

Can Regulation Save Crypto?

Peterson Institute for International Economics - Financial Statements Webinar

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Let It Burn: Should Crypto be regulated at all?

More precisely: **Should crypto assets and services providers be regulated and supervised (beyond AML rules) as a *distinct asset class*, not as securities?**

EU – Yes, Big Bang; **UK** – Yes, Incrementally?; **US** – Undecided

Why:

- Significant consumer harm
- Securities regulation not working
- Potential financial stability risks

EU Markets in Crypto Assets (MICA) Regulation

In force 12-18 months after Q1 2023 publication of final text

MICA defines the perimeter of crypto regulation as a distinct asset class:

Crypto Asset (CA) is “a digital representation of a value or right which may be transferred or stored electronically, using distributed ledger or similar technology.”

Exceptions: **Non-Fungible Tokens** (if not identical series); **Third Country CAs** if exclusively at customer’s initiative; **derivatives** subject to MIFID

Asset-Referenced Token (ART) is a CA that is not an EMT “and that purports to maintain a stable value by referencing to any other value or right or a combination thereof, including one or more official currencies.”

Significant if 2.5m transactions, €500m daily value, other criteria

Size Cap if 1m transactions, €200m daily value ‘widely used for means of exchange’ or threat to monetary policy

Electronic Money Token (EMT) is a CA “that purports to maintain a stable value by referencing to the value of one official currency”

Significant test same as ARTs

MICA Applies Key Parts of Existing Markets and Conduct Regulation

Requirements	Crypto Asset	ART	Significant ART	EMT	Significant EMT
White Paper? (and liability)	✓ Except purely mining, free 'air drops', others. <u>Yes</u> Grandfathering	✓ <u>No</u> Grandfathering	✓ <u>No</u> grandfathering	✓ <u>No</u> grandfathering	✓ <u>No</u> grandfathering
White Paper Prior Approval?	✗ Prior Notification	✓	✓	✓	✓
'Conduct Standards'?	✓	✓	✓	✓	✓
Prior Approval: Management?	✗	✓	✓	✓	✓
Supervision?	✗ Market regulation oversight	✓ National competent authority	✓ European Banking Authority	✓ National competent authority	✓ European Banking Authority
Reserve Asset Rules?	✗	✓	✓	(✓)	(✓)

MICA Regulation of Crypto Asset Service Providers: Scope

Crypto Asset Service Providers (CASP) provides one or more of these crypto-asset services to third parties on a professional basis:

custody and administration, operation of a trading platform, exchange (CA vs CA or fiat money), execution of orders, placing, transfer services, reception and transmission of orders, providing advice, portfolio management

- “or more” implies ok to bundle services in same legal entity
- “DeFi” exemption but only if fully decentralised and no intermediary
- Note: Lending not is not a CA service
- Banks and investment firms can be CASPs
- No grandfathering for licences
- National Competent Authorities are supervisor but important ESMA roles

MICA Crypto Asset Service Providers: Key Requirements

CASPs gain EU-wide passport rights

- **Corporate Structure and Governance**

- CASP must have legal entity in EU
- Corporate structure, jurisdictions must not prevent effective supervision
- Corporate governance, conduct and capital requirements

- **Client asset safekeeping** rules and custody loss liability

Crypto Hacking Losses

\$3 billion (Year to 12 October)

\$2.1 billion (2021)

Source: Chainanalysis

Emerging UK Crypto Regulation: Contrast with MiCA

Financial Services and Markets Bill (FSMB) progressing in Parliament

- Incremental, step-by-step approach: converging to MiCA?
- **Starts with** Digital Settlement Assets (**Stablecoins**) and Digital Asset Service Providers
- Recent amendment: wide definition of **CAs to be ‘regulated activities’ and subject to ‘financial promotions’**
- Apply FCA ‘financial promotions’ high risk investment warnings: “This is a high-risk investment and you are unlikely to be protected if something goes wrong”
- Further HM Treasury consultation soon...

