venues often serve as (i) venues of exchange, operating the platform on which buyers and sellers trade virtual and fiat currencies; (ii) in a role similar to a traditional broker-dealer, representing traders and executing trades on their behalf; (iii) as money-transmitters, transferring virtual and fiat currency and converting it from one form to another; (iv) as owners of large virtual currency holdings; (v) as issuers of a virtual currency listed on their own and other platforms, with a direct stake in its performance and also (vi) as custodians of customer assets.

The conflicts of interest listed above have led to real world examples of consumer harm and market integrity harm. For example, crypto-asset trading venues where operators have secretly enjoyed unfair informational advantages, which were used to front-run investors' trades. Or, in the recent implosion seen at FTX, where consumer assets were lent to FTX's trading arm – Alameda Research.

We agree with HM Treasury that the conflicts of interest obligations that traditional financial institutions that provide multiple services and business lines are subject to is a good starting point to consider.

12. Do you agree that so-called algorithmic stablecoins and cryptobacked tokens should be regulated in the same way as unbacked cryptoassets?

The WFE believes that the requirements are appropriate. We propose that stablecoin issuers obtain independent attestation (such as by external audit firms) that their reserve assets meet these requirements on a regular basis. Additionally, the WFE recommends that issuers publish a term sheet disclosing the rights of holders and further details on the token. These will all result in higher compliance and regulatory calibre for stablecoin issuers, alongside higher financial standards, and requirements.

13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

The proposal is broadly clear apart from in one area. HMT defines governance tokens as "a subset of utility tokens which are used solely by holders to vote on a blockchain or network's decisions, but do not provide any kind of

exclusive perks or discounts." As governance tokens provide voting rights, somewhat akin to the way that shares provide voting rights in traditional finance, it would seem strange that a tradeable governance token would not be subject to the same regulation as a security.

Chapter 5: Regulatory Outcomes for Cryptoasset Issuance and Disclosures

14. Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

We agree that cryptoassets admitted to trading on a regulated trading venue or cryptoassets that have become subject to public offer should have regulation applied in public interest. This is covered by the two regulatory trigger points presented by HM Treasury.

15. Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

Exchanges provide a trusted space for investors by setting requirements for products offered on their venues. For example, stock exchanges frequently require that there is a minimum level of liquidity for a company to become listed (this is often measured through the number of shares already issued). The New York Stock Exchange (NYSE) requires a market value of $40mn and 1.1mn publicly held shares to initially list on its exchange[1]. This liquidity requirement provides reassurance to investors that they will be able to sell their share if they need to. Requirements like these ensure that only high-quality products are traded on exchanges. This reassures investors of the integrity of both the exchange and the traded product. Depending on the jurisdiction, governments and regulators might have additional requirements for listings.

In the UK, exchanges have a legal duty to ensure that companies listed on their markets comply with the relevant regulatory requirements and disclose accurate and complete information to investors. It seems reasonable that crypto-asset trading venues could be required to do something similar.

Chapter 6: Regulatory Outcomes for Operating a Cryptoasset Trading Venue

19. Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

An alternative might be to base rules for crypto-asset venues on the regulation surrounding regulated markets. Or, particularly where consumers directly access the market, to develop a bespoke regime that takes into account the greater risk profile of retail consumers using platforms rather than institutional investors.

A further alternative might be to permit crypto-asset trading venues to operate as either an MTF-type structure or a regulated market-type structure. This would permit legitimate competition.

Chapter 7: Regulatory outcomes for cryptoasset custody

[1] https://www.nyse.com/publicdocs/nyse/listing/NYSE_Initial_Listing_Standards_Summary.pdf

23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

Adapting existing frameworks for traditional finance custodians for crypto-asset custody activities could provide a clear regulatory framework for crypto-asset custodians and help ensure that investors' assets are safeguarded. However, it will be important to consider the unique aspects of crypto-asset custody, such as the use of private keys and DLT, and tailor the regulatory standards accordingly to address potential risks and ensure adequate protection for investors.

