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Seven regulatory developments for 2021

The Digital Regulator



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Executive summary

'The past causes the present, and so the future' is a frequently cited justification for studying history. In what follows, we review some of the key developments that characterised the digital regulation in 2020, to anticipate the possible milestones in the digital regulatory space for 2021.

Our seven forecasts are:

1. A handful of Central Banks (CBs) will go live with their respective digital currencies;
2. The Financial Action Task Force (FATF) will continue to enforce the Travel Rule and expand its reach to Decentralised Finance (DeFi);
3. The Basel Committee on Banking Supervision (BCBS) will introduce a crypto prudential regulation;
4. GSC projects will box themselves through a challenging regulatory journey;
5. The U.S. Securities and Exchange Commission will approve the first crypto ETF;
6. The regulatory enforcement tool will materially shape sustainable cryptofinance;
7. The US will materially clarify and align its cryptofinance regulatory framework.

These expectations are all rooted in the past and we do not list what we hold as certain to happen, such as Switzerland completing its comprehensive digital regulatory framework. 2021 will surprise us with brand new digital regulatory developments some of which, for instance in the area of taxation, are easy to anticipate.

In this Digital Regulator, we propose seven regulatory developments that are likely to shape cryptofinance in 2021.

We expect developments in the areas of central bank digital currency (CBDC) applications, anti-money laundering (AML) regulations, prudential banking rules, global stablecoin (GSC) projects, United States' (US) crypto exchange-traded funds (ETFs), enforcement activity and US regulatory framework.

1. The seven forecasts for 2021

We selected 7 topics out of several digital regulatory developments that would most likely characterise 2021. These topics are all rooted in the past couple of years. We did not state what we held as obvious, for instance the completion of a comprehensive digital regulatory framework in Switzerland. As the year unfolds, we will experience many brand new digital regulatory developments in areas that have remained relatively dormant to date – such as taxation.

1.

A handful of Central Banks will go live with their Digital Currencies

- CBDC was the number one digital regulatory topic in 2020. Important developments in many jurisdictions and landmark pronouncements by supranational authorities, suggest that the widespread introduction of CBDCs is ineluctable going forward. The ultimate trigger for it is the demand for continuously available payment services and the emergence of electronic payment instruments and systems.
- In January 2020, the Bank for International Settlements (BIS) anticipated that the most important CBs were likely to issue CBDCs in the next few years. The BIS itself emerged as a major driver for CBDCs when it established the international Innovation Hub focused on analysing economical and functional use cases for CBDCs as well as options for their technical design. During 2020, analysts established a clear distinction between wholesale and retail CBDCs.
- The design and implementation of retail CBDCs has emerged as more challenging than a wholesale CBDC, due to i) the risk of structural disintermediation of commercial banks and the centralisation of credit allocation, ii) the facilitation of systemic runs on banks in crisis situations, iii) the blurring of responsibilities for the enforcement of 'know your customer' (KYC) and AML regulations, iii) the need to ensure friendliness of end-user applications alongside the resiliency of the value chain to outages and cyber-attacks, iv) the potential of the dual banking system coming under stress, v) the potential complications for the conduct of monetary policy.
- During 2020, the monetary authorities of: i) China completed the design of a CBDC, experimented with it in the real-world, and called for global operating standards; ii) The Bahamas rolled out a retail CBDC, becoming the first country world-wide to do so; iii) Canada launched a retail CBDC project; iv) Japan set up a team dedicated to CBDC and anticipated real-world testing during 2021; v) France began testing a wholesale CBDC; vi) UK anticipated rolling out a CBDC in the coming years; vii) Brazil announced the launch of a CBDC before 2023; viii) Australia started developing a wholesale CBDC on a private Ethereum network. Finally, the BIS, the Swiss National Bank (SNB) and the SIX Swiss Exchange successfully completed a wholesale CBDC experiment. The BIS issued the final principles for CBDCs, thereby establishing a minimum set of common standards and key features for all CBDCs to adhere to.
- It is reasonable to expect, against this backdrop, for a handful of CBDCs to be implemented in the real world during 2021. Primacy will most likely go to wholesale CBDCs, as this form of CBDC does not bear the risk of affecting the conduct of monetary policy or the dual banking system. The degree of reliance on, and the type of, Distributed Ledger Technology (DLT), will vary from case to case. The implementation of CBDC will act as a catalyst for broader monetary and financial innovations, including DLT-based innovations.

2.

