

WFE Response to HM Treasury's Consultation and Call for Evidence: UK Regulatory Approach to Crypto-assets and Stablecoins

March 2021



Introduction

We are grateful for the opportunity to respond to HM Treasury's Consultation and Call for Evidence: UK Regulatory Approach to Crypto-assets and Stablecoins.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 200 market infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%), with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges trade some \$95 trillion a year; while the 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up \$1 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 investors and companies wishing to invest, raise capital and manage financial risk.

We seek 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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Overview

The WFE is supportive of the sentiments expressed in the Economic Secretary's statement regarding the UK Government's future policy for crypto-assets and the particular desire for its proposals to take the form of an "agile, risk-led approach to regulation, rooted in the principle of 'same risk, same regulatory outcome'¹".

Such an approach is essential in enabling regulation that has the appropriate flexibility to be future-proof, whilst providing regulatory certainty in an evolving and changing sector. The WFE was further encouraged by HM Treasury's (HMT) statement that "given the cross-border nature of crypto-assets, the UK is committed to working with other jurisdictions and through the international standard-setting bodies to support harmonisation of treatment as far as is feasible. In doing so, the approach should allow for changes to reflect international discussions."

In responding, the WFE would also like to emphasise the role of 'clearing' and how it could (and just as importantly, how it could not) interrelate with the trading of crypto-assets and the use of associated distributed ledger technology. Further, the WFE would like to highlight the importance of distinguishing between so-called 'crypto-asset exchanges' and the regulated, secure and lit² markets that established exchanges provide.

Please find our specific responses to the questions detailed below.

¹ Our support is based on the understanding that the ambition is for a technology-neutral approach; and that the 'regulatory outcome' does not contravene the commitment to a level-playing field, nor unnecessarily creates regulatory arbitrage in practice.

² "A lit market is one where orders are displayed on order books and are therefore pre trade transparent." [Glossary of useful terms linked to markets in financial instruments](#)

Response to Questions

1 Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

The UK's definitions and classifications are a helpful regulatory approach to crypto-assets. However, it will be important to have the flexibility to further mould the classifications to internationally agreed definitions, as and when they are developed and adopted at international level.

More generally, providing clarity around classification is beneficial in helping to build consensus and for creating harmony with other jurisdictions globally. It is important that any definitions should aim to provide greater clarity on the types of asset that fall within the regulatory perimeter and, where possible, refer to the types of platform where they are available.

The WFE would also advocate the avoidance of detailed 'technical' definitions, which may be too specific in what they capture, when the field of products is evolving and may quickly extend outside of what is defined in technical terms due to these rapid technological advancements. The WFE has previously welcomed, and would encourage the continued practice of, the FCA's use of definitions which are based on the nature of the assets represented/embodied. This also benefits the application of regulation, eg, if the embodied value is a share, then all rules for shares apply, if the embodied value is a commodity, then all rules for commodities apply.

A commonly understood approach, based on an existing application of rules and regulations (with their associated widely understood definitions and classifications) for financial markets, provides the much-needed legal certainty that reduces regulatory arbitrage, inconsistencies and market fragmentation³, whilst also helping to ensure the scalability of services.

In the absence of current international guidance, the WFE would also encourage consideration to be given to how the classifications might interrelate with other jurisdictional approaches (as well as the potential use of regulatory deference more broadly) to best enable the development of common understandings for the purposes of enhancing trading between the UK and third-countries. This could also have the potential to improve the speed to market for innovative products to be traded, as market participants and authorities would act within a well-established, more clearly defined, legal framework and with a set of rules which are appropriate and clear for investors. These considerations should be given a high priority, given the inherent cross-border nature of crypto-assets.

