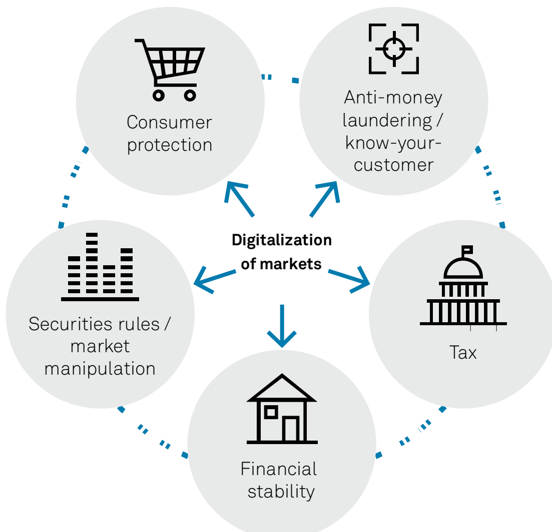
Regulation Of Digital Assets | How Far, How Fast?

Jon Palmer, CFA
New York
jon.palmer
@spglobal.com
+1-212-438-1989

Alexandre Birry
London
alexandre.birry
@spglobal.com
+44-20-7176-7108

Regulators are, rightly, becoming increasingly vocal about digital assets because transformational change is already on the way and the industry is not pausing for policymakers to catch up.

Key Areas Of Regulatory Focus



Source: S&P Global Ratings.

Read more

The Future Of Banking: Cryptocurrencies Will Need Some Rules To Change The Game, Feb. 19, 2018

Digital and Digitized Assets: Federal and State Jurisdictional Issues, The American Bar Association Derivatives and Futures Law Committee, Dec. 2020

Platforms and Tokens, By Markus Brunnermeier and Jonathan Payne, Nov. 5, 2020

The challenges

Defining a "digital asset" is a mix of art and science. Regulatory initiatives target activities themselves rather than the distributed ledger technology (DLT) that applications are built on. The context of these activities is considered by regulators to classify digital tokens that are used on these networks. However, the issue of classifying digital tokens is not always straightforward.

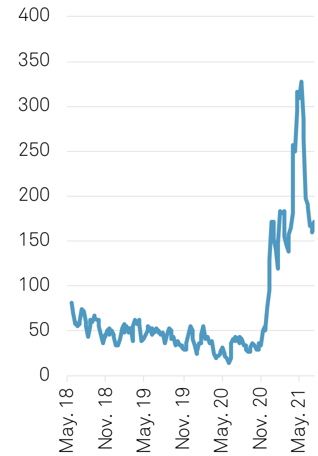
How policymakers and regulators define a digital token has cascading implications. For instance, Bitcoin is classified as a commodity in the U.S., placing it primarily under the supervision of the Commodity Futures Trading Commission (CFTC), which regulates derivatives and has anti-fraud and anti-manipulation enforcement authority over cash commodities, with some Bitcoin-related products and services falling under the supervision of the Securities and Exchange Commission (SEC; either solely or jointly with the CFTC). But unlike Bitcoin, not all cryptocurrencies are classified as commodities in the U.S., and to complicate things further, a cryptocurrency's classification can change over time. How a digital token is defined will determine under what supervision authority, and within what scope of diverging laws and regulations in any given jurisdiction it falls (for example, see "SEC Charges Ripple," SEC, December 2020).

It also raises the fundamental policy question of how to balance innovation and regulation. Regulatory stances vary considerably between countries and are even mixed within countries. In the Asia-Pacific region for instance, Singapore has positioned itself as an innovation hub by providing regulatory clarity and taking an open regulatory stance. Conversely, China has largely banned the private cryptocurrency industry, while rapidly progressing with the development of a digital yuan.

A lack of policy response can have consequences. The history of digital assets in South Korea serves as a case study. Rapid uptake of digital assets and speculative trading in South Korea led to wide divergence between prices on South Korean and foreign exchanges that prompted the government to intervene in 2017. In 2018, two South Korean exchanges were hacked, with about $70 million in tokens stolen. In 2020, in its first step toward comprehensive regulation of digital assets, South Korea passed new legislation taking effect in September 2021.

The potential risks require coordination among policymakers, regulators, and standard setters. Cross-border applications of DLT require a globally coordinated response, especially considering that protocols underpinning these applications may not be managed centrally, and while the key areas of regulatory focus are not new, associated risks often manifest themselves differently than in traditional finance.