The FATF will continue to enforce the Travel Rule and expand its reach to DeFi

- In June 2019, the FATF extended to digital assets transactions the standards applicable to traditional fiat banking transactions and typically complied with the SWIFT messaging system. It updated the Interpretative Notes #15 and #16 and introduced the so-called 'Travel Rule' to digital assets transactions.
- The rule requires any virtual asset transfer (minimum of USD/EUR 1,000) between a Virtual Asset Service Provider (VASP) and any other obliged entities to share i) the originator's name, ii) the originator's account number, iii) the originator's physical address, national identity number or customer identification number, or date and place of birth, iv) the beneficiary's name, and v) the beneficiary's account number.
- The sudden entry into force of these standards took the industry technologically unprepared and generated several initiatives designed to fill the gap as rapidly as possible. The FATF began reviewing the state of compliance in June 2020 and indicated a pragmatic attitude in how actors were expected to comply with the rule during the transition phase leading to a fully-fledged technology solution.
- It is reasonable to expect that the FATF will continue to enforce compliance with the Travel Rule in 2021. The Rule is pivotal for the future of cryptofinance because it attributes the same level of compliance trust enjoyed by fiat banking transactions, to the still mistrusted cryptofinance transactions. This action also ensures a level playing field and minimises jurisdictional arbitrage in the critical AML / CTF areas.
- It is also reasonable to expect that the FATF will tackle the DeFi in 2021. During 2020, the DeFi developed the offer of blockchain applications to complex financial use cases, such as stablecoins, decentralised exchanges and lending platforms. DeFi applications raise new AML regulatory challenges, given their peer to peer (P2P) nature. The FATF is determined to implement P2P-specific AML regulatory requirements in 2021.

3.

The Basel Committee on Banking Supervision (BCBS) will introduce a crypto prudential regulation

- In a discussion paper on ‘designing a prudential treatment for cryptoassets’, released on 12 December 2019, the BCBS proposed for consideration a conservative global prudential standard, in terms of full capital deduction for cryptoassets held in the balance sheet.
- The BCBS explained that banks faced specific risks when dealing with cryptoassets that went beyond traditional liquidity, credit, market, operational risks, including money laundering / terrorist financing and reputation risks. Specific risks include legal entity issuer risk, the limited versus unlimited pool of users, the mechanistic or personal validation protocol, the prevailing legal regime, and market data transparency.
- The BCBS also listed cryptoasset risks that may impact banks through other ways, such as the issuance and validation of cryptoassets, the taking of long positions in crypto ETFs, the financing of third-party investments in cryptoassets, lending and taking cryptoassets as collateral, proprietary trading or trading on behalf of clients, and the use of cryptoassets for internal or inter-bank operational processes.
- The BCBS proposed a conservative global prudential standard in terms of the harshest Pillar 1 minimum capital requirement. Public consultation on the discussion paper closed on 13 March 2020. The industry disagreed and some of the commentators, including ourselves, suggested that a global standard under Pillar 2 would be a better way to reconcile sustainable and beneficial financial innovation with an effective control of cryptoasset risks in the banking system.
- It is reasonable to expect that the completed public consultation will be followed by a final and binding set of recommendations. This expectation is reinforced by the range of regulatory discussions about the recent surge in the price of bitcoin and cryptoassets more generally. Global cryptoassets’ prudential regulations for banks would durably affect the way banks deal with, and manage, cryptoassets, and, in turn, would materially affect the development of the entire cryptoassets industry.

4.

GSC projects will box themselves through a challenging regulatory journey

- GSC emerged in June 2019 (Facebook's project Libra), on the back of a strong business and use case: tackling the inefficiency of international payment systems and promote financial inclusion. The initiative presented regulators with new challenges following the potential systemic relevance, threat to legal tenders and monetary policies, of GSCs, and their lying outside the regulatory perimeter from a governance and risk management standard perspective.
- The Financial Market Supervisory Authority (FINMA) pioneered the stablecoin guidelines by supplementing its initial coin offering (ICO) guidelines as early as Autumn 2019. FINMA issued requirements that allowed for differentiation between projects, depending on the underlying exposure of the stablecoin and the legal rights of its holders. It emphasised that AML, securities trading, banking, fund management and financial infrastructure regulation, can all be of relevance. FINMA confirmed that Libra would need a payment system license and sound international regulatory coordination.
- In April 2020, the Financial Stability Board (FSB) opened consultations on its paper 'Addressing the regulatory, supervisory and oversight challenges raised by global stablecoin arrangements'. The final set of recommendations were issued in October 2020. The FSB offers 10 recommendations for the promotion of effective regulations for GSCs. It calls for regulation, supervision, and oversight, proportionate to the risks. It also stresses the value of flexible, efficient, inclusive, and multi-sectoral cross-border cooperation, coordination, and information sharing arrangements among authorities that consider the evolving nature of GSC arrangements and the attendant risks over time.
- It is reasonable to expect one or more GSC projects to box themselves successfully through the difficult regulatory journey in 2021. The FSB recommendations removed the fundamental uncertainty created by the earlier regulatory reaction in the aftermath of project Libra. The business case for GSC is strong; the regulatory journey for GSC will not, however, be all downhill. The European Commission hinted at the tortuous implementation road ahead, when it issued its proposal for an EU regulatory framework on crypto assets, specifying authorisation requirements for GSC.

5.

