

IOSCO consultation on Crypto-Asset Trading Platforms - AMAFI comments

EXECUTIVE SUMMARY

Association française des marchés financiers (AMAFI) is the trade organisation working at national, European and international levels to represent financial market participants in France. It acts on behalf of credit institutions, investment firms and trading and post-trade infrastructures, regardless of where they operate or where their clients or counterparties are located. AMAFI's members operate for their own account or for clients in different segments, particularly organised and over-the-counter markets for equities, fixed-income products and derivatives, including commodities.

AMAFI welcomes IOSCO's consultation on Crypto-Asset Trading platforms (hereafter CTPs), and would like to seize this opportunity to highlight its efforts in the last year to work constructively with the French authorities as well as the French financial markets industry and crypto-assets players on proposing a regulatory framework for the trading of crypto-assets.

It is possible to approximate and apply IOSCO's recommendations and principles to CTPs, but regulators should keep in mind that the existing regulations and recommendations for trading venues can be unfitting for this new type of trading platforms. These latter platforms include technological specificities that should be considered when drawing from existing regulations. Without this necessary awareness brought about by new technologies, it can be harder to capture the subtleties of the operating of these new platforms.

In addition, considering the technological particularities of CTPs and implementing proportionate but crucial requirements on innovative projects to enhance confidence of users are necessary conditions for the development of globally competitive European players. In this sense, certain obligations applicable to traditional trading venues cannot, for the time being, be applied directly to CTPs. As a matter of fact, for these requirements to be effective from a supervisory point of view, they require a certain maturity of platform models as well as larger trading volumes. In other words, it is a matter for regulators to support the development of CTPs at the right pace without compromising their competitiveness too early. With respect to these constraints, AMAFI believes it is essential for the regulatory framework to be conducive to the development of these new markets, without jeopardising the end-user protection. An efficient regulatory framework in this aspect would necessarily need to be built through constructive dialogue between traditional actors and those already operating in the Crypto-Assets' markets.

COMMENTS ON KEY CONSIDERATIONS REGARDING CTP ACTIVITIES

Access to crypto-asset trading platforms

How access is provided to CTPs and who is responsible for the on-boarding of participants set as major challenges for regulators considering regulating CTPs' activities, in order to prevent any form of illegal or criminal trading.

a) Access criteria

AMAFI is in the line with IOSCO regarding the fact that each CTP should clarify to an authority the criteria that would allow participants to have access to the platform and its services. These criteria should be objective, transparent and non-discriminatory.

b) Participant on-boarding

AMAFI believes that CTPs or intermediaries must determine compliance principles and methods such as KYC, anti-money laundering requirements and suitability assessments in order to avoid any case where a CTP could be used for illegal activities as well as mitigate significant risks.

IOSCO TOOLKIT:

If a regulatory authority is considering the issues and risks relating to participant access to CTPs and the on-boarding process, an assessment may include:

- *A review of the CTPs' policies and procedures regarding access criteria;*
- *A review of the assessments made by CTPs of their participants for "appropriateness" from the perspective of:*
 - *KYC,*
 - *AML/CFT, and*
 - *product suitability; and*
- *Consideration of whether CTPs should provide risk disclosure, and, if so, assessing the adequacy of such disclosure.*

The Association shares IOSCO's analysis and suggestions for issues regarding the access to CTPs.

Safeguarding participant assets

In the view of AMAFI, a crypto-asset "custodian" is a person or entity which controls the means of access to these crypto-assets and deals with events affecting these crypto-assets and associated rights.

Unlike trading venues, CTPs can safeguard their clients' crypto-assets. Considering this major specificity, attempts to apply to CTPs the regulations and recommendations related to trading venues as a whole would likely end up suggesting an incomplete or unsuitable framework.

a) Custody of assets and protection against loss

AMAFI shares the analysis of some risks that could arise for a CTP or third-party offering custody services such as the risks of operational failure, theft, loss and inaccessibility of keys. However, some points must be detailed regarding the responsibility of each parties:

- Inaccurate record keeping:

It is the responsibility for each crypto-asset custodian (CTP or third party) to keep an accurate record of clients' positions. This record keeping would in fact set a written record of the positions of holders of crypto-assets in the different blockchains by the person who controls the means of access to them. This record would reflect the positions of service providers' clients. In other words, the custody, distribution and movements of the crypto-assets recorded on the corresponding distributed ledger technologies (DLTs) .