MICA CASP Rules and Crypto 'Exchanges'

Largest Crypto Exchanges (Source: Reuters 9 November) and Group HQs (Source: Company Websites, Crypto News Services)

Exchange (and Headquarters)	Volume YTD (USD)
Binance (None: Cayman? Seychelles?)	\$4.953 trillion
OKX (Seychelles)	\$960.93 billion
UpBit (South Korea)	\$800.00 billion
Coinbase (USA)	\$775.09 billion
FTX (Bahamas)	\$626.69 billion
KuCoin (Seychelles)	\$554.87 billion
Crypto.com (Singapore)	\$453.96 billion
Huobi (Seychelles)	\$452.62 billion
Gate.io (Bahamas)	\$433.83 billion
Kraken (USA)	\$237.48 billion

FTX Creditors

Source: Delaware Bankruptcy Court filings

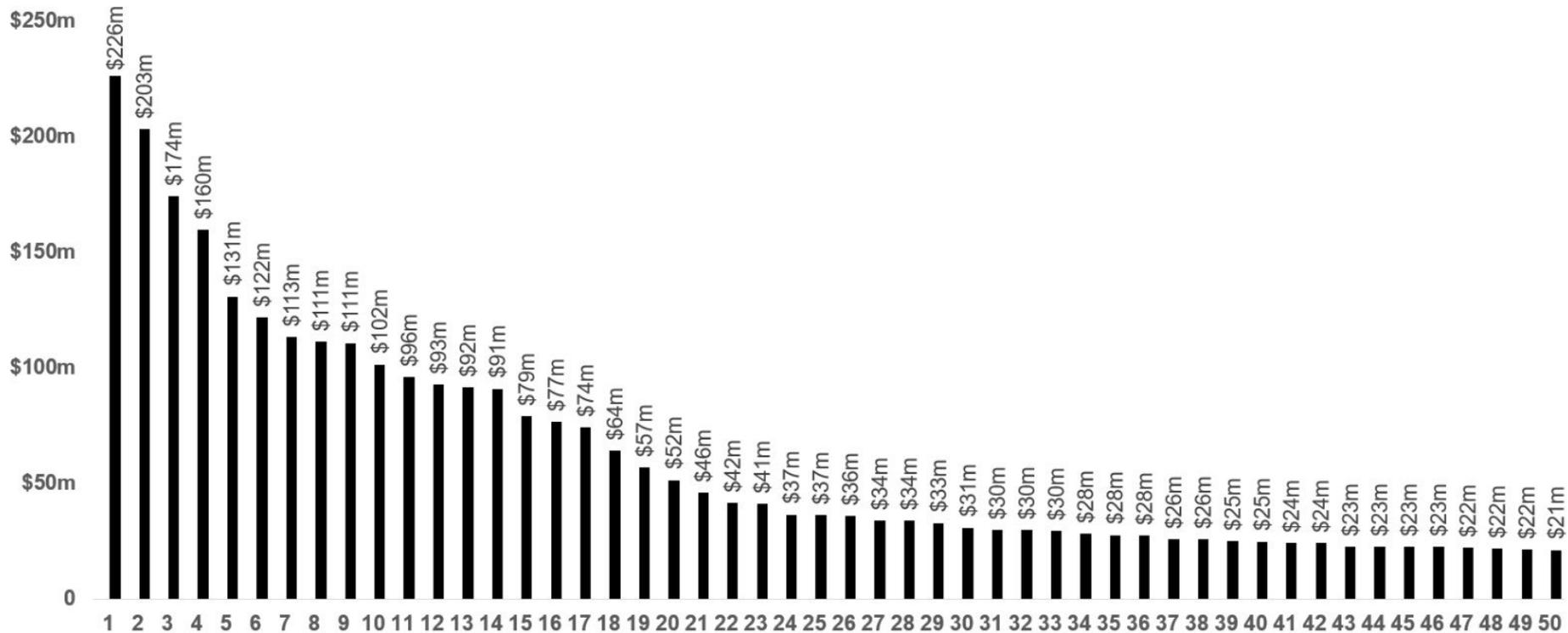
1 Million Creditors: Total Claims Unknown