24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

It will be important to distinguish between public and private ledgers, whether the custody is retail focused or institutional and the mechanism for holding private keys (hot vs. cold wallets). The risks related to custody are much the same as traditional assets but the risk profiles change substantially based on the above factors.

For example, whilst the risks around custody of private ledgers are much the same as those relating to custody of traditional assets, the risks of public ledger assets are substantially higher. This is because the public ledger cannot be controlled by a central entity to fix any errors. Furthermore, unlike traditional assets, if as a custodian you lose your customers' private keys then those cryptocurrency assets whose ownership is determined by those private keys are completely gone.

Specific risks to public chains can be categorised as:

1. Risk of total loss (theft, wrong address, etc.) and the respective implications on operational processes, and IT, operational and physical security.
2. New compliance challenges above and beyond traditional AML & KYC such as chain analytics and special sanction screening (e.g., black-listed wallets), handling of unauthorized deposits and FATF rule implementation.
3. Operating challenges including blockchain/gas fees as part of the transaction and blockchain delays/confirmation cycles.
4. Technical challenges with regard to IT security/key management.
5. New related services which become increasingly part of custody, namely staking, node operations.

<u>Chapter 8: Regulatory outcomes for operating a cryptoasset lending platform</u>

31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?

Margin loans and leveraged trading are well-established practices in traditional finance. Whilst we generally agree that the risks to retail consumers are higher than for institutional investors, we consider that both industry and regulation should aim for a high watermark of investor education and awareness about the risks involved in margin trading, standards in financial instruments labelling, and delivering an effective complaints/ clarification mechanism.

32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?

Cryptoasset lending poses several regulatory challenges and prudential risks. One of the major risks is credit risk, which is elevated when a lender is exposed to the debt of multiple institutional borrowers who have highly correlated risk profiles, as is often the case in cryptoasset markets. Furthermore, current practices around collateralisation, rehypothecation, leverage, and maturity transformation are opaque, increasing the risks associated with counterparty defaults. There are also significant liquidity risks associated with operating a lending platform, which are similar to those witnessed in the case of FTX. Moreover, cryptoasset lending and borrowing activities conducted by lending platforms typically fall outside the current regulatory perimeter, which means that most of the safeguards in place for traditional lending and borrowing activities are unavailable to users of similar cryptoasset products and services.

It is valid to note here, that terms and conditions documents from Staking Platforms or CEXs typically include limited liability provisions, which infers that the CEX is not liable for any loss of funds. Thus, the issue around Celsius (or other centralised crypto platforms) is both the lack of liability and the lack of disclosure requirements relating to the use of customer funds and the use of leverage.

Many service providers have recently announced their willingness to release audited Proof of Reserves (PoR) to provide transparency about company holdings and liquidity, including Binance and Crypto.com. We hope and expect others to follow suit, although it must be stated that PoR is not sufficient to prove solvency and no misuse of customer funds. PoR needs to be accompanied by Proof of Liabilities (PoL) that demonstrates the amount owed to depositors.

First, PoR may be gamed if just taken as a snapshot, as funds may be borrowed prior to the snapshot, and returned to their rightful owner after this. PoR must be fully audited and must involve the constant monitoring of blockchain addresses. This is addressable by requiring minimum standards (such as audits) for PoR across the industry, or taking snapshots simultaneously (i.e. at the same timestamp) for all crypto-trading platforms.

Second, PoL are important to quantify total customer deposits, however, they do not highlight any off-chain or off-balance sheet liabilities, which may be hidden by crypto-trading platforms. As this is more difficult to address, the auditing of CEXs by financial auditors and government agencies may be the only way to resolve this issue. As mentioned, CEXs act as financial intermediaries and should be treated as such, rather than convoluting CEXs with decentralised finance.

Chapter 11: Call for Evidence: Decentralised Finance (DeFi)

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

One of the main problems regulators have with DeFi is identifying who or what to regulate; or, what they can ‘hook’ regulation to. Regulators can ‘hook’ these entities when looking to apply regulation. This would mean applying regulation on the applications and not protocol level, which helps to ensure that a technological neutral approach is adopted.