AMAFI is of the opinion that the requirement to maintain a register that records the holding, distribution and movement of the custodian's clients' crypto-assets is a natural obligation of the provider who controls the means of access to digital assets on behalf of third parties and who deals with events affecting these crypto-assets and associated rights.

In any case, the use of a DLT enable such record keepers to provide appropriate and auditable reports.

- Insufficient assets to meet liabilities:

In case of an insufficient amount assets to be returned to clients due to a theft, loss or failure of the underlying technology, the responsibility must be determined whether the event is attributable or not attributable to custodian. Events not attributable to the crypto-asset custodian include, in particular, any event that the custodian can demonstrate is independent of its operation, such as a problem inherent in the operation of the DLT or an automated computer program that may be based on a smart contract that it does not control.

In the case of event attributable to the crypto-asset custodian (loss, bankruptcy, insolvency, etc.), the contract signed between the various parties should include provisions and conditions for compensation.

In general, AMAFI does not agree with the fact that the custodian is bounded by an obligation of result in terms of restitution. As a matter of fact, in a context where crypto-assets are not recorded in a formal bank account, but in a shared, often public, electronic registration device, the custodian does not control the entire custody chain. The custodian cannot have entire influence on the mechanisms specific to the DLT on which its customer's crypto-assets are recorded. In that case, he cannot be bound by an obligation of result to return the assets or the means of access to them. AMAFI believes the regulator should have a comprehensive look at the set of scenarios leading to the loss of access to the crypto-assets before deciding on the obligations attributed to the custodian on this matter.

IOSCO TOOLKIT:

If a regulatory authority is considering the issues and risks associated with the safeguarding of participant assets, an assessment may include:

- *A review of the adequacy of the arrangements by a CTP that:
o discloses participant ownership rights;*

- o secures participant assets in a manner that protects them from theft or loss, including appropriate backup arrangements regarding access to the private keys of CTP wallets;*
- o segregates participant assets (from CTP operator assets and/or other participant assets); and*
- o maintains accurate and reliable records that are sufficient to confirm participant positions;*
- *Where the CTP uses a third party for custody of participant assets, the adequacy of measures taken by the CTP relating to the security of the assets held at the third party;*
- *A review of the arrangements in place to compensate participants in the event of a loss of assets, including, for example, insurance policies, compensation funds or other contingency measures;*
- *An examination of the methods of retrieval of participant assets held outside of the regulatory authorities' geographical jurisdiction; and*
- *A consideration of the adequacy of disclosure made by the CTP to its participants in regard to the above.*

AMAFI shares IOSCO's analysis and suggestions for issues regarding safeguarding and protection against loss.

b) Financial resources

AMAFI is in the view that where a CTP holds participants assets, it should be subject to prudential mechanisms and capital requirements.

IOSCO TOOLKIT:

If a regulatory authority is considering the issues and risks relating to the adequacy of the financial resources of CTPs, an assessment may include:

- *Consideration of the imposition of:*
 - o capital requirements on CTPs that reflect the nature of the business of the CTPs, including where the CTPs perform intermediary functions;*
 - o ongoing monitoring of capital positions; and*
 - o performance of an independent audit of the CTP's financial position.*

AMAFI shares IOSCO's analysis and suggestions regarding prudential provisions and capital requirements.

More precisely, considering custody, the requirements applied to this activity should be the same as defined in the IFR/IFD prudential regime. As a matter of fact, some of the activities carried out by CTPs will be similar to those carried out by investment firms. Thus, similar regimes ensuring the consistency of the rules and the level-playing field between the different actors should apply.

