

Ref: IOSCO's Consultation Report on Policy Recommendations for Crypto and Digital Asset Markets

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EXECUTIVE SUMMARY

General comment

The exposure of retail investors across the globe to crypto-assets has grown in recent years (not just in the European Union), but so have retail investor losses amid financial crime, fraud, money laundering and other underregulated crypto-asset market activities. The challenge is to stimulate innovative products and business models to flourish and expand while ensuring the safety, stability and integrity of markets and a high standard of investor protection. As such, BETTER FINANCE welcomes the policy recommendations for crypto and digital asset markets of IOSCO, to ensure safe and stable environment for businesses, consumers and users of financial services. Although much work remains to be done in the field of Digital Finance, we acknowledge the difficulty of the task to keep up with technological developments, particularly when applied to financial services.

Transparency across jurisdictions

Policy recommendations aimed to make finance more efficient, accessible, transparent and inclusive for individual, non-professional investors are needed. Given that European retail investors face many barriers to invest and directly participate into capital markets, such as conflicts of interest in the distribution chain, lack of trust, financial literacy, transparency, adequate information disclosure, financial exclusion or inability to engage as shareholders in investee companies, FinTech initiatives, such as automated investment platforms, crypto-assets and the DLTs can certainly help to improve, alleviate or eliminate at least part of the above-mentioned obstacles, when supported by efficient policies across jurisdictions.

Risks associated with crypto-assets

There are several risks that can be highlighted in connection to crypto-assets and DLT. First, unlike in financial markets, there is no 'lender of last resort' to bail-out crypto-asset issuers, no protection system for investments or deposits, no clearing or settlement systems to certify that assets exist or clearing houses to shield from default risk, nor rules and supervision of the actors involved in issuing and trading crypto-assets. This is particularly important as specialised publications highlighted suspicions about the price volatility of certain crypto-tokens, market manipulation ("pump and dump") and potential illegal uses of these new technologies (money laundering, illegal financing, etc.).

Need for clarity

IOSCO's policy recommendations on the matter address key challenges, **but further guidance and clarity over digital/crypto-asset definitions and their use should be integrated within the policy paper**, taking into account jurisdictions, as well as regional initiatives.

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About BETTER FINANCE

BETTER FINANCE, the European Federation of Investors and Financial Services Users, is the public interest non-governmental organisation advocating and defending the interests of European citizens as financial services users at the European level to lawmakers and the public in order to promote research, information and training on investments, savings and personal finances. It is the one and only European-level organisation solely dedicated to the representation of individual investors, savers and other financial services users.

BETTER FINANCE acts as an independent financial expertise and advocacy centre to the direct benefit of European financial services users. Since the BETTER FINANCE constituency includes individual and small shareholders, fund and retail investors, savers, pension fund participants, life insurance policy holders, borrowers, and other stakeholders who are independent from the financial industry, it has the best interests of all European citizens at heart. As such its activities are supported by the European Union since 2012.

INTRODUCTORY EXPLANATION (for non-professional readers)

BETTER FINANCE's answer to the International Organisation of Securities Commissions (IOSCO) consultation on policy recommendations for crypto and digital asset markets, seeks to address the importance of investor protection issues and how to better incorporate and harmonise international regulation with respect to crypto-assets. The proposed policy recommendations are aimed at the activities performed by crypto-asset service providers (CASPs).

Crypto-assets are one of the major applications of blockchain for finance. Commonly defined as a type of private assets that depend primarily on cryptography and distributed ledger technology (DLT) as part of their inherent value. There are various crypto-assets available internationally with different features and serving different functions, thus bringing potential risks for retail investors in the EU and beyond. However, if adequate investor protection measures are in place across multiple jurisdictions, i.e through regulation, crypto-assets can create significant benefits to both market participants and consumers.

Recommendations / Questions

Recommendation 1 – (Common Standards of Regulatory Outcomes)

Regulators should use existing frameworks or New Frameworks to regulate and oversee crypto-asset trading, other crypto-asset services, and the issuing, marketing and selling of crypto-assets (including as investments), in a manner consistent with IOSCO Objectives and Principles for Securities Regulation and relevant supporting IOSCO standards, Recommendations, and good practices (hereafter “IOSCO Standards”). The regulatory approach should seek to achieve regulatory outcomes for investor protection and market integrity that are the same as, or consistent with, those that are required in traditional financial markets.

