Digital Currencies
Governance Group

The FSB proposed framework for international regulation of crypto-asset activities

Consultation Response by the Digital Currencies Governance Group

DCGG represents the interests of the crypto-asset ecosystem and advocates for an innovation-friendly regulatory environment that ensures safety for all market participants. DCGG seeks to facilitate an open dialogue and encourages communication between political representatives and digital currency experts to ensure that legislation supports both political objectives and innovation in the digital-asset space. To this end, DCGG regularly engages with policy-makers and regulators both at the national and international levels. DCGG represents a broad spectrum of stakeholders in the crypto-asset ecosystem. Among our members are Tether – currently the largest stablecoin issuer worldwide, Ledger – a leading custodian service provider, Bitfinex – a crypto-assets exchange, and Iden3 – a solution provider for self-sovereign identity management.

Introduction

DCGG welcomes the opportunity to comment on the Financial Stability Board's ("FSB") proposed framework for the international regulation of crypto-asset activities (the "Framework"). DCGG applauds the process undertaken by the FSB to consult on this important topic, and welcomes the opportunity to be part of the ongoing dialogue. The FSB report from October 2022 cited market events in the earlier part of the year that had exposed "a number of structural vulnerabilities" in crypto-asset markets and related businesses. Indeed, events like the collapse of the Terra/Luna project, and other events highlighted the need for significant standards setting, professionalisation, regulation, and reform across within the centralised finance (CeFi) digital asset space.

The subsequent collapse of FTX, while still unfolding, also appears to be underlining the need for a comprehensive, coordinated, international approach to the regulation of crypto-asset related activities within centralised finance. The FSB's initiative and ambition to harmonise the approach to crypto asset markets and their regulation and supervision is an opportunity to establish regulatory clarity for market participants, if such harmonisation promotes risk-based practices.

However, while we can understand the underlying guiding principle of "same activity, same risk, same regulation" approach, DCGG believes that a more granular approach might be needed in some instances to reflect the diversification of the sector and the different business models that have been emerging. We believe that a more differentiated approach might be more appropriate to allow for the innovation in the sector, while still meeting the objective to ensure financial stability.

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?

DCGG welcomes the FSB's recommendations on the regulation, supervision and oversight of crypto-asset activities and markets and believes that these are very comprehensive and cover the major risks these could pose to financial stability.

Notwithstanding, in order to improve the thoroughness of the recommendations, making sure they are proportionate and prevent financial instability in the long term, DCGG proposes that the FSB considers a more granular approach to the "same activity, same risk, same regulation" principle in relation to crypto assets and crypto asset activities. This is because, while crypto assets are based on the same blockchain technology, they do have specific use-cases or users. Any regulation, supervision or oversight of crypto asset activities should be befitting to their specificities, rather than an overarching regulation under the "same activity, same risk, same regulation" principle, as this approach would stifle innovation and competition. Taking the example of stablecoins, these can be either used for professional investors, such as for their proprietary trading or settlement operations, or be addressed to retail investors or customers, e.g., for payments operation for instance for social media platforms.

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?

DCGG believes that the CA Recommendations sufficiently cover the areas where risks within the market have been identified before. Given the size and volume of the current market, we believe that any decisions regarding either the regulation of services, or the supervision or oversight of actors in the ecosystem should be proportionate to their relevance, size, business model and purpose.

We agree with the recommendations for providers of unhosted or self-hosted wallets, that if they only provide the hardware or software, they should not be subject to any regulation of crypto assets service providers (CASPs), but should comply with the requirements regarding cyber security and resilience, such as the BCBS Principles for Operational Resilience, BCBS Principles for the Sound Management of Operational Risk and the IOSCO Principles on Outsourcing. Furthermore, we welcome the clarification that the CPMI-IOSCO Principles for financial market infrastructures (PFMI) should only apply if the activity is performed by a systemically important FMI.

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)?

DCGG welcomes the FSB's effort to establish a sound categorisation mechanism for crypto assets, stablecoins and global stablecoins. However, we believe that the FSB would benefit from introducing more detailed classification on stablecoins, and crypto assets at large. For stablecoins in particular, it is important to differentiate how these tokens operate, including the overarching business and user model, the mechanisms used, such as whether the reserves system is fractional or not, and inter-ecosystem differentiation in terms of traceability and ability to freeze assets (in cases of criminal transfer risks). Comparing it, for example, to traditional asset management regulation and requirements, there is a difference whether it is addressed to professional investors, such as for hedge funds or alternative investment funds, or retail investors, such as through pension funds or retail asset management.