Google Searches On Digital Asset Regulation Peaked In 2021



Note: 4-week average number of searches for “bitcoin regulation”, “crypto regulation”, “SEC crypto”, “Basel crypto”, “bitcoin ban”, “crypto tax”.

The current landscape

Interest around regulation has accelerated in the past few quarters. New entrants in financial services are forging ahead, building innovative ecosystems on DLT, often with unclear policy frameworks in place. Policymakers are playing catch-up and attempting to adapt to a dynamic new industry, often with existing regulations that are not entirely fit for purpose.

It remains unclear how most jurisdictions are going to balance innovation and regulation. We expect more clarity in the coming years, with additional coordination and guidance at the international, regional, and national levels. Until then, stakeholders expose themselves to regulatory risk where guidance and regulation are subject to change.

A global agenda is taking shape. The G20 is collaborating with international standard setters such as the Financial Action Task Force (FATF) and the Financial Stability Board (FSB) to establish a coordinated approach to regulating digital assets. The primary focus has been on financial stability and anti-money laundering (AML) and combating the financing of terrorism (CFT). In 2018 the G20 agreed to regulate digital assets for AML/CFT in line with FATF standards, and recently the Basel Committee published a consultative paper on the prudential treatment by banks of their exposures to digital assets. While we've seen progress from collaborations at the international level, the regulatory landscape for digital assets is still in a discovery phase and is far from reaching the level of regulatory clarity in traditional finance.

At regional and national levels, approaches to regulation vary considerably. Some are relying more on preexisting regulations (e.g., Switzerland), while others have implemented more targeted regulatory schemes (e.g., Japan). Regulatory stances also differ, with some adopting policies that favor private sector innovation (e.g., Singapore) and others tightly controlling private industry (e.g., China). Policymakers and regulators are becoming increasingly awake to both the potential benefits and the potential risks. In the U.S. for instance, we have seen increased attention from Congress and the SEC to address gaps in current regulation, casting a shadow over the U.S. industry, in our view. Globally, jurisdictions are at varied stages in establishing regulatory frameworks, with some Asia-Pacific countries appearing the most established.