Question 1: Are there other activities and/or services in the crypto-asset markets which Recommendation 1 should cover? If so, please explain.

BETTER FINANCE **supports the overall intention of Recommendation 1**, which could ensure investor protection and financial stability. In this respect, scholars note that “*regulation and uniformisation of practices are the best way to protect the economic and financial order, in addition to opening new choices to the market*”. Regulation is needed in order to offer investor protection, preserve the benefits of the emerging instrument and its underlying market, remove legal uncertainty, and create the necessary resolution mechanisms in case of a crisis. While functions and activities of crypto-asset markets may hold some similarities across jurisdictions, **there should be a well-defined space which identifies the examples of crypto-assets, with clear and flexible future-proof definitions, allowing a smooth identification of the legal regime applicable to them.** Additionally, given the scope of the policy recommendations put forward by IOSCO, for crypto and digital asset markets, **Recommendation 1 should also extend to encompass digital assets (when treated separately by jurisdictions).** In this respect, enhanced cooperation and coordination would be welcome.

Question 2: – Do respondents agree that regulators should take an outcomes-focused approach (which may include economic outcomes and structures) when they consider applying existing regulatory frameworks to, or adopting new frameworks for, cryptoasset markets?

BETTER FINANCE is of the view that new frameworks for crypto-asset markets that mirror the way in which traditional products are considered in financial markets (**same business, same risks,**

same rules) should be adopted when applicable. In order to ensure a consistent regulation of financial services and products regardless of whether these are provided in a traditional or digitally innovative manner, new assets and services that embody the same characteristics and provide the same functions as traditional ones should be regulated the same. However, given the complexity of crypto and digital assets, BETTER FINANCE is cognisant that some jurisdictions may consider adopting outcome-focused approach, while others adopt new targeted frameworks. In either case, **as long as regulators utilise adequate investor protection measures and ensure clarity and understandability of key terms and associated risks for example, through transparent and clearly disclosed methods, investors can benefit from either of the approaches.**

Recommendation 2 – (Organizational Governance)

Regulators should require a CASP to have effective governance and organisational arrangements, commensurate to its activities, including systems, policies and procedures that would, among other things, address conflicts of interest, including those arising from different activities conducted, and services provided by a CASP or its affiliated entities. These conflicts should be effectively identified, managed and mitigated. A regulator should consider whether certain conflicts are sufficiently acute that they cannot be effectively mitigated, including through effective systems and controls, disclosure, or prohibited actions, and may require more robust measures such as legal disaggregation and separate registration and regulation of certain activities and functions to address this Recommendation.

Question 3: Does Chapter 2 adequately identify the potential conflicts of interest that may arise through a CASP's activities? What are other potential conflicts of interest which should be covered?

Apart from the already identified areas of potential conflicts of interest for crypto-assets, **the recommendation should also be extended to the conflict of interest that may arise from the provision of custodial wallet services for crypto-assets by CASP, for example.** Crypto-asset wallets are used to store public and private keys and to interact with DLT to allow users to send and receive crypto-assets and monitor their balances. Crypto-asset wallets come in different forms, and are either held offline by the user (hardware-based, offline) or digitally by the platform (software-based, or online). Some wallet providers support multiple crypto-assets/DLTs, while others are crypto-asset/DLT specific. DLT networks generally provide their own wallet functions (e.g. Bitcoin or Ether). There are also specialised wallet providers. Some wallet providers, known as 'custodians', not only provide digital wallets to their customers, but also store their crypto-assets (i.e. their private keys) on their online systems on behalf of their customers, which holds various risks associated with the provision of this service, such as piracy or asset (mis)use.

Question 4: Do respondents agree that conflicts of interest should be addressed, whether through mitigation, separation of activities in separate entities, or prohibition of conflicts? If not, please explain. Are there other ways to address conflicts of interest of CASPs that are not identified?

BETTER FINANCE believes that disclosures and prevention (policies and controls) approach already identified by IOSCO for addressing conflicts of interest should be adopted as standard market practice. **Regulators should, furthermore, consider whether requiring CASPs to cease the activities or relationship that creates conflict of interest is an applicable tool** that can be utilised to address cases where such issues are deemed persistent or inherent to the range of CASPs' operations.