DCGG is conscious of the FSB's concerns arising from the TerraUSD crash earlier this year in relation to the stablecoin ecosystem. While our members agree that this needs to be scrutinised, the FSB should avoid putting the different types of stablecoins under the same regulatory umbrella. Fiat-backed, crypto-backed, and algorithmic stablecoins have divergent reserve and stability mechanisms; subjecting these to the same legislative framework without the necessary differentiation, would be inconsistent with their specific characteristics and risk management procedures. Regulators should also be looking at the white papers of different stablecoin solutions to serve as the base for their recommendations to ensure that they are accurate and relevant. In this case, diverting from the "same activity, same risk, same regulation" principle to introduce a more detailed classification between GSC, stablecoins, and other crypto assets, would be more constructive and sustainable in the long term.

This holds also true for all crypto assets by and large. It is clear that between tokens such as Bitcoin and other crypto assets, there are significant and key differences (i.e., different levels of capital invested in these products), diverse client profiles, and different kinds of technology used as an underlying structure. Therefore, it would be beneficial not only for the industry, but for financial stability in general, to introduce a narrower differentiation between crypto assets and develop a sound regulatory framework.

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

In relation to the CA Recommendations, DCGG's members are conscious of the rationale of safeguarding financial stability. Notwithstanding, it is important to avoid excessive regulatory generalisation of the crypto space and assume that all strands of the industry carry high levels of risk. Many prominent market participants, among which are the members of DCGG, have long established dedicated practices, risk management policies and governance arrangements to ensure their products and services are not exposed to turmoil within the market.

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

DCGG believes that the FSB recommendations are covering key financial stability issues. However, while the FSB reports each list numerous risks under this banner, their analysis should in our view also be looking at mitigating risk factors. The FSB and domestic policymakers should also consider the potential of GSCs to enhance financial stability for the crypto assets market. GSCs allow for sophisticated market participants engaging in cryptocurrency markets to efficiently shift and rebalance capital across global markets. This helps to improve price discovery, which is the best deterrent to financial instability. While the FSB report does not define financial instability, this term often denotes rapid decrease in prices in a given or various markers. The reasons for rapid price decreases can vary but are often attributable to poor price discovery - the process by which interactions between buyers and sellers produce a market price involves "discovering" where supply and demand meet, for a given asset, at a given time. For example, the 2008 financial crisis is best explained as a prolonged case of ineffective price discovery, where mortgage originators who are best positioned to perform credit analysis were incentivised to turn a blind eye and retail real estate customers who had the greatest financial incentive to conduct credit analysis were not in a position to do so. Further, the agility of GSCs allow for efficient transfers of stable assets such as tokens denominated in USD to be sent to areas of the world where currency purchasing power instability is inherent. It is easier to transfer stablecoins than to get a USD bank account, or any bank account in many parts of the world. The FSB should consider the ability of GSCs to help persons in jurisdictions with less sophisticated financial markets.

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?

DCGG agrees that the report accurately characterises the functions and activities within the crypto-ecosystem that pose or may pose financial stability risk. In terms of the interconnectedness of different crypto activities, the FSB should also consider that this is still a nascent industry that is still exploring viable and stable business models. We believe that it would be counterproductive to the innovation that the crypto and stablecoin industry can deliver, to have too many restrictive requirements in place, such as co-ownership.

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

DCGG agrees in part with the analysis of activity patterns and supports the requirement for crypto asset service providers to have an effective risk management framework that comprehensively addresses all material risks associated with their activities. We fully support that the framework should be proportionate to the risk, size, complexity, and systemic importance, and to the financial stability risk that may be posed by the activity or market in which they are participating. However, the unique characteristics of crypto assets and GSCs should also be considered in the assessment of risks, in particular in relation to the prevention or mitigation of money laundering risks. Most cryptocurrencies transfers can be traced and have allowed law enforcement to trace and seize criminal funds, arrest perpetrators, and have allowed authorities to halt high-risk activities on decentralised markets through sanctions. Many of the largest GSCs by market cap offer similar traceability and can additionally remotely freeze secondary market wallet addresses in cooperation with law enforcement. In effect, GSCs and responsible crypto asset businesses enhance the identification, deterrence and response to illicit activity.

