WORLD FEDERATION OF EXCHANGES

Response: CPMI-IOSCO consultative report on application of the Principles of Financial Market Infrastructure to stablecoin arrangements

30 November 2021

Background

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructures, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~20%). with everything from local entities in emerging markets to groups based in major financial centres. Collectively, member exchanges are home to nearly 53,000 listed companies, and the market capitalisation of these entities is over $95 trillion, while the 50 distinct CCP clearing services (both vertically integrated and stand-alone) collectively ensure that traders put up $1 trillion of resources to back their risk positions.

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise financial stability, consumer confidence and economic growth. And we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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Response to CPMI-IOSCO Consultative Report on application of the Principles of Financial Market Infrastructure to stablecoin arrangements.

The WFE welcomes the opportunity to respond to the CPMI-IOSCO consultative report "Application of the Principles for Financial Market Infrastructure (PFMI) to stablecoin arrangements". The WFE strongly supports the enabling of technological innovation, both within the sector it represents and to the benefit of the wider financial services environment. However, it is important that when evaluating the impact of these technologies regulators do so with a view to the 'same services, same risks, same rules' principle and take a technology-neutral approach.

Establishing a co-ordinated, widely understood and applied approach to the regulation of stablecoin arrangements (SAs) via the use of the PFMI, will benefit national and supranational regulators, consumers and the industry alike. The current lack of certainty in regulatory coherence risks affecting investor protection and could, at the same time, slow down the growth of a developing facet of the financial services industry (especially as some jurisdictions already started the political process to regulate stablecoins and their service providers (e.g. in the European Union in MiCA). More broadly, a clear classification of SAs is of key importance both for current operators of SAs to comply with existing regulations, and for national authorities to determine what, if any, special considerations or changes are needed to prevent SAs from disrupting systemic stability. (It should also be considered whether the evolving nature of the crypto asset market may mean that such classification will need to have suitable flexibility to 'absorb' innovations.)

For example, The FSB has identified two broad mechanisms for stablecoin design: asset-linked stablecoins backed by fiat currency or financial assets, and algorithm-based stablecoins which increase or decrease supply based on fluctuations in demand.[1]

However, the variety of stablecoin configurations within these categories is broad, and indeed, not all stablecoins fit solely into one category or the other. Existing asset-linked stablecoins may be backed by fiat money on a one to one basis, other cryptocurrencies, or a basket of assets. 'Hybrid' stablecoins using a combination of financial assets and algorithmically determined changes in supply to maintain their value.

Examples of popular stablecoins

Coin	*Stabilisation mechanism*	*Governance mechanism*
USD Coin	1:1 backing with US dollar held as collateral	Centralised – managed by consortium of stakeholders
AMPL	Algorithmic with no collateral	Decentralised – managed by holders of specialised governance token
Dai	Various crypto-assets held as collateral. Acceptable collateral determined by vote of governance token holders	Decentralised – managed by holders of specialised governance token

Applicability of the PFMI to SAs

1. **Is it clear when SAs are considered FMIs for the purposes of applying the PFMI?**

Yes. Like most crypto-assets, a mechanism for recording transactions is an inherent feature of stablecoins, enabling them to serve as both a transfer mechanism and a payment system. It therefore follows that an SA possessing these

[1] Financial Stability Board, Regulation, Supervision and Oversight of "global stablecoin arrangements"

functions should be regarded as FMI for all areas of regulation and oversight. The paper provides clear guidance to enable discussion and resolution of any points of conflict between relevant stakeholders in future.

Considerations for determining the systemic importance of an SA

2. Are the suggested considerations for determining the systemic importance of SAs clear, comprehensive and useful? Are there any risks or considerations missing?

Yes, though we would add that as a general principle markets should adopt an approach based on deference to the jurisdiction in which an SA is domiciled. This would discourage regulatory confusion and fragmentation while also respecting the authority of regulators to determine rules and regulations in their jurisdictions.

International co-ordinating mechanisms should be employed to ensure national regulatory regimes are aligned with the common objective of ensuring overall financial stability, while still taking account of the nuances and particularities of national regulatory, legal and economic environments. In particular we would dissuade regulators from seeking to gain a competitive advantage for their jurisdiction through regulatory arbitrage.

Governance

3. Is the guidance provided on governance clear and actionable to inform how SAs will need to ensure clear and direct lines of accountability and set up governance arrangements to observe the PFMI?

Yes. A technology-neutral based approach to FMI regulation means ensuring that SAs possessing the characteristics of FMIs are subject to the same regulatory and supervisory nexus as traditional FMIs. In general, this means that any SA must be ultimately controlled by identifiable natural persons and legal entities who can be held accountable for ensuring regulatory compliance. As the broader Decentralised Finance (DeFi) space expands, it is important that mechanisms exist to ensure accountability and compliance with broader regulatory responsibilities, such as AML/CTF and KYC rules. This could be accomplished through assigning neutral third-party operators on decentralised networks to apply rules and ensure legal and regulatory obligations are upheld, as well as discouraging the use of permissionless blockchains and networks.