3 Do you have views on the government's proposed objectives and principles for crypto-assets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

The WFE would like to take the opportunity to highlight the importance of distinguishing between so-called "crypto-asset exchanges" (as referred to in HMT's *Glossary of Terms*⁴) and the regulated, secure and lit markets that established exchanges provide. Since the emergence and popularity of crypto-currencies (Bitcoin, Ethereum, and many more), crypto-asset trading platforms have been referred to as "exchanges", implying that they qualify as such in the traditional sense. This can mislead investors into thinking that such entities are regulated or meet the regulatory standards of traditional exchanges where they are not or do not (a perception that has unfortunately been falsely perpetuated by some "crypto-asset exchanges" in the recent past). While some crypto-asset platforms

³ 'Market Fragmentation – Addressing Measures and Examples of Market Fragmentation in Crypto-Assets Regulation', WFE, September 2020

⁴ UK Regulatory Approach to Crypto-assets and Stablecoins: Consultation and call for evidence, HMT, January 2021, Pg. 38

are regulated, or enforce their own standards, unless they are recognised by regulatory authorities and adhere to a set of acknowledged regulations, they cannot offer the same security to market participants. This includes having an appropriate level of pre- and post-trade transparency. In this context, regulation should ensure that there is no substantial difference between trading in fiat-based products and trading crypto-asset based products. The ‘same risk, same rule’ principle should apply.

With consumer protection and market integrity in mind, a clear distinction should be made between these two types of institution (ie, exchanges and other types of platform), through a form of regulatory recognition, in order to avoid any potential for investor deception or a false sense of security⁵. The WFE would emphasise the need for a distinction to be made in the proposed regime between products listed on a regulated venue (including crypto-asset derivatives) and products that are not. Crypto-asset derivatives, for example, traded on a regulated exchange are subject to the same standards of market integrity and transparency as other exchange-traded products and we would encourage the framework to highlight this distinction. Crypto-asset platforms should only be referred to as “exchanges” where they are compliant with the regulations pertinent to traditional exchanges. If they do not adhere to such standards, they should not be permitted to use the term “exchange”, or at least not without clarifying how they do – or do not – meet the standards of an exchange.

The WFE also notes and welcomes the reference to “same risk, same regulatory outcome” and ensuring a “proportionate” approach. However, there is a need to ensure that those principles are adhered to in the oversight of crypto-asset products and that a ‘technology-neutral’ approach is truly adopted. For instance, the FCA implemented the ban on sale to retail investors of CFDs and CFD-like products that reference crypto-assets. This differs to the restrictions the FCA placed on CFDs and CFD-like products that reference other assets for sale to retail investors. This approach can arguably represent a form of international market fragmentation, is not technology neutral and would not necessarily conform with the stated principle of proportionality⁶.

In the absence of current guidance at the international level on the regulation of crypto-assets, the WFE would reiterate the importance of fully and fairly applying existing regulation to crypto-assets which embody the value or nature of financial instruments that already fall within the existing regulatory perimeter. Taking such an approach, would give greater certainty to the regulator and the user⁷ whilst arguably aiding a more common understanding of the regulatory approach ie, there would be fewer differences in the regulatory treatment of crypto-assets across jurisdictions (in turn encouraging greater international regulatory harmonisation and therefore business).

5 What are your views on the extent to which the UK’s approach should align to those in other jurisdictions?

HMT identifies the existing patchwork of different regulatory approaches that have so far emerged across global regulatory jurisdictions, “A number of other jurisdictions are considering or have implemented legislative changes to bring crypto-assets and stablecoins into regulation. Approaches across different jurisdictions vary in terms of scope and substance.”⁸ As previously stated (in response to question 1), in the absence of current international guidance, the WFE would also encourage consideration to be given to how the UK’s approach might relate to other jurisdictional approaches, to best enable common understandings for the purposes of trading between the UK and

⁵ IOSCO’s 2020 report “Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms (CTPs)”, highlights the many issues related to the regulation of crypto-asset platforms that may be heightened by the business models used by such platforms.

⁶ WFE Response to the Financial Conduct Authority – CP19/22: Restricting the sale to retail clients of investment products that reference crypto assets, WFE, October 2019

⁷ Addressing the regulatory, supervisory and oversight challenges raised by “global stablecoin” arrangements, FSB, April 2020, Pg. 1

⁸ UK Regulatory Approach to Crypto-assets and Stablecoins: Consultation and call for evidence, HMT, January 2021, Pg. 11

third-countries. To enable cross-border trade (for an inherently cross-border product), consideration should be given to ensuring that there is the ability to apply regulatory deference or (mutual) recognition to the regulation of crypto-assets (and digital assets in general) for third-country jurisdictions. This will be key to ensuring that the regulation can operate in an international context.