Recommendation 3 – (Disclosure of Role, Capacity and Trading conflicts)

Regulators should require a CASP to have accurately disclosed each role and capacity in which it is acting at all times. These disclosures should be made, in plain, concise, nontechnical language, as relevant to the CASP's clients, prospective clients, the general public, and regulators in all jurisdictions where the CASP operates, and into which it provides services. Relevant disclosures should take place prior to entering into an agreement with a prospective client to provide services, and at any point thereafter when such position changes (e.g. if and when the CASP takes on a new, or different, role or capacity).

Question 5: Does Recommendation 3 sufficiently address the manner in which conflicts should be disclosed? If not, please explain.

Beyond disclosures requirements as a minimum standard, **regulators should ensure that CASPs establish and operate policies, procedures, and effective organisational arrangements for identification, prevention, management and mitigation of conflict of interest, and report on them annually.**

Recommendation 4 – (Client Order Handling)

Regulators should require a CASP, when acting as an agent, to handle all client orders fairly and equitably. Regulators should require a CASP to have systems, policies and procedures to provide for fair and expeditious execution of client orders, and restrictions on front running client orders. Regulators should require that a CASP discloses these systems, policies and procedures to clients and prospective clients, as relevant. Orders should be handled promptly and accurately recorded.

Recommendation 5 – (Market Operation Requirements)

Regulators should require a CASP that operates a market or acts as an intermediary (directly or indirectly on behalf of a client) to provide pre- and post-trade disclosures in a form and manner that are the same as, or that achieve similar regulatory outcomes consistent with, those that are required in traditional financial markets.

Question 6: What effect would Recommendations 4 and 5 have on CASPs operating as trading intermediaries? Are there other alternatives that would address the issue of assuring that market participants and clients are treated fairly?

BETTER FINANCE considers both recommendations 4 and 5 as important elements in achieving consistent regulatory outcomes for crypto-asset market activities and infrastructure. Clear disclaimer on arrangements, as well as best execution requirements are essential in preventing malpractices and for the protection of investors. The handling of client's order must be treated in a fair and efficient manner. In particular, both pre-contractual and post-trade information should equal that required in traditional financial market. To go further, costs and fees should also be expressed as a percentage of a transaction. Post-execution requirements should also record the status of the portfolio on the date of the transaction (stored in the client area). In particular, an annual report on the crypto-asset portfolio of client, including the fees incurred and the amount of gains/losses, should provide an adequate and transparent view while allowing for proper tax reporting.

Recommendation 6 – (Admission to Trading)

Regulators should require a CASP to establish, maintain and appropriately disclose to the public their standards— including systems, policies and procedures— for listing/admitting crypto-assets to trading on its market, as well as those for removing crypto-assets from trading. These standards should include the substantive and procedural standards for making such determinations.

Recommendation 7 – (Management of Primary Markets Conflicts)

Regulators should require a CASP to manage and mitigate conflicts of interest surrounding the issuance, trading and listing of crypto-assets. This should include appropriate disclosure requirements and may necessitate a prohibition on a CASP listing and/or facilitating trading in, its own proprietary crypto-assets, or any crypto-assets in which the CASP, or an affiliated entity, may have a material interest.

Question 9: Will the proposed listing/delisting recommendations in Chapter 4 enable robust public disclosure about traded crypto-assets? Are there other mechanisms that respondents would suggest to assure sufficient public disclosure and avoid information asymmetry among market participants?

One of the most challenging aspects of crypto-assets is related to the lack of appropriate, granular and non-technical disclosure of the crypto-asset and its associated characteristics, ownership and governance procedures as well as information about Trusted Third Party (TTP), which could be a reliable and neutral link ensuring regulatory compatibility and legal certainty, for example. **The regulators should make sure that consumers are properly informed about the risks when accessing such crypto-assets via regulated centralised exchanges.**

Apart from the proposed information to be disclosed by CASPs, BETTER FINANCE is of the view that the **crypto-asset issuer or sponsor should also be easily identifiable**. Issuance of crypto-assets is generally accompanied with a document describing crypto-asset and the ecosystem around it, the so-called **white papers**. Those ‘white papers’ are, however, not standardized across regions and the quality, the transparency and disclosure of risks vary greatly. Moreover, such prospectus-like document can be complex, technical and rather long. It is therefore uncertain whether investors or consumers who buy crypto-assets understand their nature, the rights associated with them and the risks they present. BETTER FINANCE encourages the establishment of a set of international standards and the obligation to publish white papers when issuing crypto-assets. In addition to this, a recommendation to provide a white paper summary, as a key investor information document, should be promoted in order to make it easier to understand. Finally, the **inclusion of finance externalities** (non-financial reporting, such as ESG risks) in pre-contractual disclosures should be extended to crypto-asset issuers as well. Such reporting should be tailored to the incipient stage of the market, and potentially to the size of the issuer, but **must necessarily inform consumers of its carbon footprint**, if any.