Furthermore, regulations should be flexible enough to take into consideration the purpose of the crypto asset or stablecoin, whether it is likely to achieve mass adoption, and the mechanics of its operation (e.g., the reserves management framework, stability mechanism, how it generates income). The concept of "same activity, same risk, same regulation" is an approach which runs the risk of inadequately addressing and even over-reaching on the industry in a way which will negate the positive economic benefits that can be had from a well-regulated crypto industry, as well as to misrepresent any potential risks associated with such groups.

For example, regarding stablecoins specifically, Tether USDt's model is such that every token issued is backed by a dollar (or equivalent) held in reserve, and those Reserves are invested in highly liquid, conservative interest-bearing assets such as Treasury Bills. It is based on a supply and demand mechanism, meaning that Tether is fully collateralized, and not operating with fractional reserves or attempting to maintain stability through algorithmic methods of issuance and redemption. Recognising such distinctions between different types of stablecoin in the context of the FSB's recommendations allows for the promotion of a fair and effective regime which balances consumer protection, while also allowing for continued and positive innovation in the industry.

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

We believe that the FSB report accurately identifies regulatory, supervisory and oversight issues and challenges as related to financial stability. However, as outlined previously, the FSB reports each list the major financial stability-related risks, but in our view, the analysis should also consider the potential of GSCs to enhance financial stability for cryptoasset markets. GSCs allow for sophisticated market participants engaging in cryptoasset markets to efficiently shift and rebalance capital across global markets. This helps to improve price discovery, which is the best deterrent to financial instability.

Innovation across the traditional financial and crypto markets alike is another critical issue that warrants consideration at the international level. DCGG members believe that potential oversight issues could be efficiently and sustainably resolved, should traditional financial infrastructures have the willingness to adopt innovative practices to utilise the effective tools that blockchain technology provides which would allow for more effective cooperation among participants across all markets. Oversight and regulation could be positively reformed and strengthened if crypto businesses, as well as FIUs, banks and other competent authorities from the traditional financial market, take advantage of the game changing technology underpinning these novel products to innovate, and thus maintain and improve financial stability.

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?

Overall, DCGG agrees with the differentiated requirements for cryptoasset issuers and service providers. The underlying technology of crypto asset products and service providers is paramount for transparency, and effective risk management. DCGG is of the opinion that, in the proposed recommendations, the FSB must account for the benefits of the Blockchain technology for risk mitigation and compliance purposes, i.e., the ability to create more efficient reserves transparency mechanisms which enhance consumer protection.

With this in mind, DCGG is also encouraging its members and firms in the industry to voluntarily adopt sound risk management practices, and is collaborating with thought leaders in the industry on standards and best practices. DCGG believes that voluntary adoption is the best way for the industry to coalesce around specific risk management practices that are purpose fit for the industry, best protect customers, and limit contagion risk and financial instability.

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.

DCGG's members strongly recommend that the FSB reconsider applying the "same activity, same risk, same regulation" regulatory principle across the industry at large, and take into account the relevance, customer base, underlying technology and size of regulated service providers. More granular differentiation within the recommendations, and the oversight approach as a whole is therefore imperative.

It is important that the regulator is mindful of the fact that the crypto industry is still a nascent sector and many entities are relatively small. To allow the sector to grow, any risk management requirements should be proportionate to the risks they could pose and whether its business services are directed to retail customers (B2C) or wholesale customers (B2B). As explained above, the DCGG is also encouraging its members and firms in the industry to voluntarily adopt sound risk management practices, and is collaborating with thought leaders in the industry on standards and best practices. DCGG believes that voluntary adoption is the best way for the industry to coalesce around specific risk management practices that are purpose fit for the industry, best protect customers, and limit contagion risk and financial instability.

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?

We agree with many of the issues raised in the overall analysis of recent market developments and the existing stablecoins. However, we disagree with the analysis that the existing stablecoin arrangements analysed would not meet the FSB's High-level Recommendations.

