GLOBAL
DIGITAL
FINANCE

3 October 2019

VIA EMAIL:
cp19-22@fca.org.uk

Financial Conduct Authority
Wholesale Conduct Policy
12 Endeavour Square,
London
E20 1JN

Re: CP10/22 - Consultation on restricting the sale to retail clients of investment products that reference cryptoassets

Dear Wholesale Conduct Policy Team,

We support efforts by global standard setters, national authorities and regulators to consult and work with the nascent global digital/virtual asset industry.

To that end, we are hereby providing input to the Consultation regarding restricting the sale to retail clients of investment products that reference cryptoassets.[1]

The input has been drafted and led by the GDF Advisory Council.

About GDF

Global Digital Finance ("GDF") is a not-for-profit industry body that promotes the adoption of best practices for crypto and digital assets and digital finance technologies through the development of conduct standards, in a shared engagement forum with market participants, policymakers and regulators.

Established in 2018, GDF has convened a broad range of industry participants, with 300+ global community members—including some of the most influential digital asset and token companies, academics and professional services firms supporting the industry. GDF includes Circle, ConsenSys, DLA Piper, Diginex, Hogan Lovells, Huobi and R3 as patron members.

The GDF Code of Conduct is an industry-led initiative driving the creation of global best practices and sound governance policies, informed by close conversations with regulators and developed through open, inclusive working groups of industry participants, legal, regulatory and compliance experts, financial services incumbents and academia. Code principles undergo multiple stages of community peer review and open public consultation prior to ratification.

[1] https://www.fca.org.uk/publication/consultation/cp19-22.pdf

Consultation Inputs

1. Do you agree with our analysis of the key risks and harm posed by these products? Is there any additional evidence or factors that we should consider?

GDF is concerned with the FCA's analysis of the risks and harms caused by derivatives referencing cryptoassets.

Valuation

The FCA raised concerns over the valuation of the underlying cryptoasset in a derivative. References were made to the disparity of two separate analysts. GDF disagrees with this methodology for determining whether an asset can be valued accurately. A more thorough approach would be to show the spread of a larger range. It can then be seen whether there is a cluster of values in the same area. These two valuations could represent outlying values.

The FCA also pointed to the alleged lack of intrinsic value in unregulated tokens. This is not strictly true; these tokens carry value in the same way that fiat currency does i.e. the price of the currency usually includes an element of perception rather than necessarily being a true indication of the strength of the currency. Businesses are valued in a similar way, share prices are not necessarily an indication of the true valuation of the company, as sentiment will often play a role. Therefore, the lack of intrinsic value does not seem to be consistent with other approaches. GDF also considers that intrinsic value is not necessary in derivatives. The definition of a contract for differences, for example, includes a contract, the purpose or pretended purpose of which is to secure a profit or avoid a loss by reference to fluctuations in "an index or other factor designated for that purpose in the contract". There is no requirement in the definition that the underlying subject matter should have any intrinsic value.

The FCA also raised concerns regarding consumers suffering from sudden and large losses. It is in the nature of derivatives that they can operate in a way that leads to sudden and large losses (or, conversely, sudden and large gains). That is why derivatives are already regarded as higher risk investments under the existing regulatory regime, and why there are already protections in place – such as the appropriateness test under the Market in Financial Instruments Directive – to prevent the wrong kinds of consumers from entering into derivatives contracts.

Any assessment of appropriateness by a regulated firm involves considering whether the client has the necessary experience and knowledge in order to understand the risks involved in relation to the product or investment service. In our view, that already creates a sound framework for the sale of derivatives. If the risks associated with crypto derivatives are different, the regulated firm should be taking that into account when considering appropriateness – and, if the FCA is concerned about the inherent riskiness of crypto derivatives are correct, the regulated firm should be finding it more difficult to find customers for whom those derivatives are appropriate than it would for other forms of derivative.

GDF notes the difficulties in predicting oil prices or the price of potatoes. Despite sophisticated investment methods, an airstrike on a refinery or freak weather close to harvest time often renders methods unreliable.