50 Biggest Unsecured Creditors Owed \$3.1 billion

“oh fuck, people wired \$8bn to Alameda and oh God we basically forgot.” Sam Bankman-Fried in Vox 16/11

Top 50 Unsecured Creditors to FTX.com (Exchange Customers)

Source: Galaxy Research



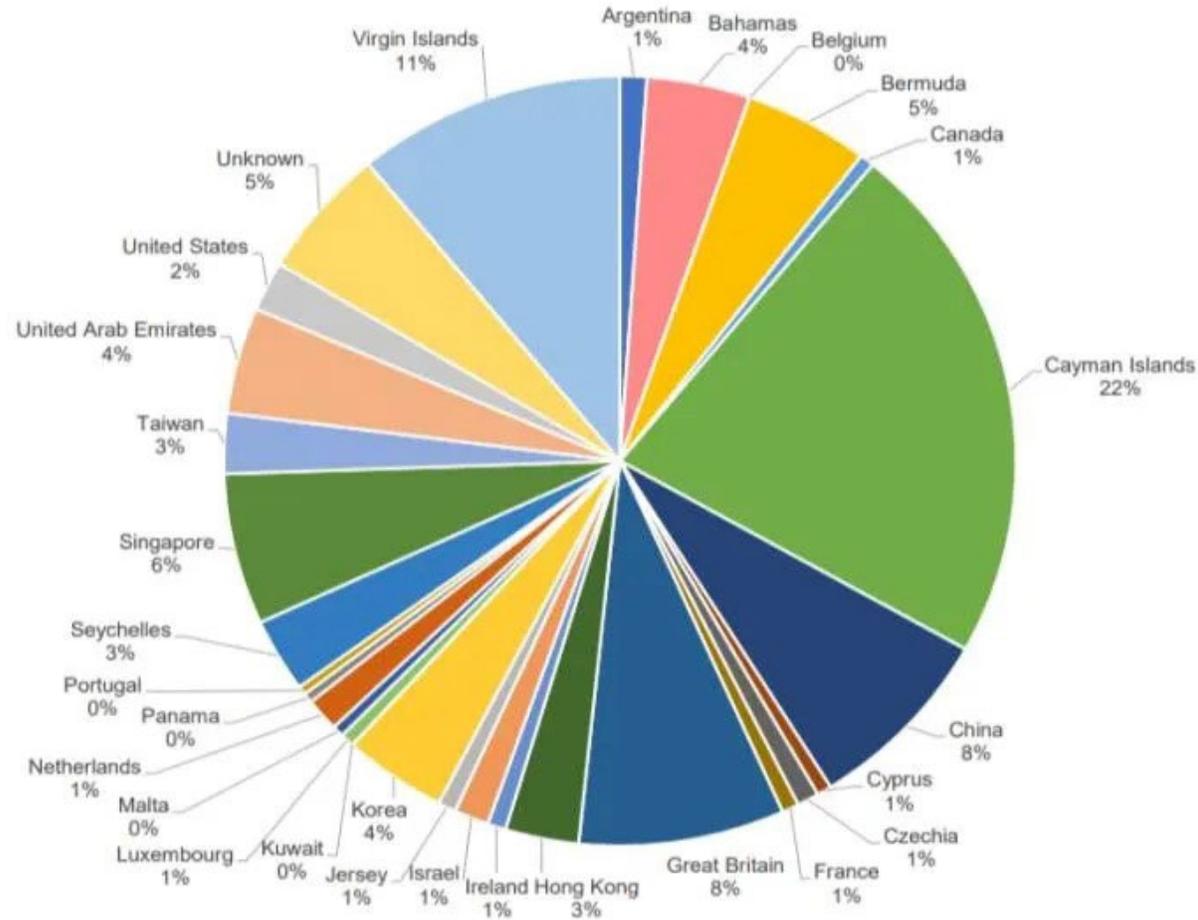
Data: Docket #51 @ <https://cases.ra.kroll.com/FTX/Home-DocketInfo>