We would like to clarify some aspects in relation to the comments on one of DCGG's members, Tether. The FSB report states on page 4 on the transparency of Tether's reserves that "those reserves have not been disclosed in detail and have not been audited." The DCGG would like to clarify that the issues and recommendations in relation to reserves disclosure have been addressed and that the transparency in relation to its reserves has been increased further. Tether's stablecoins are backed by a strong, conservative portfolio that consists of cash & cash equivalents, such as short-term treasury bills, money market funds, and commercial paper holdings from A-2 and above rated issuers. The value of Tether's reserves is published daily and updated once per day. We believe that this is fully compliant with the framework suggested by the FSB and should be industry practice.

As part of Tether's continued commitment to transparency, the DCGG would like to point out that Tether Holdings Limited do regular assurance opinions every quarter. To allow easier accessibility, Tether makes all their historical and most recent opinions (carried out by BDO Italia) available on its website. The opinion and the underlying report from Tether clearly and unambiguously show that all Tether tokens are fully backed by reserves and provides a comprehensive breakdown of those reserves.

In relation to the FSB report's statement (on page 4) that "Tether limits users' access to direct redemption from the issuer", it should be clarified that throughout the market turmoil in 2022, including during the critical periods in May, following the turbulences around Terra and Luna, and in November following the fallout from the FTX bankruptcy, Tether continued to honour redemptions normally, with verified customers (in allowed jurisdictions) able to redeem USDt on Tether.to for USD$1.

Moreover, in the analysis and recommendations, the FSB should also consider the different use cases of GSCs and their subsequent redemption requirements. Tether follows AML and KYC obligations and can only process issuances and redemptions to KYC-verified customers for primary, as well as secondary markets. Verifying every Tether token user in the world, in particular when talking about secondary markets, within a short amount of time when Tether token prices are at a discount, is a very challenging feat for any company, including the leading financial companies in the world. Tether's KYC verification standards have been adjusted to best address the use-case of Tether tokens, cryptocurrency and crypto assets trading activities. GSCs with other use-cases such as those proposed by massive social media companies, addressing wider retail customers, could carry different risks that require more universal redeemability, but the FSB should take care not to equate all GSCs as serving the same use-cases. As a consequence, the DCGG believes that its members are complying with the FSB recommendations in relation to the redemption requirements.

Last but not least, when looking into redemption requirements of stablecoin issuers that fall in scope and comply with supervisory and regulatory requirements, the FSB should also look into the counterparty risks and access to bank accounts that can hamper the immediate redemption of stablecoins.

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

The revised FSB High-level recommendations over GSC arrangements appear in tune with market developments, however DCGG's members believe that, while the proposed criteria for a stablecoin to be categorised as a GSC in Annex 3 seems to cover some important aspects, it is important to ensure that FSB and SSBs develop an appropriate methodology to measure a stablecoin's "potential to become GSC" (p. 9). To ensure the industry is granted fair and proportionate treatment, regulators must be able to establish a proper, fit-for-purpose framework to measure the risks posed by stablecoins before categorising them as GSCs. Firstly, it is key for the regulator to consider the extent to which a stablecoin is actually used for payments (such projects were proposed by large social media companies). This factor was considered as the most important element to legislate on by the EU through the Markets in Crypto-Assets Regulation. Regulators should also consider to what extent other use-cases are in place, and the real implications of these use-cases on the broader financial system. Secondly, it is important to stress how cryptocurrencies and stablecoins promote financial stability by allowing enhanced law enforcement investigations and by the ability of GSCs to help people in jurisdictions where financial stability is endemic. Thirdly, and most importantly, competent authorities must take into consideration and be able to assess the capacity of the internal controls and policies the stablecoin issuer has put in place to mitigate potential risks within the market. DCGG's members enact some of the most sophisticated frameworks for risk mitigation, consumer protection and stress testing of operational arrangements, and AML/Sanctions screening measures. They also cooperate on a daily basis with supervisory bodies to ensure standards are being applied in a successful and sustainable manner and with law enforcement on criminal investigations. With this in mind, DCGG is of the opinion that a crucial criterion for assessing whether a stablecoin poses risks to financial stability is the assessment of the quality of internal controls and mechanisms to ensure smooth operation, promoting overarching proportionality towards the industry.

13. Do you have comments on the key design considerations for cross-border cooperation and information sharing arrangements presented in Annex 1? Should Annex 1 be specific to GSCs, or could it be also applicable to crypto-asset activities other than GSCs?