In summary, the prudential regime for investment firms is designed for institutions that are not considered systemic (those with a balance sheet size greater than €15 billion). At this stage, we can consider that CTPs will not be qualified as systemic. Under this regime, investment firms must have permanent access to equity capital, the amount of which is the higher of the three amounts below:

- **The ¼ of overhead costs;**
- **The amount of initial capital required;**
- **A requirement based on risk factors specific to the activities performed by the IA (k factors).**

It should be noted that in the case of investment firms considered as "small non-interconnected investment firms", only the first two amounts are to be taken into consideration.

As for example, for custody, the k-factor (K-ASA) is 0.04% of the assets in question. This appropriate approach for CTPs and the crypto-asset custody service could be considered by IOSCO for inclusion in its recommendations and principles targeted towards crypto-asset trading platforms.

Conflicts of interest

AMAFI shares IOSCO's concerns regarding potential conflicts of interest for CTPs providing end-to-end services (trading, settlement, custody, market making, advisory, etc.).

IOSCO TOOLKIT:

If a regulatory authority is considering issues and risks relating to conflicts of interest, an assessment may include:

- *An evaluation of the policies and procedures of a CTP that are established to mitigate and manage the conflicts of interest of various stakeholders, including a review of:*
 - o *the disclosure of all relevant details, including where a CTP or related parties, or the operator, employees, officers and/or directors of the CTP or its related parties, may have any financial interest in the crypto-assets traded on that CTP; and*
 - o *policies and procedures regarding access to and the confidentiality of information about participants on the CTP, or other information that should be treated as confidential;*
- *Where a CTP or related parties, or the operator, employees, officers and/or directors of the CTP or its related parties, are permitted to engage in proprietary trading and/or market making on the platform, a review of:*
 - o *the disclosure of relevant trading activities;*
 - o *the separation of market making activities from trading activities or services provided to participants;*
 - o *the transparency of policies and procedures that address, among other things, participant priority, the fair pricing of trades with participants and/or favorable execution of trades with participants; and*
 - o *disclosure relating to whether an issuer of a crypto-asset or related party is a participant on the platform; and*
- *A review of the disclosure of steps taken to mitigate and manage any conflicts of interest.*

As mentioned by IOSCO above, the Association is in favour of CTPs communicating to the competent authorities:

- the procedures put in place to avoid any conflict of interest;
- the rules of transparency provided for.

Description of CTP operations

As a matter of fact, and as stated in the consultation paper, full information about how a CTP operate should be available for its participants. Nevertheless, at this stage of the technology and activities' development, some structural elements cannot be clarified as much as they would be for trading venues.

For example, the notion of price discovery applied to CTPs cannot be explained in an accurate way yet. In order to communicate relevant information on the price discovery mechanisms, it is necessary to wait for the development of volumes and a certain maturity of the platforms. Only at this stage will it be appropriate to impose the communication of this issue to participants.

Moreover, regarding trading operations and assets movements on the blockchain, the use of DLT avoid trade errors and enables the monitoring of assets movements. However, some issues specific to the underlying technology, such as forks, must be addressed.

IOSCO TOOLKIT:

If a regulatory authority is considering the issues and risks relating to the transparency of CTP operations to participants, an assessment may include a review of the disclosure related to:

- *Order types and interaction;*
- *Price discovery and transparency of orders and trades on the CTP, including trading volumes and turnover;*
- *Fees charged by the CTP;*
- *Rules relating to the prevention of market abuse;*
- *The technology used by the CTP;*
- *Policies and procedures relating to error trades, cancellations, modifications and dispute resolution;*
- *The treatment of assets where the distributed ledger has undergone a hard fork, or other irreversible changes to the distributed ledger protocol that makes previously valid ledgers or transactions invalid;*
- *The treatment of airdrops, corporate actions or other comparable events; and*
- *Information about the crypto-assets that the CTP offers for trading, including:*

- o initial and on-going criteria for selection;*
- o the principals or issuing developers behind the crypto-assets;*
- o the type and details of the DLT and/or protocol used;*
- o any hacking vulnerabilities of the technology underlying the crypto-assets; and*
- o the traceability of the crypto-assets.*

AMAFI shares the points highlighted by IOSCO in its toolkit above, except the one regarding “price discovery”.