This video link illustrates the complexity of a narrow view of volatility from the autumn of 2019, "CBOE Global Markets indicates the 20-day historical volatility, or HV, of bitcoin has fallen to 31.5%, below that of online retail giant Amazon.com, tech-darling Netflix, and Nvidia Corp, the chip producer that sells GPU cards to bitcoin miners. Furthermore, it's creeping towards that of tech-behemoth Apple Inc.– one of the most popular stocks on Wall Street.!

Experienced investors actively seek out volatility. Experienced retail investors will often seek to diversify a portfolio. Cryptoassets are a new asset class that provide both diversification and potential returns and losses of course.

Financial Crime

The FCA makes reference to financial crime and cybercrime in the crypto space. GDF would highlight that financial crime is not unique to cryptoassets. Whilst the FCA has referenced the immaturity of the crypto market as the reason why it is vulnerable to such attacks, the traditional industry is also vulnerable. The SWIFT-based attacks on the Bangladeshi and Russian Central Banks are indicative of this, where central banks themselves have been compromised from a cyber-attack showing that illicit activity also takes place in the 'traditional' markets. It therefore seems imprudent to point the finger at the crypto industry.

Putting aside the wider question of the prevalence of financial crime in relation to crypto (as opposed to other assets), we do not think that the occurrence of crypto thefts is likely to have an impact on the proper functioning of the markets relating to crypto derivatives. Thefts of crypto currencies would have to be on a very substantial scale to get to the point where they would move the price of a crypto currency and thus affect the price of a derivative.

Concerns were also raised on the lack of transparency. Derivatives referencing cryptoassets would have to conduct AML checks and therefore this should quell this concern. It should be noted that activities such as the buying and selling of art, wine or stamps, do not have AML checks in place.

The consultation made reference to pump and dump schemes. Again, this is not something that is unique to cryptoasset derivatives and could happen in any market. A more mature crypto market would be less susceptible to this in so far as there would have to be higher volumes to be able to achieve it, but this is still a generic issue that can happen in any market.

As mentioned above, such market manipulation still occurs within the highly regulated financial services industries (LIBOR scandal[2], Derivatives mis-selling[3]).

We draw the FCA's attention to many initiatives in the cryptoasset industry to ensure a more fair, transparent and efficient market. We appreciate that the nascent market is unregulated, that is why such organisations as GDF has produced a number of code of conducts (market integrity, funds and fund managers, trading exchanges), to ensure this objective (fair and transparent efficient market) is achieved. There are also many other such organisations globally, that are striving for the same objective (CryptoUk[4] & Chamber of Digital Commerce[5])

Discriminatory practice

The report suggests that the initial assessment only noted that there may be an adverse impact on the Cyprus Securities Exchange. It is less the discriminatory practice to other jurisdictions and more the outlying step that the UK would be taking that is a concern for GDF. Whilst China, HK and USA have implemented similar positions, this does not seem to be consistent with the way in which the UK addresses market integrity and consumer protection issues and is a step change from the European approach.

