



DIGITAL CURRENCIES
Governance Group

MANAGING THE FAILURE OF SYSTEMIC DIGITAL SETTLEMENT ASSET (INCLUDING STABLECOIN) FIRMS

CONSULTATION RESPONSE: DIGITAL CURRENCIES GOVERNANCE GROUP

Digital Currencies Governance Group (DCGG) and our members, which include among others the global stablecoin issuer Tether, digital asset exchange Bitfinex and cold wallet provider Ledger, strongly believe that the UK has the unique power to bring together disparate players in the cryptoasset community and to become a global hub for cryptoasset technology and investment. DCGG, on behalf of its members, welcomes the thought and effort put into this consultation, which aims at positioning the UK right at the centre of the nascent and vibrant crypto market.

The Digital Currencies Governance Group (DCGG) welcomes the Government's commitment to place the UK's financial services sector at the forefront of crypto asset technology and innovation and believes in a staged and proportionate approach to crypto asset regulation, which is sensitive to risks posed and responsive to new developments in the market. Importantly, regulation should not stifle new development, and policymakers should avoid creating unintended consequences by intruding on regulations inappropriate for what remains a rapidly developing product.

We accept that the Government / BoE will want to address any financial stability issues that may materialise should a firm that has reached systemic scale fail – wherever that firm sits in the financial ecosystem – as well as the need for consumer protection. At the same time, we want to ensure that implemented control measures are effective and suitable for the risks posed by stablecoins.

QUESTION I: DO YOU HAVE ANY COMMENTS ON THE INTENTION TO APPOINT THE FMI SAR AS THE PRIMARY REGIME FOR SYSTEMIC DSA FIRMS (AS DEFINED AT PARA 1.8) WHICH AREN'T BANKS?

Issue 1: Disproportionate Risk Mitigation

As stated in the consultation paper, the FMI SAR was established to address the risks posed by the possible failure of payment systems recognised as systemic where such “disruption or discontinuity due to insolvency **would not best serve the public interest given potential impacts on financial stability**, as wider financial sector descriptions might occur given the volume and value of transactions processed”.

We believe that the control measures introduced by the FMI SAR, which address the concerns mentioned above, cannot be transferred to DSA firms because the level and nature of risks is different.

Today, stablecoins are predominantly used as a bridge between fiat currencies and digital assets, facilitating lending/borrowing and trading in the crypto space. Their use as means of payment is extremely limited. One of the reasons is that current transactional costs incurred by either blockchain protocols or providers of transfer services are comparatively higher, as well as the widespread availability of fiat-based solutions, limit their use as means of payment. Even if transaction costs fall, or stablecoins migrate to low or zero fee blockchains, there is little incentive for non-crypto users to use DSAs for payments.

The Financial Stability Board is of the opinion that **only global stablecoins that would be adopted at scale and would enter the mainstream financial system as a store of value or means of payment could pose a risk to financial stability**. In its report “Assessment of Risks to Financial Stability from Crypto-assets”, it identifies major risks when global stablecoins are denominated in currency other than that of the jurisdiction they are operating for emerging market and developing economies, as payment structures may not be developed, and domestic currency may not be stable.

Taking current status and level of stablecoin adoption into consideration, the risk to financial stability might be a potential, particularly with the evolution of Web 3.0 and the tokenisation of any commercial activity, but there is no evidence of such risk today.

Thresholds need to be set, with distinction made between stablecoins used as means of exchange and those used as financial instruments. It is not at all clear what DSA firms would fall under the “systemic” category, given that stablecoins are geared to be complementary to rather than replacements of other payment systems. Thus, we believe that the appointment of the FMI SAR as the primary regime for systematic DSA firms is premature and not suitable for the risks stablecoins currently pose.

Issue 2: Unique features of the stablecoin market

We would also like to draw attention to the fact that DSA entities have features not attributed to FMIs.

We note the use of the term “systemic DSA firm” to refer to systemic DSA payment systems and/or an operator of such a system or a DSA service provider of systemic importance. In the case of stablecoins, this might include – but is not limited to – the issuer of a stablecoin, a wallet, or a third-party service provider.

Stablecoin arrangements can be designed and organised in a variety of ways. Such arrangements can include issuance, redemption, and stabilisation of the value of the coins, transfer of coins, and interaction with coin users for storing and exchanging coins. Only the transfer function in stablecoin arrangement can be comparable to the transfer function performed by other types of FMI. In some cases, all three functions are conducted by a single entity, while in others, the functions are unbundled. Thus, we would urge distinctions to be drawn between these entities: for instance, many types of wallets are mere technological devices that do not have a custodial obligation and we would urge any regime to differentiate between the various aspects of the blockchain and digital payments ecosystem.

Another unique feature is the use of distributed and/or automated technology protocols as well as decentralisation of operations and/or governance facilitated by the use of these technology protocols as opposed to the centralised nature of FMI functions in existing FMIs. Governance of the transfer function may be performed by software, such as smart contracts, which as well provides for transparency and predictability. Automation of a transfer function also requires an expert judgement to identify a problem for software implementation. In such circumstances, external control as provided in the FMI SAR may not be a proper tool to ensure the continuity of services.

QUESTION 2: DO YOU HAVE ANY COMMENTS ON THE INTENTION TO ESTABLISH AN ADDITIONAL OBJECTIVE FOR THE FMI SAR FOCUSED ON THE RETURN OR TRANSFER OF CUSTOMER FUNDS, SIMILAR TO THAT FOUND IN THE PESAR, TO APPLY SOLELY TO SYSTEMIC DSA FIRMS?