Market integrity

Although regulatory authorities will have to address new market abuse issues regarding CTPs, these issues will be specific to this technology. Therefore, it would be a mistake to consider only applying the existing market abuse regulations to CTPs. These have been designed to be effective about trading venues.

IOSCO TOOLKIT:

If a regulatory authority is considering issues relating to market integrity, an assessment may include a review of:

- *Traditional market integrity rules with a view to their applicability to crypto-asset trading;*
- *The rules, policies or procedures in place to govern trading on the market;*
- *Mechanisms for monitoring the rules, policies or procedures;*
- *The trading hours of the CTP and how they may impact the CTP's ability to effectively monitor trading;*
- *The management of any information asymmetries; and*
- *The availability of updated information regarding factors that may impact the asset, the value of the asset, its developer or the technology used.*

AMAFI shares most of the elements highlighted by IOSCO above, with a focus on the necessary adaptation of market integrity rules to crypto-asset trading.

 **Price discovery**

As mentioned previously in the part “description of CTP operations”, AMAFI believes that the technologies at stake in crypto-trading are not enough mature to ensure efficient and full transparent price discovery mechanisms. At this stage of development, imposing to CTPs a full and clear communication on their price discovery mechanisms does not seem very relevant. Moreover, this would certainly hinder the development of companies wishing to develop CTPs and related technologies to crypto-trading

IOSCO TOOLKIT:

If a regulatory authority is considering issues and risks relating to price discovery, an assessment may include consideration of:

- *Whether and what pre- and/or post-trade information is made available to participants and/or the public and, on what basis;*
- *The overall potential impact of pre- and post-trade transparency on order execution quality for participants and market quality generally;*
- *The market microstructure of the CTP (e.g., continuous auction, call market, reference price model); and*
- *The crypto-assets traded, including the liquidity of the crypto-assets and their characteristics.*

At this stage, AMAFI believes that it is premature to comment on this subject and draw any type of recommendations for CTPs.

Technology

a) Systems resiliency, reliability and integrity

As expressed for market integrity previously, crypto-trading raises new specific issues that should not be addressed by rules and principles originally dedicated to trading venues.

Regarding systems resiliency, AMAFI believes that CTPs are not enough mature to be subject to stress testing and capacity performance planning.

IOSCO TOOLKIT:

If a regulatory authority is considering issues and risks relating to system resiliency, integrity and reliability, an assessment may include a review of:

- *The CTP's business continuity/disaster recovery plans to ensure continuity of services;*
- *Where appropriate, stress testing and/or capacity planning processes and results;*
- *Quality assurance procedures and performance monitoring of any critical systems that are provided or developed by third-parties (whether or not outsourcing agreements are in place);*
- *Governance and change management procedures; and*
- *Independent systems reviews to assure that relevant technology standards are met and maintained as intended.*

At this stage of the technology and CTPs' development, AMAFI does not share bullet points n°2, n°3 and n°5 highlighted in the toolkit above.

b) Cyber security and Resilience

The association believes that the managers of a CTP must communicate to the regulatory authorities all measures taken to protect themselves and counter identified cyber risks and threats.

IOSCO TOOLKIT:

If a regulatory authority is considering the issues and risks associated with cyber security and resilience, an assessment may include consideration of a CTP's:

- *Policies and procedures that support an appropriate governance structure that identifies key systems or assets that could be at risk;*
- *Physical or organizational measures to control and protect against cyber risks (e.g., vulnerability testing, penetration testing);*
- *Measures to detect cyber anomalies;*
- *Policies related to incident response; and*
- *Business continuity plans and/or disaster recovery plans.*

AMAFI is in the line with IOSCO's suggestions regarding cyber security and resilience.

 **Clearing and settlement**

Regarding clearing and settlement, AMAFI agrees with IOSCO's assessment that the use of DLT systems presents new important considerations for regulators in relation to crypto-asset trading. AMAFI also joins IOSCO in pointing to the complexity of the outcomes of the use of such a technology, depending on factors such as settlement finality, legal transfer of ownership, and the responsibility of the CTP regarding the rest of the operators.