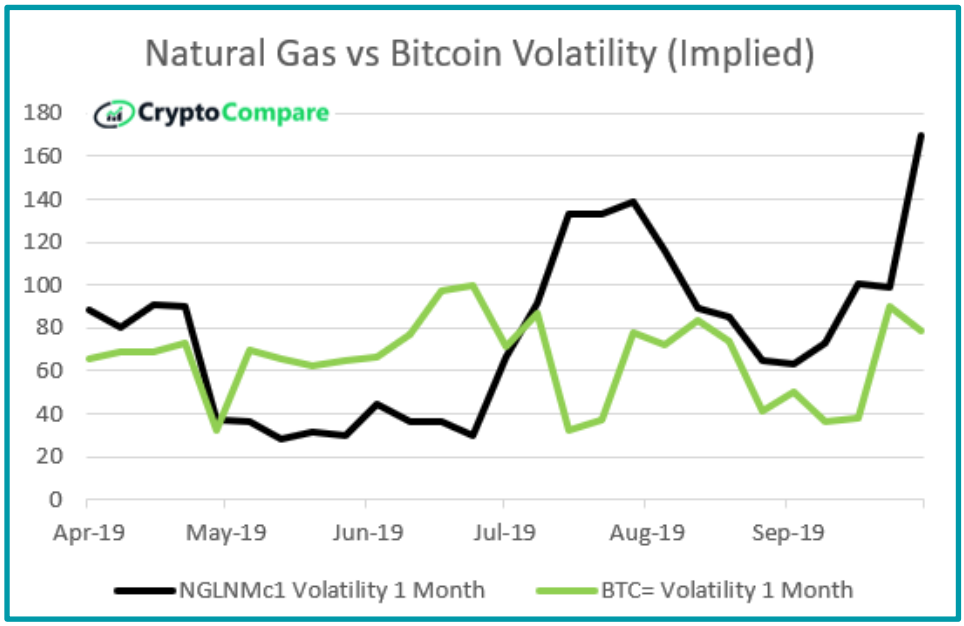
Volatility

The mapping of the volatility of Bitcoin in the consultation, in comparison to gold, nickel, lean hogs and orange juice, correctly identified that bitcoin was more volatile over that duration. However, the graph shows a reduction in the volatility moving from 2011 to 2018. This reflects the maturing of the cryptoasset market and making a conclusive observation from this limited period is premature. Reservations surrounding new and innovative financial products can be understood, however, the more mature cryptocurrencies have a place alongside small cap equities, commodities, emerging and foreign exchange markets. Whilst Bitcoin can be a volatile instrument, there are examples of other heavily traded instruments that pose the same and sometimes a higher risk to investors. Small cap equities and commodities are two such asset classes. Both of these are offered to retail investors through CFD's and other derivatives markets.

In the graph below, Natural Gas, available to retail investors as a CFD, shows a greater volatility than Bitcoin for the period of April to September 2019. Retail investors have access to many volatile derivatives in the form of CFDs. Derivatives have periods of volatility at times due to many factors and price volatility is

[2] LIBOR scandal
[3] Derivatives mis-selling
[4] CryptoUK
[5] Chamber of Digital Commerce

an inherent attribute of market products. GDF would like further clarification as to the volatility threshold in which underlying assets need to meet in order to be available to retail investors.



Source: Refinitiv Eikon, CryptoCompare

Consumer understanding

The analysis from the FCA suggests that consumers are not receptive to the warnings from regulators and are instead driven by social media and the fear of missing out. This is not unique to cryptoassets and highlights greater social issues.

The FCA has raised a concern on the level of understanding of investors. GDF reiterates that level of understanding has always been a concern in derivatives and is what led to the appropriateness and suitability tests. Is there a reason why this has been deemed insufficient in derivatives referencing cryptoassets? GDF considers current market practices on determining appropriateness and suitability sufficient to ensure consumers are being offered the correct products.

GDF questions the underlying data used and over which time period, as the basis of assessment for this consultation. There are many reasons why investors may be losing money and cannot be solely due to a lack of consumer understanding. As mentioned earlier, the cryptoasset market is maturing and the losses may be a reference to the mispricing of the assets. A lack of competition in the markets may be leading consumers to options that are not the best available to them.

A statement refers to there not being a legitimate investment purpose for cryptoasset derivatives. GDF notes that there are circumstances where one may wish to hedge against their exposure to cryptoassets, in the same way in which they would in fiat currency. In addition, there were concerns that there was an equal split between people viewing investments relating to cryptoassets as either 'a bet or an investment'.

According to the Global Policy Forum, in 2011 only 0.6% of foreign exchange could be traced to genuine international trade in goods and services. Of the rest, a minimum of 80% was directly attributable to exchange rate speculation.

GDF reiterates that derivatives by their nature are speculative and carry an element of risk. A CFD referencing the price of oil could just as easily be referred to as 'a bet or an investment'

2. Do you agree with our proposal to prohibit the sale, marketing and distribution of CFDs, futures, options and ETNs referencing relevant cryptoassets to retail consumers?