Further, this could have the potential to enhance the speed to market for innovative products to be traded, as market participants and authorities would act within a well-established, more clearly defined, legal framework and with a set of rules which are appropriate and clear for investors. These considerations should be given a high priority, given the inherent cross-border nature of crypto-assets.

In terms of cross-border co-operation and alignment of requirements, there are also concerns around the fragmented regulatory oversight of crypto-asset trading platforms and how that fragmentation may give rise to consumer protection or market integrity issues. The innate ability for crypto-asset trading platforms to operate across borders and the regulatory implications for that have already been noted: “Crypto-asset trading takes place 24 hours a day with investors, participants, intermediaries and platforms from around the world” and gives rise to the “risk that a CTP provides access to participants in a jurisdiction in which this is not permitted.”⁹ To avoid such risk, and the risks more generally associated with crypto-asset trading platforms providing services across jurisdictions without structured regulatory oversight¹⁰, the regulatory community needs to ensure formal information sharing arrangements and active enforcement on an international basis. The importance of information sharing has been signalled multiple times by many international standard-setting bodies, in the absence of any globally harmonised approach to their oversight¹¹. This is increasingly relevant in light of surges of use during the pandemic outbreak¹² as well as operational failures¹³ in the wider context of market integrity.

A more universal monitoring process should be implemented with the objective of instilling requirements in crypto-asset trading platforms that are in line with the ‘same risk, same rule’ principle and that of ensuring a level-playing field with existing market infrastructure.

9 Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

If said token/crypto-asset meets the definition of a financial instrument, as outlined in existing legislation (ie, a security token considered a specified investment), and therefore falls within the regulatory perimeter of the supervisory authority, then those regulations should be applied fairly and evenly. The ‘same risks, same rules’ principle is necessary for the regulation of future technologies/products in order to remain technology neutral and ensure a level-playing field, whilst providing consumer protections.

18 Do you have views on location and legal entity requirements?

In order to enable cross-border trade, any approach would need to acknowledge and incorporate the flexibility for enabling regulatory deference for third-country jurisdictions (whilst recognising and making appropriate allowance for the autonomy of national competent authorities, as well as their knowledge and understanding of the needs of

⁹ Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms, IOSCO, February 2020, Pg. 26

¹⁰ Ibid. Pg. 16-17

¹¹ Ibid. Pg. 26

¹² Bitcoin jumps to three-year high as Covid crisis changes investor outlook, The Guardian, Philip Inman, 17th November 2020

¹³ Sudden ‘Major’ Outage Sparks Serious Bitcoin Exchange Warning, Forbes, May 2020

their local markets). This will be key to ensuring that there is the necessary regulatory harmonisation for that cross-border trade to happen.

HMT should also be mindful of the impact of UK-based service provision on customers based in other jurisdictions and their local requirements and rules. The importance of sharing of information on crypto-asset trading platforms is also discussed in response to question 5.

19 Are there any areas of existing regulation where clarification or amendments are needed to support the use of security tokens?

The application of existing regulations is an important component for delivering regulatory certainty, and we believe that, where security tokens meet the definition of a specified investment, they fall (or should fall) within the regulatory perimeter of the supervisory authority. Securities tokens may grant their holders rights similar to that of traditional securities and in some jurisdictions may be considered equal to those and therefore may be regulated as such. Additionally, security tokens derive their value not from themselves but from an underlying element, which is co-ordinated through a specified issuer and presents the holder with some form of ownership (hence the aforementioned rights). For a security token to be a transferable security under MiFID, for example, it must be “negotiable” on the capital markets. We believe that this requirement of MiFID is beneficial in clarifying that incorporation of a new element of capital market structures into a regulated environment. Requiring that shares be negotiable in order to consider them specified investment ensures that the trading of innovative (and so by definition previously unknown) instruments are kept in regulated and supervised environments. This can help to safeguard the integrity of the market as new instruments develop. A common approach helps to deliver these positive outcomes.