FTX Creditor Locations

Source: Delaware Bankruptcy Court filings

Case 22-11068-JTD Doc 115-1 Filed 11/22/22 Page 8 of 21

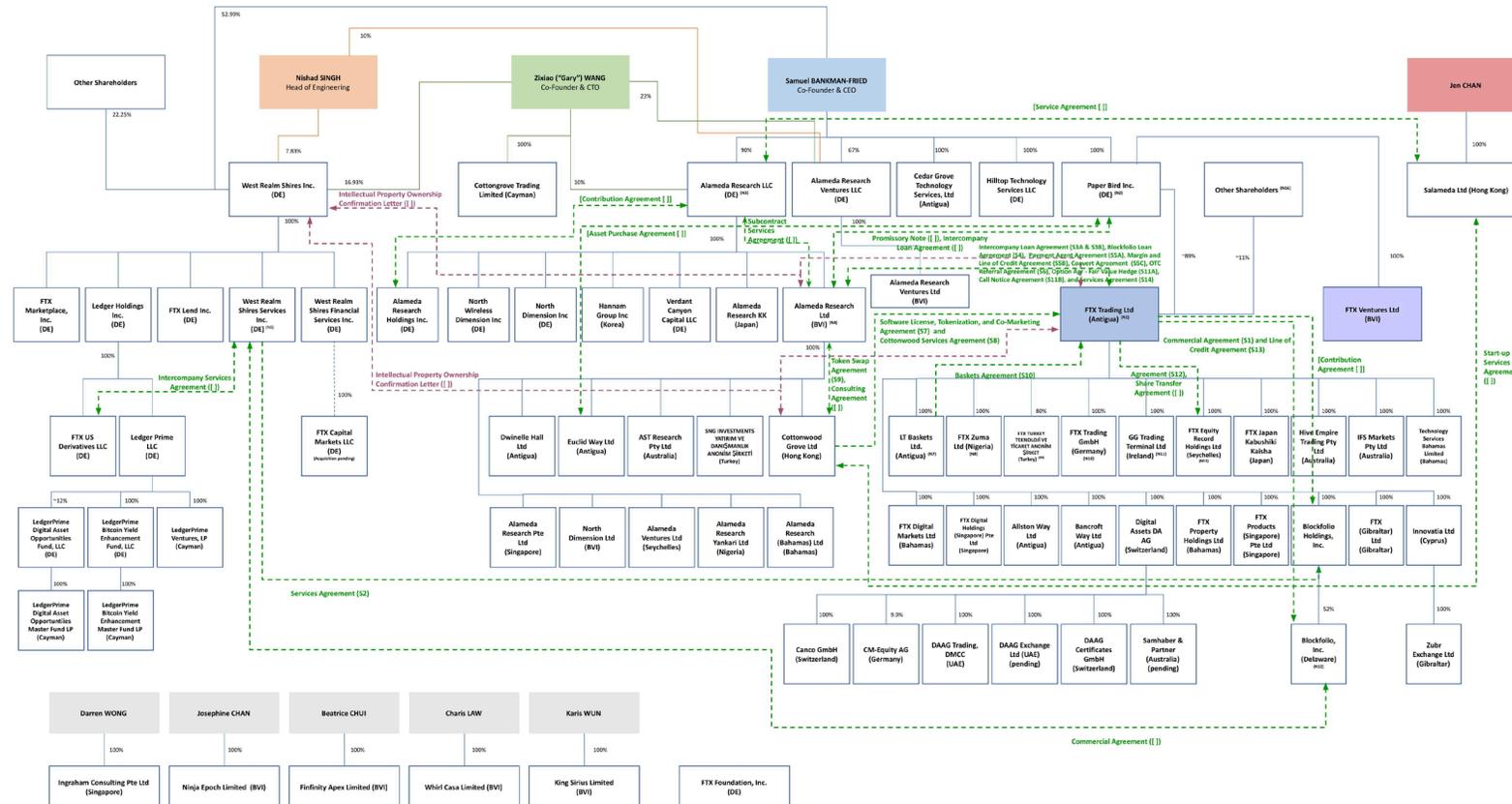
**GLOBAL CUSTOMER DISTRIBUTION (WRS AND DOTCOM SILOS)
AS OF THE PETITION DATE**



FTX Corporate Structure

“FTX is not an exchange, its much wider. Everything is integrated in this complicated way, which is creating this black box.” Jean-Marie Mognetti, CEO asset manager CoinShares, FT 11 November 2022

Source: FT Alphaville



MICA and Crypto ‘Exchanges’

FTX International Case Study Should Inform MICA Licensing

“I fucked up, and should have done better”. Sam Bankman-Fried tweet Nov 10 2022

- Dominant Founder
- Inadequate corporate governance
- Untested offshore jurisdiction
- Complex and sprawling corporate structure, with bundles of services
- Complex intergroup transactions (and rehypothecation of customer assets)
- Ineffective systems and controls
- Ineffective segregation of client assets/reserve assets
- Centralized, off-chain transactions and co-mingled wallets: not DeFi
- Vulnerability to hacks
- Thin capitalization

Supervisors Beware: How many other exchanges have similar weaknesses?

MICA: How to Supervise the Crypto Exchanges?

"I am concerned for my colleagues that will have to perform this supervision in the future because these are animals with whom it is difficult to engage." Andrea Enria, Chairman ECB Single Supervisory Mechanism (FT interview 13 Nov 2022)

- **Resource challenge** for National Authorities, EBA, ESMA
- **Tight deadlines for licensing process.**
- Supervisors should **refuse licensing until *after* improvements** in corporate structure, etc – **Binance** and French AMF is the **key test case**
- ESMA should explore rules on **bundling of multiple services**