DCGG strongly supports a sound framework for cooperation and information sharing to make sure there is regulatory clarity for stablecoin issuers. The harmonised oversight network must be designed in such a way that no excessive administrative burden is imposed on market participants, and ensure that, for the relevant supervision purposes, user data is protected.

It appears sensible that, if a strong cross-border cooperation framework is established and it does not excessively encumber crypto operators' reporting obligations, that these arrangements go beyond GSCs. DCGG is of the view that these arrangements provide a solid foundation for transparent supervision, and could be further amended to be applied to other crypto-asset activities, as long as all relevant specificities of such activities are taken into account so that innovation within the sector is not restrained. Particularly, while cryptocurrency businesses are able to expedite law enforcement investigations with assistance in real time tracking and freezing of assets, these businesses are limited in their ability to share information by privacy laws. These businesses file suspicious activity reports, as necessary, to the financial investigation unit (FIUs) in the jurisdiction of domicile but given the global nature of cryptocurrencies it's possible that the nefarious activity affects persons in different jurisdictions. It is therefore suggested the FIUs worldwide improve their inter-FIU-communication standards in order to better facilitate law enforcement response for egregious crimes like terrorist financing child exploitation. The responsibility to improve risk mitigation policies should not be limited to businesses but should be extended to government bodies through the use of improved policies and technologies.

14. Does the proposed template for common disclosure of reserve assets in Annex 2 identify the relevant information that needs to be disclosed to users and stakeholders?

DCGG agrees that the proposed template for common disclosure, or something similar, of reserve assets does identify the relevant and important information for users. DCGG's members already enforce similar disclosure practices, befitting to the template proposed by the FSB, and are firm supporters of full transparency in this regard to ensure stability and protect their userbases. However, transparency and disclosure requirements for reserve assets should be proportionate to the potential risk they represent.

15. Do you have comments on the elements that could be used to determine whether a stablecoin qualifies as a GSC presented in Annex 3?

We believe that some of the quantitative and qualitative elements that have been suggested are a good indicator to determine whether a Stablecoin or a Stablecoin issuer would be considered a global stablecoin. That being said, any quantitative criteria, e.g., number and type of stablecoin users, transactions, market share in cross-border use payments and remittances, as well as other criteria, such as the interconnectedness with financial institutions, the crypto ecosystem and the broader economy should be closely mirroring the assessment and criteria used for other significant Financial Market infrastructures (FMIs), such as for payments (PFMIs) or the clearing and settlement.

We would like to highlight that the currently operational and popular stablecoins have a very specific use case, e.g., enhancing cryptocurrency activities. This use case is limited by the relatively small size of cryptocurrency markets in comparison to traditional financial markets and the new nexuses between them. On the other hand, stablecoin projects launched by companies with massive global user bases, such as large social media companies, large retailers, traditional financial services companies or tech giants would have a wholly different risk categorization as their ability to expand and interconnect with traditional financial markets would be greater.

We believe that the FSB should make a distinction in the use cases of stable coins and look at the criteria suggested in annex 3 of the report more closely, before deciding whether a stablecoin should be considered a global stablecoin. Some of the following aspects should be considered:

- **Number and type of stablecoin users:** A distinction should be made on the type of users, e.g., whether a stablecoin is created for retail customers, or for sophisticated investors or businesses that use the stablecoin for their trading or settlement purposes;

- **Market share in cross-border use in payments and remittances**: We agree that this should be an important criterion for establishing whether a stablecoin is considered a global stablecoin;
- **Interconnectedness with financial institutions and the broader economy**: Many stablecoins still have only a very limited use case for crypto assets trading and settlement. The impact for the wider financial system is therefore in our view for most specialised stablecoins rather small;
- **Interconnectedness with the wider crypto-assets ecosystem, other crypto-asset services and decentralised finance**: While this can be a criterion, we believe that the interconnectedness with the traditional financial institutions would be the more relevant criteria when measuring the potential impact on financial stability;
- **Integration with digital services or platforms** (e.g., social networks, messaging applications): We agree that it is important to consider whether it is used for payments of wider services.

We are available to address any further questions you may have and look forward to an ongoing dialogue with the FSB on these issues.