The CPMI-IOSCO report identifies the range of potential issues arising from mechanisms unique to SAs acting as FMIs and provides a framework for further discussions between regulators, the FMI industry and other stakeholders on how to ensure any globally significant SA remains in alignment with the PFMI.

4. What are the challenges that SAs may face due to the use of distributed and/or automated technology protocols and decentralisation, when seeking to observe Principle 2 on governance, in particular when ensuring the clear allocation of responsibility and accountability?

The challenges on observing Principle 2 will be specific to the set up and configuration of a specific SA. Public distributed ledgers, automated protocols and other technologies are not necessarily attributes of *all* stablecoins and do not necessarily represent an obstacle to accountable governance per se. However, it is crucial that any SA maintain the ability for direct intervention by individual natural persons who can be accountable for the governance of the SA. This is not only so that that the functioning of the SA can be adjusted if necessary to avoid systemically destabilising behaviour, but to demonstrating liability and accountability to increase trust among market participants in SA itself. Where issues surrounding governance and accountability arise on a cross-border basis we would support a policy of deference to supervisors in the country in which an SA is domiciled, where prudent and where regulatory regimes align to international standards.

Interdependencies

5. Is the guidance on Principle 3 clear and actionable to inform how SAs will need to comprehensively manage risks from other SA functions and entities and their interdependencies?

Yes, we believe the guidance is clear and actionable.

Settlement finality

6. Is the guidance on Principle 8 on settlement finality clear and actionable to inform how SAs will need to manage risks arising from a misalignment between technical and legal finality?

The guidance is clear but the potential for software 'forks' in distributed ledgers to undermine settlement finality during clearing is a product of an individual ledger, its operations and governance. DLTs have differing capacities to reverse or unwind transactions and correct errors without producing 'hard' forks depending on software configurations and governance protocols.

There are additional legal complications arising from the use of 'smart contracts' and other commercial contractual agreements entered into automatically by computer programs or algorithms. Under the Shoe Lane principle in English common law, acceptance of an offer – and thus, the conclusion of a contract – requires an act of human will. The enforcement of contracts agreed autonomously between computer programs is correspondingly legally uncertain.[2] Contra the popular phrase among crypto-currency enthusiasts, 'code is not law'.

This may be an area where bespoke regulatory arrangements for DLT underpinning SA arrangements may be needed to ensure settlement finality and ensure equivalence with traditional FMIs. Any international standards must appropriately account for differences between jurisdictions' settlement finality and insolvency frameworks. However, finality is an important topic and solutions need to be found with regard to "probabilistic finality".

Money settlements

7. Is the guidance on Principle 9 on money settlements clear and actionable to inform how SAs will need to manage risks associated with the use of a stablecoin as a settlement asset? In particular, is the guidance clear on the considerations which an SA should take into account when choosing a stablecoin as a settlement asset with little or no credit or liquidity risk as an appropriate alternative to central bank money?

Yes. The use of a stablecoin underpinning a particular SA as an alternative to existing settlement instruments is central to their utility as a payment system. Moreover, it is important that an SA be able to demonstrate appropriate management of associated risks to its business model through regulatory compliance and disclosure. Recent media reports and regulatory actions against Tether, a popular stablecoin in existing crypto-markets, have demonstrated the potential systemic risks arising from uncertainty over convertibility. In the event of a run on a stablecoin is not fully backed by central bank currency or equivalent assets, said stablecoin could be forced to rapidly liquidate reserves of other assets, with unpredictable and potentially systemic consequences therefore adequate conditions need to be fulfilled (e.g. prudential requirements etc.).

The guidance provided in the report to manage credit and liquidity risks is clear and actionable and conforms with best practice, as well as highlighting the importance of stablecoins operating under robust regulatory and supervisory frameworks.

[2] Clifford Chance, Legal considerations around smart contracts

General

8. Are there other issues or principles of the PFMI where additional guidance for SAs would be useful? If so, what is the issue identified and how is it notable for SAs?

We have not identified any other areas where additional guidance would be useful at this time. We would reiterate that the 'same business, same risks, same rules' principle is necessary for regulation to remain technology neutral and enable a level playing field. Existing regulation should, naturally, be supplemented where required to address any specific risks related to the technology or its employment. For example, existing international principles and standards related to operational resilience and cyber security should be considered as part of the overall regulatory regime governing SAs. This would provide a greater degree of certainty for market participants as they ensure high standards of investor protection and market integrity.

9. Are there any terms used in this report for which further clarification would be useful for SAs when seeking to observe the PFMI?

No. We would note that the advantage of a principles-based approach (in this case, the PFMI) is that it sets a standard, while allowing for different technologies and for innovation. Anything more prescriptive could invite regulatory arbitrage or become outdated, particularly in such a fast-developing area.