Question 10: Do respondents agree that there should be limitations, including prohibitions on CASPs listing and/or trading any crypto-assets in which they or their affiliates have a material interest? If not, please explain.

BETTER FINANCE **agrees with this approach** – prohibition of CASP listing/trading and **even requiring CASPs to cease their activities (under strict conditions) could prevent market conflicts when necessary**, concerning disclosure of inside information and prohibitions on insider dealing, unlawful disclosure of inside information and market manipulation, among others.

Recommendation 17 – (Management and disclosure of Operational and Technological Risks)

Regulators should require a CASP to comply with requirements pertaining to operational and technology risk and resilience in accordance with IOSCO's Recommendations and Standards. Regulators should require a CASP to disclose in a clear, concise and non-technical manner, all material sources of operational and technological risks and have appropriate risk management frameworks (e.g. people, processes, systems and controls) in place to manage and mitigate such risks.

Question 17: – Are there additional or unique technology/cyber/operational risks related to crypto-assets and the use of DLT which CASPs should take into account? If so, please explain.

BETTER FINANCE is of the view that DLT-based financial market infrastructures (FMIs), fulfilling the same functions as traditional ones, should be regulated under the principle of “same business, same risks, same rules”. However, given the unknown operational, transparency and cybersecurity risks and challenges that these venues or market participants can pose, a regulatory sandbox for DLT-based FMIs could be utilised. **There are various technology/cyber and operational risks that are associated with crypto-assets, but IOSCO's Chapter 8 manages to encapsulate some of the important ones.** The inclusion of **finance externalities** (non-financial reporting) must also take into account **material risk arising from carbon footprint, for example.**

Question 18: Are there particular ways that CASPs should evaluate these risks and communicate these risks to retail investors? If so, please explain.

Retail investors would benefit from **clear, concise and easy-to-understand disclosures of the associated risks with crypto-assets** (e.g., prominent warning on the non-guarantee of deposits). CASPs should further inform consumers in details **on costs and charges of crypto coins** (both in currency and percentage of transaction) as well as on the **energy consumption** of their crypto-assets.

Recommendation 18 – (Retail Client Appropriateness and Disclosure)

Regulators should require a CASP, to operate in a manner consistent with IOSCO's Standards regarding interactions and dealings with retail clients. Regulators should require a CASP to implement adequate systems, policies and procedures, and disclosure in relation to onboarding new clients, and as part of its ongoing services to existing clients. This should include assessing the appropriateness and/or suitability of particular crypto-asset products and services offered to each retail client.

Question 19: What other point of sale/distribution safeguards should be adopted when services are offered to retail investors?

Apart from **clear, concise, non-technical and accurate disclosures on the key features and risks related to the crypto-assets and services offered by the CASP, as well as any fee, commission or incentive it charged,** CASPs should have easily identifiable avenues for **consumer/investor redress mechanisms.** Regulators should ensure that CASPs not only provide a safe investing environment for non-professional investors, but **mechanisms to address any complaints.** Importantly, there should be **safeguards in place in regard to online media platforms which may misleadingly promote crypto- assets.**

Question 22: IOSCO also welcomes views from stakeholders on potential additional issues for consideration.

BETTER FINANCE believes that **IOSCO's policy recommendations should be extended to include sustainable finance considerations in the context of crypto-assets.** Running and operating DLTs and crypto-assets may require high computational resources, which can translate into a high consumption of energy. An example is bitcoin's blockchain, whose annual operation (mining) consumes slightly more electric energy than Switzerland or Argentina. Other DLTs have improved their protocols to require less computational power, but the emergence of so many crypto-assets (5,100 in 2020) and, hopefully, more in the future, many may not be utilising the most environmentally friendly models. The policy recommendations **should integrate disclosures in relation to energy consumption of crypto-assets in order to allow investors to properly assess the suitability of particular crypto-asset products and services.**