SEBA BANK

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Cryptocurrency Markets and Regulators

What to expect

The Digital Regulator

Redefining Finance for the New Economy

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Executive summary

The 12-month period of substantial increases in cryptocurrency values (bitcoin's value grew by 845% from 14 April 2020 to 14 April 2021) evolved, in May 2021, in a correction that has exposed market conduct, infrastructure, and investors' protection issues. The US federal financial and banking regulators have teamed up to pursue, rapidly and rigorously, a clear and explicit cryptocurrency regulatory framework. Given the US share in the global economy and the influential role of its regulators, the outcome of the process is likely to shape cryptocurrencies regulation and markets globally. Investors should welcome further regulatory clarity in areas such as market infrastructure, conduct, and investor protection inspired by traditional financial regulation, which will promote the development of institutional-grade cryptofinance in the mid to long term. Cryptocurrencies are not deemed systemically relevant by Central Banks, and a major clampdown can be excluded.

The last few weeks have offered several noteworthy regulatory developments in the digital space. For example, Germany and Spain softened the requirements for institutional asset managers to invest in cryptocurrencies, various nations took further steps to develop Central Bank Digital Currencies (CBDC), crypto exchanges have come under scrutiny in a few jurisdictions, and several new countries announced the introduction of cryptofinance regulatory frameworks.

The US regulators are contemplating action in the wake of recent market developments. A regulatory upgrade is required to promote institutional-grade cryptofinance.

1. Market Correction and Regulatory Action as A Chance to Promote Institutional-Grade Cryptofinance

Financial regulators have been traditionally supportive of cryptofinance. The regulatory frameworks that have been put in place at different paces and levels of sophistication in various countries–such as Switzerland, several European and Asian countries, and the US–over the last few years have supported the development of cryptofinance infrastructure, which in turn has allowed an increasing number of investors to participate in cryptocurrency markets. The rapid expansion of these markets over the last year has, however, also exposed weaknesses in crypto areas such as market infrastructure, market conduct, and investors protection and led US regulators, in particular, to act. Below, we briefly review these developments to conclude that stepping up the regulatory frameworks governing cryptocurrencies markets is a wise strategy in support of the development of institutional-grade cryptofinance.

Market growth and recent correction

- Bitcoin price rose from USD 6,845 on 14 April 2020 to USD 64,705 on 14 April 2021. A correction has followed, which has taken the price from the all-time high level of USD 64,705 to USD 31,663 as of 17 May 2021, marking bitcoin's sixth major historical correction from all-time highs in relative terms and the major correction in USD terms. The use of leverage served to magnify the movements, particularly from January 2021 (the total number of outstanding derivative contracts reached a level of USD 27.7 billion on 13 April 2021; liquidations reached a level of 7.1 billion USD on 18 May 2021).

Market weaknesses exposed

- The market growth and correction exposed market conduct, infrastructure, and investors protection issues. The ability of influential market participants such as E. Musk to materially move the market by tweeting decisions and opinions has raised market conduct concerns among regulators and the broader public. The same goes for the opacity surrounding the operations of pivotal elements of cryptocurrencies markets such as Tether, which disclosed that, as of 31 March 2021, only 3.8% of the over USD 40 billion Tethers in circulation were backed by cash (USD). This disclosure surprised investors on the negative side and raised market transparency concerns. Also, major cryptocurrency exchanges suffered outages during the correction. Coinbase experienced difficulties on 19 May 2021, with some users unable to log in, view balances, and make trades; on the same day, Binance had to pause some crypto withdrawals temporarily, and Kraken remained frozen for hours. These events led to losses driven by weak infrastructure. Lastly, publicly accessible information and analyses support the idea that the sell-off experienced in May 2021 was mainly attributable to short term retail holders or late retail investors and deleveraging activity, despite several regulators issuing investor alerts since the beginning of the year. The market correction was also materially affected by China's announcement of a national policy banning crypto mining and prohibiting payment firms, including online firms, from facilitating transactions in cryptocurrencies.

US regulatory response

- On 20 May 2021, the Office of the Comptroller of the Currency (OCC) announced talks with the Federal Reserve (FED) and the Federal Deposit Insurance Corporation (FDIC); the aim of these meetings is to set up an interagency policy team pursuing a clearer cryptocurrencies regulatory framework. The OCC has requested a review of the cryptocurrencies standards, including interpretative letters and guidance regarding cryptocurrencies and digital assets. Meanwhile, the FED, OCC, and FDIC have begun collaborating on the production of a joint cryptocurrency regulatory framework, specifying that core topics for consideration include the capital and operational treatment of cryptocurrencies. On 26 May, the Securities and Exchange Commission (SEC) reported that cryptocurrency markets are currently subject to regulatory gaps and pointed to regulatory action to protect cryptocurrency investors on crypto exchanges; the regulations are to be similar to those characterising traditional exchanges such as the New York Stock Exchange or the Nasdaq.

The steady growth in the bitcoin price and, more broadly, the cryptocurrency market cap over the last twelve months that culminated in a severe market correction in May 2021 has exposed weaknesses at the level of market infrastructure (operations and governance of crypto exchanges), market conduct (the influence of individuals, headlines, and trading behaviours on prices), suitability requirements, and protection measures for retail investors. Neither the US federal banking and financial regulators nor the European Central Bank currently see the volatility in the cryptocurrency markets as a threat to the stability of the broader financial market; thus, a major clampdown can be excluded. The focus of the ongoing regulatory action will, therefore, be investor protections, which will probably take the form of increased prudential oversight and regulation of cryptocurrency markets and their players, particularly cryptocurrencies exchanges.