38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?

The similarities and differences between traditional finance, centralised, and decentralised finance are somewhat misunderstood. Before setting out our view, we want to make it clear what we think the differences are. In the context of trading:

- Traditional finance (TradFi) refers to those entities which facilitate execution of trades of traditional financial instruments such as securities, derivatives, or cash. These are regulated exchanges, alternative regulated venues and over-the-counter (OTC) brokers.
- Centralised Finance (CeFi) refers to entities in the crypto-sphere that facilitate execution of trades of crypto-assets in a system that broadly replicates the traditional financial system. An example of this would be Binance which operates a CTP that functions, among other things, in a similar way to an exchange.
- Decentralised Finance (DeFi) refers to a system in the crypto sphere that facilitate execution using a decentralised finance protocol. An example of this would be Uniswap, where owners of governance tokens control changes to the protocol.

We broadly agree with HM Treasury's intent to deliver the same regulatory outcomes for DeFi. We recognise that it is likely that a more bespoke regime will be required for DeFi due to its somewhat unique nature but would caution against the suggestion that it is completely different to TradFi or CeFi.

DeFi is just another way to enable financial services. It carries many of the same risks that all financial services and trading of assets carry. As regulators start to engage with and regulate CeFi, there seems to be no justification on the grounds of the risks DeFi presents or the objectives of regulators to not introduce regulation to protect consumers and ensure market integrity.

When it comes to de-centralised exchanges, the term is somewhat of a paradox. By its very nature. an exchange is a central marketplace where buyers and sellers meet. Therefore, many of the requirements placed on regulated markets could be applicable to de-centralised exchanges.

Furthermore, we are aware that DeFi contains power concentrations. In an effort to avoid having faith in any individual or organisation, many DeFi apps have experimented with novel organisational forms, that are known as decentralised autonomous organisations (DAO). By issuing unique "governance" tokens that provide its owners the opportunity to suggest and vote on protocol improvements, the DAO's core principle is to distribute decision-making authority among all interested parties. However, if someone were to purchase a large number of governance tokens, DAOs may become captured by singular interests. We also know from traditional finance that decentralised governance models can be inefficient.

These problems are far from theoretical, Ethereum's recent switch to proof-of-stake from proof-of-work was largely driven by the centralised team at the Ethereum foundation. "The Merge" – as it has come to be known – could be transformative for Ethereum as it may reduce energy usage by 99% if reports are to be believed. But, it also shows that a central actor, or set of actors, can take control of a so-called decentralised app.

The smart contracts governing DeFi are also not accessible to ordinary individuals. In fact, owners of "governance" tokens may be asked to vote on something that they have no understanding of. That means that they are open to being exploited. Issues like these have led to international standard setters like the Bank for International Settlements to label decentralization an "illusion"[2] and for the International Organization of Securities Commissions (IOSCO) to determine that most of the new services in decentralised finance which are emerging "replicate more traditional financial services and activities, but with weaker regulation and increased risks for investors."[3]

We therefore welcome HMT's work aimed at exploring how to regulate DeFi. Looking at IOSCO's principles for Secondary and Other Markets and engaging in their workstream is a valuable starting point.

[2] https://www.bis.org/publ/qtrpdf/r_qt2112b.htm#

[3] https://www.iosco.org/news/pdf/IOSCONEWS637.pdf

Chapter 13: Call for evidence: Sustainability

47.When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?

We recognise that this is an evolving market but think that, to meet the goals of 'same risk, same regulation,' sustainability-related information should apply to crypto assets. For example, the FCA ESG Handbook already specifies detailed disclosure rules applicable to a variety of entities and products. The FCA recognises that there will be some gaps, and that it would be helpful to allow the market to evolve before mandating that a particular underlying asset (or consensus mechanism) should have a disclosure requirement. The FCA has already made the determination that from a company perspective (regardless of what the company does) TCFD disclosures are required for certain listed companies and we would not recommend modifying that aspect at this time.