- EU and UK should collaborate on **rigorous client asset segregation rules**
- **FCA investor warning is a good model** for EU standards
- MICA's new **enforcement powers need to be used** to back up supervision

Conclusions

- Should Crypto be Regulated? **The debate is over** in EU and UK
- EU and UK **regulation legitimizes Crypto** as a distinct asset class
- **MICA will require big improvements**, e.g. to corporate structure and client asset protection by the Crypto exchanges
- But **consumer protection for Regulated Crypto still depends** on tough client asset rules, clear risk warnings, enforcement and effective supervision
- Risk that competition between EU jurisdictions to become crypto hub impacts **rigor of licensing**
- AMF's (re)licensing of **Binance is the key test case** to learn from FTX

Can Regulation Save Crypto: Further Reading

- Financial Stability Board, *Regulation, Supervision and Oversight of Crypto-Asset Activities and Markets* October 2022
- US Financial Stability Oversight Council, *Report on Digital Asset Financial Stability Risks and Regulation* October 2022
- Council of Europe Press release 29 June 2022, *Anti-money laundering: Provisional agreement on transparency of crypto asset transfers*
- Financial Conduct Authority, *Supervisory Notice on Binance Markets Ltd* 25 June 2021
- HM Treasury, *UK regulatory approach to crypto assets, stablecoins, and distributed ledger technology in financial markets* April 2022
- Chamber of Digital Commerce, *Proof of Reserves: The Practitioners Guide to an Emerging Standard for Increasing Trust and Transparency in Digital Asset Platform Services*
- Matthew Elderfield, *A divide has emerged in EU and UK crypto regulation* Financial Times, 31 August 2022
- FT Alphaville coverage of FTX failure