DCGG believes the regulations should be carried out in accordance with the sector using DLT technologies, which have automatic control mechanisms embedded in the network, including an automatic recording of each transaction in the network and access to this information by regulators.

If necessary, stablecoin issuers can be integrated to the embedded supervision system. In this case, the transactions of stablecoins can be viewed instantly by the regulator. This would be an adequate pre-emptive measure, not stifling innovation and minimizing the need of the SAR.

To give one example, rather than adding to the FMI SAR an additional objective from the PESAR covering the return or transfer of funds and custody assets which may only be considered when the FMI SAR is applied in relation to systemic DSA firms, the UK regulator could require that the information concerning rights of redemption is regularly shared by way of a balance sheet published on the blockchain, within the parameters of GDPR and with regard to any privacy concerns. This will ensure that transactions stay fast and smooth whilst taking all necessary consumer protection measures.

In further example, features unique to stablecoins can be leveraged when protecting stablecoin holders from losses. These include the tokenisation of client losses, the ability to trade tokenised losses and the ability to swap tokenised losses (debt) for future value (equity).

QUESTIONS 3 AND 4: DO YOU HAVE ANY COMMENTS ON THE INTENTION TO PROVIDE THE BANK OF ENGLAND WITH THE POWER TO DIRECT ADMINISTRATORS, AND TO INTRODUCE FURTHER REGULATIONS IN SUPPORT OF THE FMI SAR TO ENSURE THE ADDITIONAL OBJECTIVE CAN BE EFFECTIVELY MANAGED, OR WHAT FURTHER REGULATION MAY BE REQUIRED? DO YOU HAVE ANY COMMENTS ON THE INTENTION TO REQUIRE THE BANK OF ENGLAND TO CONSULT WITH THE FINANCIAL CONDUCT AUTHORITY PRIOR TO SEEKING AN ADMINISTRATION ORDER OR DIRECTING ADMINISTRATORS WHERE REGULATORY OVERLAPS MAY OCCUR?

We do not disagree that the Bank of England, rather than the FCA, should be the lead regulator in case of the insolvency of systemic firms – if financial stability is the overarching priority, then this is clearly sensible. Given the differing objectives of the Bank of England and FCA, but the overarching requirement for financial stability, we agree in principle that consultation should take place between the two bodies if special administration needs to occur, but with the Bank of England taking a dominant role.

However, we would urge for the introduction of a stablecoin-specific regime rather than a copy-and-paste of an existing scheme to avoid a path of **MF Global UK Limited insolvency proceedings**, where SAR did not deliver the desired results in terms of improving speed, rate of return and cost of process.

Recovery and Resolution Plans

DCGG is of the opinion that in order to avoid the introduction of the SAR in cases of DSA firms being unable/likely unable to pay their debt, more attention should be paid to an operational recovery and resolution plan to support an orderly redemption.

Rather than extending the scope of the FMI special administration regime, appropriate tools can be introduced to prevent the disruption of services, covering credit risk, liquidity risk, operational risk, and

settlement risk. Such tools include embedded supervision which allows for the real-time automatic monitoring of the full asset-backing of a stablecoin, where trustworthiness and transparency of data are ensured by the DLT. This would give more oversight capabilities to the Bank of England, minimizing the need for the SAR. Such measures would also decrease the administrative burden for supervised institutions, enhancing the competitiveness of the UK digital services sector.

DCGG would also like to note for the consideration that the system currently being developed under the Markets in Crypto Assets Regulation (MiCA) in the EU focuses on operational redemption, which would include contractual arrangements, procedures, and systems, including the designation of a temporary administrator, to ensure that all holders of the stablecoin are paid in a timely manner with the proceeds from the sale of the remaining reserve assets. The plan must also ensure that any critical activities performed by the issuer or third-party entities shall continue that are necessary to achieve this. The stablecoin issuer shall notify this plan to the competent authority after authorisation. The plan should be reviewed and updated regularly.

Furthermore, in addition to the point made earlier recognising the various stablecoin arrangements present in the market, it is important to give recognition to the delineation between the roles that issuers, exchanges, and wallet providers play across the industry as it relates to DSAs issued by DSA firms. The consultation paper is right to point out in paragraph 2.9 that DSA allows users to store value which is then used for movement of funds between cryptoassets. However, in regard to the extended objective covering return or transfer of funds in relation to systemic DSA firms, careful attention needs to be paid to the interplay – and shifting responsibility – that takes place between issued stablecoins across primary and secondary markets. ‘Ownership’ of stablecoins can shift based on the decentralized nature of the issuer or stability mechanics; the description put forward in the paper currently leaves a certain amount open to interpretation around who would be liable to claims on DSAs made by users in instances of failings outside of the primary market issuer. Such markets operate independently of some DSA firms acting as primary issuers of stablecoins.

Apart from that, a recovery plan must be developed and maintained by the issuer of a stablecoin. The plan would contain recovery measures to be taken by the issuer to restore compliance with the requirements applicable to the reserve of assets, the preservation of services related to the stablecoins, the timely recovery of operations, and the fulfilment of the issuer’s obligations in the case of a significant risk of disrupting operations. MiCA provides that power would be given to the national competent authorities to ensure that the plan is implemented properly.

**OVERALL, DCGG CONCLUDES THAT SIGNIFICANTLY MORE WORK IS NEEDED TO
CREATE A REGIME THAT WORKS FOR STABLECOINS, ACCURATELY MANAGES
RISKS, AND CONSIDERS THE BREADTH AND FLUIDITY OF THE BLOCKCHAIN
ECOSYSTEM.**