The credit implications

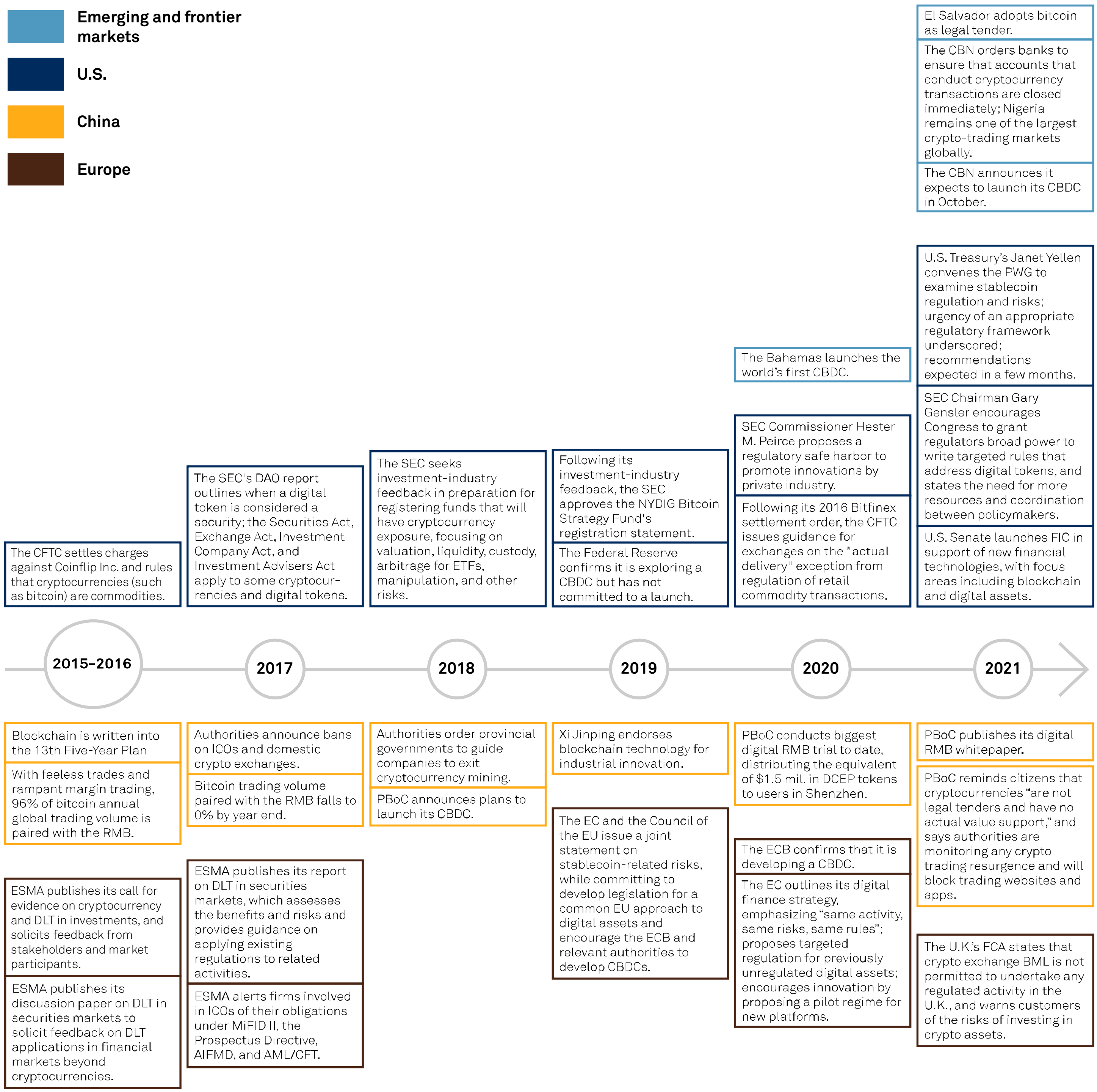
An acceleration in regulatory initiatives doesn't necessarily protect traditional finance incumbents. The building of a coherent regulatory framework around digital assets and decentralized finance (DeFi) could legitimize and accelerate industry development by attracting new customers and incentivizing the arrival of new entrants that pose a risk to traditional finance incumbents' operating models. We will continue to monitor new entrants, traditional finance incumbents, which we believe will ultimately disrupt themselves, and growth in various DLT applications, such as issuance, lending, and trading.

Clear and stable regulatory frameworks would reduce risks for stakeholders. This includes both traditional finance incumbents interested in developing related activities and new entrants that operate digital asset business models. For now, first movers are exposed to regulatory risk. We will continue to monitor international, regional, and national bodies as well as track related legal developments.

Effective regulation is necessary for the development of innovative market infrastructure that is more efficient and promotes financial inclusion. DLT and digital assets have the potential to lower transaction costs, lower financing costs, improve liquidity, increase accessibility, and increase productivity. Effective regulation will facilitate the confidence and trust needed for wider adoption that brings innovations to scale. We will continue to monitor regulatory developments around consumer and investor protections and wider public interest in digital assets and DLT applications.

A weak regulatory response would entail systemic risks. Inadequate regulation with rapid growth in DeFi and digital assets increases risk to financial stability, with the potential for contagion to the traditional financial system in the long run. We will continue to monitor cyber risk, DeFi growth, initial coin offerings (ICOs), and stablecoins.

The Digitalization Of Markets: Policy And Regulatory Developments Are Accelerating



AIFMD--The Alternative Investment Fund Managers Directive. AML/CFT-- Anti-money laundering/combating the financing of terrorism. BML--Binance Markets Ltd. CBDC--Central bank digital currency. CBN--Central Bank of Nigeria. CFTC--Commodity Futures Trading Commission. DAO--Decentralized autonomous organization. DCEP--Digital currency electronic payment. DLT--Distributed ledger technology. EC--European Commission. ECB--European Central Bank. ETFs--Exchange traded funds. ESMA--The European Securities and Markets Authority. FCA--Financial Conduct Authority. FIC--Financial Innovation Caucus. ICOs--Initial coin offerings. MiFID II-- Markets in Financial Instruments Directive. NYDIG--New York Digital Investment Group. PBoC--People's Bank of China. PWG--President's Working Group on Financial Markets. RMB--Chinese Renminbi. SEC--Securities And Exchange Commission. Source: S&P Global Ratings.