20 What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

The WFE strongly supports the nurturing of innovation and technology which benefits consumers and provides enhanced, safer and more efficient marketplaces. The use of DLT is something that many of our members (in the market infrastructure sector) are exploring to achieve those aims. However, it should be understood that such technologies cannot currently replace all aspects of what established exchanges and clearing houses provide – that of reducing and mitigating credit risk exposure. Although it is recognised that some technologies are being developed to deliver new services (for certain types of financial products, when used for certain financial activities), in a different manner, to reduce or remove the need for services, such as clearing, as a result of the associated processing benefits with those new technologies. However, at its heart, DLT fundamentally represents a (streamlined) means of record keeping. In this context, it supports but does not, outright and in all cases, replace the core functions performed by exchanges, creating and operating a market and acting as a source of valuable data. (Nor should or does it necessarily replace the clearing function for all financial activities, which consists of imposing a discipline on market participants who maintain open credit exposures to each other). We should equally not lose sight of the fact that a transition from legacy to new infrastructure requires a concerted effort not only from the operator but from the users of such services to ensure continued integration into their business flows.

To expand on the role of clearing, in theory, there is no reason in principle why some security tokens could not be centrally cleared, bringing the benefits of multilateral netting and volume assimilation between different asset-classes and collateral and default management processes. Please note, however, that the process of clearing (as distinct from settlement) is really about credit exposure reduction and mitigation, and therefore raises issues related

to the liquidity and ability to assess the risk of the instrument in question. (Settlement – the actual exchange of cash or other assets in return for a specific financial instrument – is a different and is a more purely operational matter, in which DLT can play a role.)

The distinction outlined above, between clearing and settlement, becomes more important when one moves beyond the (normally relatively short) timeline of the securities horizon and into the handling of longer-term contracts, ie, repos and derivatives. Conversely, if time to settlement of tokens is reduced to zero or thereabouts (perhaps through the use of DLT), then this risk may be lessened and appropriate use of technology to deliver such services is an area being developed and considered by members of the WFE. However, it may be difficult to move the whole market simultaneously to 'T+0', given the many technological and logistical challenges of aligning other related processes, although it is worthwhile recalling that certain products already process within a T+0 environment even within legacy technology. It may also be somewhat misleading to characterise 'T+0' as a necessarily desirable outcome for all securities settlement (whether in tokenised form or not), since instant settlement of trades could have a significant dampening effect on the viability of economic activities, dependent on the type of financial activities it relates to, that help make such markets liquid and attractive for investing in the first place. In particular, netting benefits would be lost.

21 What are the potential drawbacks of DLT for wholesale markets and FMIs?

The appropriate use of such technologies can potentially offer enhancements for consumers and for the delivery of safe and efficient marketplaces. However, such technologies should be delivered with (experienced) oversight from both the industry seeking to use it and from the supervisory authorities charged with regulating its use. As with all new technologies, in order to enable its use to progress the industry, a balance must be found between unnecessarily stifling innovation with draconian rules and having too loose a regulatory environment without proper controls. Inappropriate use or inexperienced oversight might result in negative, unforeseen, consequences. However, in the application of such new technologies it is important to consider what it can and what it cannot do. DLT technologies cannot yet (nor necessarily should) replace the current services, in all scenarios, provided by exchanges and CCPs as it does not have the same core objectives and criteria of oversight because it has not been designed to replicate those functions across all types of economic activities. Technologies cannot currently replace all aspects of what established exchanges and clearing houses provide – that of reducing and mitigating credit risk exposure – which is highly beneficial for certain financial activities.

As previously mentioned, the use of DLT and other technologies is being pursued by WFE members, in order to harness the benefits and efficiencies that can be derived for their consumers and the marketplace. Whilst it is difficult to speculate about the future of technology in the age of rapid advancements, the care and sensitivity that needs to be applied in the general oversight of the financial services industry should result in an equally careful application and supervision of new systems that operate in market infrastructures or for those which claim to provide those services. To ensure an orderly and managed integration of such technologies, established and experienced businesses who work with the regulatory authorities are best placed to oversee any introduction of DLT in the operation of trading venues and post-trade financial market infrastructures. The ability to co-ordinate multiple stakeholders to safely and successfully navigate large, disruptive shifts in the technology landscape is, indeed, a strength of the 'traditional' exchange industry (eg, the electronification of order books).