GDF contends that the proposal appears to be out of step with other jurisdictions and is not required.

The table overleaf highlights the contrast in approach taken by the proposal, in comparison to CFDs. PS 19/18 only came into force on 1 August 2019 and comes as an intervention for 'poor conduct by UK and EEA firms offering CFDs to retail consumer'. What evidence, if any, does the FCA have that these measures, that were implemented after this consultation was published, are not sufficient to safeguard retail consumers from the risks posed by cryptoasset derivatives?

Comparison of High-Risk Asset Regulation by the FCA

Cryptoasset derivatives	*CFDs and CFD-like options*	*CoCos*	*NMPIs*
CP19/22 ***Proposed:*** ***Ban the sale, marketing and distribution to retail investors of derivatives and ETNs referencing unregulated transferable cryptoassets.*** · *Scope to cover CFDs, futures and options* · *A ban would apply to products sold, distributed or marketed in or from the UK to retail investors. This would include banning sales to UK retail investors by other firms within the EEA, including where retail investors seek products via reverse solicitation.* · *It would also prevent UK brokers or platforms marketing and distributing products available in other jurisdictions to UK retail investors.* · *However, retail investors could still seek products from a third country firm via reverse solicitation.*	*PS 19/18* ***In force:*** ***CFDs may be sold to retail investors under the following conditions:*** · *Limit leverage to between 30:1 and 2:1.* · *Close out a customer's position when their funds fall to 50% of the margin needed to maintain their open positions on their CFD account.* · *Provide protections that guarantee a client cannot lose more than the total funds in their CFD account.* · *Stop offering monetary and non-monetary inducements to encourage trading.* · *Provide a standardised risk warning, which requires firms to tell potential customers the percentage of their retail client accounts that make losses.* *The following exclusions apply:* · *Firms that sell CFD-like options in other jurisdictions, where the product is sold through an intermediary outside the UK.* · *Sales and distribution activities of EEA firms outside the UK. These firms are still prohibited from actively marketing unrestricted CFD-like options to UK retail consumers.* · *If intermediaries sell, market, or distribute CFD-like options in or from the UK, they will be subject to FCA rules.*	*PS 15/14* ***In force:*** ***CoCos of any kind should not be sold or promoted to ordinary retail investors.*** · *Firms selling or promoting CoCos to retail investors are subject to the restrictions, including firms based outside the UK but promoting or selling into the UK on a services basis.* · *For MiFID or equivalent third country business, only the approval or communication of a financial promotion is subject to the restrictions for transactions within MiFID scope.* · *The rules only apply to promotions or sales to retail investors. They do not apply to sales to retail investors who have elected to be treated as professional investors, provided the requirements of re-categorisation are met (see COBS 3).* · *The restrictions on the retail distribution of CoCos apply to firms dealing with professional investors who opt to be treated as retail investors.* · *Intermediation activities that give effect to transactions in CoCos are not in scope of the rules.* · *The scope of the rules only applies to sales and approval and communication of promotions, and not to other activities by firms higher up the chain of distribution.*	*PS 13/3* ***In force:*** ***Banned the promotion of NMPIs to ordinary retail investors – even where a communication is disseminated in such a way that it's likely to be received by a retail client.*** · *Only certain types of promotions can be communicated to certain types of retail client.*

Source: GDF

3. Do you have any comments on the draft Handbook rules and definitions we propose to achieve our policy intention?

GDF questions the deletion of COBS 22.5.11 (4) '50% of the value of the exposure that the trade provides when the underlying asset is a cryptocurrency'. This provision only entered into force on 1 August 2019 ie. after this consultation paper was published and merely two months old by the deadline for comments. This provision was put in place following a consultation (CP18/38) in which it was deemed that holding 50% of the value of exposure to trades involving crypto assets seemed to provide adequate protection. Given that this has just come into force, GDF believes that the FCA should avoid deleting this provision and instead have a longer period of data collection and analysis to ascertain the effectiveness of this revision.