These actions will likely bring the regulation and prudential oversight of cryptocurrencies markets closer to those regimes in place for traditional financial markets. Until clarity on any additional regulation and oversight of cryptocurrencies markets is available, investors are likely to suffer from heightened uncertainty and refrain from acting, keeping the markets in a 'wait and see' position. However, investors should welcome the prospect of regulation and oversight of cryptocurrency markets, akin to traditional markets, because it will allow more institutional investors to engage with cryptocurrencies and expand market participation.

2. Other Noteworthy Developments

Institutional investors see some ease in the conditions required to participate in the cryptocurrencies markets. The positive changes concern Germany and Spain and shall help institutional adoption.

- Germany has passed legislation that allows wealth and institutional investment fund managers (called Spezialfonds, estimated to be as much as 4,000 institutions) to invest as much as 20% of their portfolio in cryptocurrencies. The law is set to come into effect on 1 July 2021.
- Spain has softened the rules governing cryptocurrencies investments. It will allow investment fund operators, collective investment institutions, and variable-capital collective investment programs' investment companies to invest in cryptoassets. Investments in vehicles that track underlying indexes of tokens are, however, excluded.

Numerous developments in the CBDC space emphasise the priority Central Banks (CB) are giving to the introduction of CBDCs.

- The CB of Kazakhstan will launch a CBDC pilot program. The first step shall be a comprehensive study of the benefits and risks of CBDC and the definition of some core tasks such as the method of its emission and distribution, the technology used, and the impact on monetary policy.
- The CB of Georgia considers the introduction of a CBDC. The country hopes to benefit from the advantages of CBDCs as outlined by other countries. It clarified upfront that it will adhere to the technical standards set out by the Bank for International Settlements.
- The CB of Bahrain is working with JPMorgan Chase on a project to settle digital funds transfers from and to Bahrain in USD. This action may be the first step in the broader development of a CBDC.
- The CB of Israel communicated details about its CBDC project, noting its retail features such as the ability by citizens to use it even in offline payments and to the possibility to convert it to cash at any moment.
- The US FED will issue a CBDC discussion paper in the coming months. The focus shall be on whether and how a CBDC could improve upon already safe, effective, dynamic, and efficient domestic payment systems in the US. The paper will also discuss important monetary policy, financial stability, consumer protection, legal, and privacy considerations that would be raised by the introduction of a CBDC.

- The CB of South Korea will start a CDBC trial in the next months. The first stage will end in December 2021 and will focus on feasibility and effectiveness issues. The CB emphasised that it has no concrete issuance plan as of yet.
- The CB of Indonesia is studying the potential benefits of a CBDC and analysing the infrastructural requirements and their impact on monetary policy and payment systems.
- The CB of South Africa has commenced a feasibility study for a retail CBDC. The study is expected to close in 2022.
- The CB of Sweden announced a partnership with Handelsbank to test its CBDC in a real environment after having developed the e-krona only in a simulation environment.

Various cryptocurrencies exchanges have come under regulatory scrutiny in the wake of the market correction, evidencing the focus on this infrastructure by regulators triggered by the correction.

- Turkey announced reporting obligations for cryptocurrencies exchanges that concern any transactions exceeding an equivalent of USD 1'200 to the government's financial crime agency.
- Thailand strengthens the requirements for the opening of new accounts at crypto exchanges. The crypto exchanges must now verify the identities of new customers in person, requiring customers to be physically present for the verification process.
- Argentina has ruled that all cryptocurrency exchanges operating within the country must file comprehensive transaction data on their customers every month. The rules also require exchanges to identify all their clients.

Several new jurisdictions are committed to regulating cryptocurrency markets, which will strengthen cryptocurrencies markets globally.

- The government of Vietnam recently commissioned a research group with the task to conduct an in-depth study of cryptocurrencies for the purpose to regulate the sector. The group shall consider cryptocurrencies regulation already promulgated (or being developed in countries such as the US, Japan, and Europe.
- Uganda shall develop a comprehensive cryptocurrencies regulatory framework. This move follows initial steps taken to amend the country's Anti-Money Laundering laws to include crypto exchanges and other virtual asset providers.
- Bosnia and Herzegovina intends to prepare a bill to regulate cryptocurrencies in preparation for developing the sector in an orderly manner.

3.
Conclusion

The significant appreciation of cryptocurrencies values over the last year that culminated in a major and ongoing market correction since May 2021 has exposed weaknesses in the cryptocurrency markets at both the infrastructure level and the participant conduct level; the correction also clarified the need to step up protection for investors. The US regulators have taken the lead in developing a more suitable regulatory framework that is likely to extend key features of traditional financial market regulation into cryptocurrencies markets. There is consensus amongst the major central banks that cryptocurrencies are not systemically relevant. This view should exclude any major clampdown on the cryptocurrencies industry. While the ongoing regulatory action leaves market participants under heightened uncertainty and the markets in a "wait & see" position, investors should welcome additional regulatory clarity for cryptocurrencies markets because it will create additional stability and allow more participants to engage.

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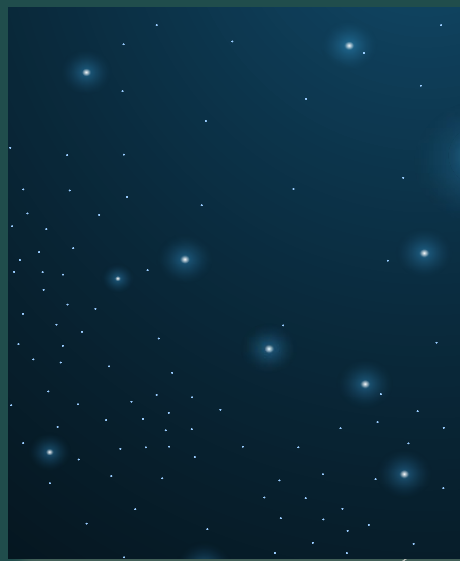

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