However, as highlighted in the recent OECD report on the tokenisation of assets¹⁴, there are still a number of issues to overcome in the embedding of DLT in such services. Technology must also be readily understood, in terms of the

¹⁴ The Tokenisation of Assets and Potential Implications for Financial Markets, OECD, January 2020, Pg. 33

service it provides and how well it can scale and be safely implemented. DLT enables the decentralisation and streamlining of record-keeping. It does so by removing the need for a central ledger in which to record financial transactions. It is not purposed to replace the role of CCPs in all scenarios (*See response to question 20*). DLT may be able to reduce operating costs and speed up settlement. But that does require integration and alignment with a number of other long-established processes. Even then, it seems unfeasible – and more importantly undesirable – to take trusted third parties (ie, exchanges and CCPs) out of the equation for all types of financial activities.

22 Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation be optimised for DLT?

The WFE believes the scope of existing regulations should be sufficient to extend to most potential DLT use cases (which are typically new technologies, as opposed to new activities). Legislation, rules and supervisory practices should only be adapted if strictly required and should avoid conferring undue advantage to one technology over another or inadvertently limiting competition by unnecessarily increasing barriers to entry. We consider it important that innovation should be market driven and needs to take place in a safe and controlled environment in which participants can have confidence. Any regulatory approach should encourage innovation whilst ensuring appropriate investor protection, security in the system and stability of the financial markets. Authorities should continue to proactively engage with industry to identify the nature of the application, understand the technology behind it, and, in general, ensure an appropriate regulatory framework (if existing frameworks are not deemed appropriate).

More specifically, the type of technology used to record or effect settlement, for instance, would not, *prima facie*, seem to us to be a matter for legislation. The exception to this may be related to the fact that the key test would appear to be whether settlement finality can be supported via DLT. Where DLT is being adopted it should be considered within the existing regulatory framework, to the extent practicable, and appropriate deference considerations should be built into the regime when reviewing the UK's approach to third-countries and their regulation of DLT systems.

24 If market coordination is required to deliver the benefits of DLT, what form could it take?

Ideally, any market co-ordination should be led by international standard-setting bodies to avoid patchwork approaches and regulatory arbitrage from occurring. At a national level it would be important that established industry stakeholders were also part of that conversation to ensure continuity of service, a level-playing field and to avoid unnecessary pitfalls.

25 Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

The primary consideration should be with regard to supporting and implementing international regulatory standards and guidance from the international standard-setting bodies. There is certainly space for a discussion around developing truly common standards in this emerging sector and it is important that the mantra of 'same risk, same rule' is adopted when deliberating on issues such as security. It is also important that, in seeking to drive the uptake of new technologies, the lessons of the past are not forgotten in the regulation that other sectors adhere to; and that the high standards by which established market infrastructure currently operates is not lessened for new technologies that fundamentally seek to perform the same functions as those existing market infrastructures.

The WFE would support and be pleased to work with HM Treasury to help deliver standards that accord with those principles set out above, with those appropriate common standards being developed to enable regulated trading across borders of a growing asset class.

26 What should the UK government and regulators be doing to help facilitate the adoption of DLT/new technology across financial markets/FMIs?

Helping to facilitate adoption of DLT and other new technologies, would be best served via the UK Government's support and engagement with international standard-setting bodies, to generate universal guidance for a common approach across jurisdictions. Due to the nature of the global financial services ecosystem, ideally, any work to further the adoption of DLT in the wholesale markets and market infrastructures should be led by international standard-setting bodies to avoid patchwork approaches and regulatory arbitrage from occurring. Ensuring that there is adherence to international regulatory standards, would also support cross-border trade, especially given the nature of crypto-assets. Particular areas of focus include, but are not limited to, continuity of application of existing AML/KYC and other investor protections that ensure market integrity (and financial stability more broadly), as well as the interoperability (in the technical sense) of technology platforms.

The WFE would express caution regarding the use of any potential regulatory 'incentives'. Whilst regulatory sandboxes and other closely monitored tools have proved effective ways of trialling and nurturing new technologies, a level-playing field should be ensured for the industry. Incentives should not extend to general regulatory lenience or regulatory relief for certain sectors or for particular types of technology that is not also extended to existing regulated entities. Aside from the potential threats to market integrity and consumer protection (and possibly financial stability in the long run) that may come with different requirements being extended to particular market operators, there is also the potential for an unlevel-playing field to be developed – not only between crypto-asset trading platforms and existing market infrastructure but also between the types of new service providers themselves. This would undermine those established operators who abide by high standards, with strong regulatory compliance and oversight.