The US SEC will approve the first crypto ETF

- In February 2020, the SEC rejected the Wilshire-Phoenix's bitcoin ETF proposal. It was the last proposal awaiting judgment and the ninth rejection in a row. The SEC argument is that the proposals displayed insufficient compliance with Section 6(b)(5) of the Securities Exchange Act of 1934 and that the proposed bitcoin ETFs did not establish that the relevant bitcoin market was resistant to manipulations beyond that of traditional security or commodity markets.
 - The reticence of the SEC to approve a regulated cryptocurrency investment vehicle, contrasts with the pragmatic, inclusive and innovation-friendly approach taken by other jurisdictions. Thus, the SIX Swiss Exchange lists over 140 tradeable crypto instruments, of which over 30 are exchange-traded products. Germany's Stuttgart exchange lists 7 exchange-traded notes featuring crypto underlying. Bitcoin trackers are also available on the Nasdaq Nordic Exchange.
 - It is reasonable to expect, that the SEC will approve the first bitcoin ETF proposal in 2021 in the face of rapid institutionalisation and traction being experienced broadly by the bitcoin market and cryptofinance. VanEck Digital Assets LLC filed an application with the SEC on 30 December 2020 to list the VanEck Bitcoin Trust – an exchange-traded fund that sells or redeems its shares that are invested in bitcoin.
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6.

The regulatory enforcement tool will materially shape sustainable cryptofinance

- During and following the ICO boom (2017-18), regulators issued recommendations on how to structure projects that would fulfil a key goal of financial regulation – consumers protection. They then consistently investigated projects and took enforcement actions against non-compliant projects, reminding the community about the strategic dimension of regulatory affairs and their proper management, in any cryptofinance project.
 - In May 2020, Telegram gave up fighting the US SEC charges and ended its cryptocurrency TON project. In December 2017, the SEC had warned ICO promoters and their advisers ‘to engage with the SEC staff to aid in their analysis under the securities laws’ before ‘promoting or touting the offer and sale of coins’.
 - In April 2020, Facebook had re-issued its cryptocurrency project Libra under revised terms, after global regulators reacted to its first announcement in June 2019, making it clear that there would be ‘mass regulation before mass adoption’.
 - Several less prominent projects suffered a similar fate over the last three years (due to either enforcement or the fear of it). The US SEC has brought to court 56 cases related to cryptocurrencies since 2017. In Switzerland, in 2019, FINMA initiated enforcement proceedings against three ICO companies out of investigating 60 ICOs.
 - On 22 December 2020, the SEC charged Ripple and two executives, with conducting an unregistered securities offering to investors in the US and worldwide. The SEC argues that Ripple and the executives failed to register their offer and sales of XRP or satisfy any exemption from registration. Following the announcement, the Ripple XRP token lost substantial value and several exchanges and crypto funds, de-listed the token.
 - It is reasonable to expect, with this backdrop, that enforcements will continue in 2021 to shape sustainable cryptofinance, particularly as administered by the US SEC and its extraterritorial reach. Other key jurisdictions as well as supranational authorities will continue to combine prudential recommendations with enforcements to promote sustainable cryptofinance.
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7.

The US will materially clarify and align its cryptofinance regulatory framework

- In the cryptofinance area, the US suffered from their intricately federal and state-based regulatory system and a directionally unsettled economic policy stance. This resulted in, at least from an outside perception, the cryptofinance regulatory landscape to look differentiated, featuring opposite inter-states positions, diverging federal stances and unclear economic policy directions.
 - At the State level, Wyoming, Colorado, Arizona, and Georgia have passed very favourable regulations, often exempting cryptocurrencies from state securities laws and/or money transmission statutes. But authorities in at least ten other states, such as California and New Mexico, have issued warnings about investing in cryptocurrencies, and others, like New York, have passed laws generally considered as restrictive. There is no uniform definition of 'cryptocurrency' within the US.
 - At the Federal level, the SEC has been clear on its position about even ICO-originated utility tokens being deemed to be securities if they passed the Howey test and the offeror being registered with the SEC or qualify for an exemption. Recently, the US Treasury announced rules to close the current AML gaps as they related to cryptocurrencies.
 - At the Congress level, during 2020, P. Gosar introduced the Crypto-Currency Act of 2020 with the aim to provide clarity and legitimacy to crypto assets and M. Conaway proposed the Digital Commodity Exchange Act of 2020, allowing the Commodity Futures Trading Commission to streamline all state-based regulatory requirements for US-based crypto exchanges under a single framework.
 - It is reasonable to expect that the current global cryptocurrencies momentum will facilitate a better alignment of the regulatory stances on cryptofinance at the State, Federal and Congress levels, and that 2021 may see a clear economic policy stance in cryptofinance, consistently applied at the Federal and State levels. Such a development would provide cryptofinance further maturity and sustainability, as it would concern an influential capital market globally.
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2. Conclusion

In this issue of the Digital Regulator, we have looked at the main developments that characterised 2020, to try and anticipate key milestones that are likely to shape the digital regulation in 2021. We have purposely not mentioned events that we hold as certain to happen in 2021, such as the completion of the comprehensive digital regulatory framework in Switzerland.

Mark Twain once said, 'it is difficult to make predictions, particularly about the future'. Hence, the year may unfold in a completely different direction. The year 2021 will be full of digital regulatory developments and many of them will concern brand new areas, such as taxation.

Overall, our seven forecasts will support further mainstream adoption of crypto-finance, by providing certainty to the actors and a structure to the activities. As such, we expect continuity from the past to the future.

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