4. Do you have any comments on our CBA for these proposals as detailed in Annex 2?

GDF has no comment.

5. Do you agree with excluding derivatives on security tokens and tokens that meet the definition of e-money? If not, please explain why.

GDF agrees that derivatives that reference security tokens or tokens that meet the definition of e-money should not be banned.

6. Do you agree with our proposed approach to funds? If not, please explain why.

GDF agrees that there are already well-established rules in place that dictate what funds can and cannot invest in and therefore there would be no need to extend the remit of this proposal to funds.

7. Do you agree with our proposed scope to exclude non retail consumers from the prohibition? If not, please explain why.

GDF agrees that non retail consumers should be outside of the scope of the proposal. It would also like to point out that as most individuals will come under the definition of a retail client, this should at the very least be increased to include certain categories of retail client. These categories could include people who are perhaps very rich or have worked in the financial services industry and have knowledge of these types of derivative. Equally there may be people who need cryptoasset derivatives for the purpose of hedging a position they hold, therefore a commercial reason, and for whom there should be an exemption.

In the FCA rules, "non-mainstream pooled investments" (NMPIs) can only be sold to retail customers who come within one of the exemptions to the Financial Promotion Order (e.g. sophisticated investors who have been certified). GDF argues that a similar approach should be taken to allow the sophisticated crypto individuals to invest in cryptoasset derivatives.

8. Do you agree with our conclusion that alternative options would not sufficiently address the harm? If you disagree, please indicate any preferred option(s) and how it would better address the harms we have identified in a proportionate manner.

GDF is not convinced that alternatives have been sufficiently explored. The analysis from the FCA stated that between August 2017 and October 2017 there was £3.4bn traded in derivatives referencing crypto, representing 0.7% of the crypto market. In comparison between the same months in 2018 there was £77m traded, whilst it is noted that this also coincided with a drop in the valuation of bitcoin, it also coincided with ESMA imposing a temporary leverage ratio. Given this, GDF considers that taking such action on what is approximately 0.02% of the derivatives markets is quite extreme. Previous FCA communication on matters pertaining to cryptoassets has often been that they are not of significant importance and therefore it will be monitored. As a result, the GDF questions how 0.02% has warranted such an approach.

Secondly, GDF considers that the FCA should see whether the intended impact of PS19/18 (implementing the 50% holding limit for cryptoassets) is realised. As mentioned above this has just come into force following a consultation and therefore analysis should be conducted on the efficacy of this after a suitable period of time. A leverage ratio also appears to be a considered approach. It will safeguard consumers from making excessive losses, whilst allowing people to continue to invest. The approach will also take a more pragmatic approach to the intended goal – consumer protection. Banning derivatives referencing a specific product is not as effective as creating parameters that derivatives can operate in for retail clients.

GDF agrees that minimum denomination approach would not be effective. It is noted that this approach could lead to increased investment. It may also lead to a situation where people would take out a loan to be able to reach the threshold and therefore create an even larger problem.

As mentioned previously, the concerns over social media hype and 'fear of missing out' are problems across the board and more should be done by the regulator to address this problem. The FCA could instead put in place closer supervision on firms who offer crypto derivatives to ensure that their customer facing conduct is meeting the standards required.

GDF asserts that implementing a leverage ratio; implementing strict rules on marketing; and imposing a suitability test, will provide ample protection for consumers wishing to operate in this area. The ban can be considered if there are still concerns on derivative referencing cryptoassets and these approaches have been exhausted.

The treatment of cryptoasset derivatives differently to conventional derivatives at this juncture appears premature given the revisions to the Conduct of Business Sourcebook with respect to Contracts for Difference, that were only made effective 1 August 2019. We would have expected a longer period of data collection and analysis before this consultation.

We hope you find our response helpful. Please do not hesitate to contact our Executive Director, Teana Baker-Taylor (Teana@gdf.io) for further questions or comments.