

IOSCO
Public Comment on
IOSCO's Consultation Report on Policy Recommendations for Crypto and Digital Asset Markets
July 2023

About ALFI

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the IOSCO for the opportunity to participate in this consultation on the Policy Recommendations for Crypto and Digital Asset Markets.

Questions

Question 2 – Do respondents agree that regulators should take an outcomes-focused approach (which may include economic outcomes and structures) when they consider applying existing regulatory frameworks to, or adopting new frameworks for, crypto-asset markets?

In essence, initiatives supporting investor protection and the provision of fair and accurate information is strongly welcomed and supported. It is indeed believed that the investor protection framework and tools should acknowledge and address the technological changes. An analysis of the report also underlines a convergence of the IOSCO with the European Commission, within the context of the Markets in Crypto-Assets Regulation ('MiCA'), overarching objectives and motivations in term of investors protection and transparency. During the review of the measures, proposed by IOSCO to achieve these objectives, pragmatic implications and considerations have been raised. These items are identified and detailed in the following questions.

Substance over form

In term of applying existing regulatory framework or adopting new frameworks, beyond the outcomes-focused approached it is believed that the core principle of *substance over form* should be adopted. The variety and range of crypto and digital assets is wide and growing. Facing this diversity, a future proof framework would greatly benefit from the adoption of a substance over form approach. Indeed, a technologically agnostic approach, would be to regulate an asset on the basis of its substance and not its form. This would allow a consistency of the framework for the same asset supported by different technology.

More specifically, in the context of digital asset, the case of tokenised shares, bonds, fund units or other financial instruments should be highlighted. For those instruments, robust and proven regulatory frameworks exist and should be consistently applied under both the traditional and tokenised form of the asset. A different treatment could lead to inconsistency and arbitrage between two similar assets supported by different technology.

It is believed that the consultation report does not explicitly adopt this principle of substance over form. In addition, the footnote 5 stating that:

“The term “crypto asset,” also sometimes called a “digital asset,” refers to an asset that is issued and/or transferred using distributed ledger or blockchain technology (“distributed ledger technology”), including, but not limited to, so-called “virtual currencies,” “coins,” and “tokens.” To the extent digital assets rely on cryptographic protocols, these types of assets are commonly referred to as “crypto assets.””

could even be interpreted as a principle where the technology used would dictate the applicable regulatory framework for an asset.

ALFI recommends to adopt a substance over form principle and to develop a new framework only for the virtual assets that are not already captured by existing frameworks from a substance point of view. For this purpose, ALFI suggests to provide clarification on an explicit definition of “crypto and digital asset”. Such definition should account for the diversity of digital assets calling for proportionate and different requirements (see question 21) and exclude instruments already captured by other frameworks (e.g. financial instruments / DLT-exchanged financial instruments already subject to the MiFID rules, as illustrated above).

Markets in Crypto-Assets Regulation (‘MiCA’)

Furthermore, MiCA regulation resulted and benefited from robust legal basis, extensive industry (technology and financial) outreach and feedbacks and, practical market experience and events over the last 3 years (European Commission proposal published in September 2020). In this context, MiCA is setting an appropriate yardstick and an overall alignment of the frameworks with this standard is advocated for as an efficient course of action to ensure investor protection and to foster innovation in a consistent manner.

Question 4 – Do respondents agree that conflicts of interest should be addressed, whether through mitigation, separation of activities in separate entities, or prohibition of conflicts? If not, please explain. Are there other ways to address conflicts of interest of CASPs that are not identified?

The resolution and mitigation of conflict of interests is a pivotal cornerstone of fair and well-functioning markets. In different principal-agent contexts, experience has been gathered on the management of conflict of interests. The core principles of conflict of interests management, closely related to article 32 and 72 of MiCA, are:

- the identification of conflict of interest
- the prevention of conflict of interest
- the management of conflict of interest; and
- the disclosure

and are usually formalised in a conflict of interest policy periodically reviewed.

Several questions of the consultation report imply that the management of conflict of interests is dealt with a strict incompatibility of certain activities. Notably, this also relates to other questions such as 7 and 10. It is believed that strict incompatibility is only one possibility to manage conflict of interests. An emphasis on the implementation of appropriate and robust mitigation safeguards rather than a strict incompatibility would be welcomed especially in the context of a fast-evolving environment with new services being deployed under various operational models.

However, in our views, the segregation of roles between the issuer and the custodian of crypto and digital assets should be further defined, so as to avoid conflict of interests. In this context, comparable segregation rules with regards to governance and management of conflict of interests as in the traditional assets’ markets could be considered. In this analysis, a particular distinction should be made between tokens considered as an asset, and tokens supporting the infrastructure (such as settlement tokens for instance). Another core principle to consider is the exclusion of intra-group services from the scope of applicability of these segregation requirements. Services solely provided from one entity to another within the same group may be exempted from the established requirements mainly focusing at protecting external stakeholders / investors. This for instance could be applied for custody services provided by one entity of a group on behalf of another when the group is also issuing crypto and digital assets.

Question 12 – Do the market surveillance requirements adequately address the identified market abuse risks? What additional measures may be needed to supplement Recommendation 9 to address any risks specific to crypto-asset market activities? Please consider both on- and off-chain transactions.

In term of identification of market abuse risks, the article Title VI of the MiCA Regulation provides an appropriate assessment of the risks involved for crypto and virtual assets. The Title VI ‘*Prevention and prohibition of market abuse involving crypto-asset*’ is articulated around the following key principles and risks:

- Scope of the rules on market abuse
- Inside information
- Public disclosure of inside information
- Prohibition of insider dealing
- Prohibition of unlawful disclosure of inside information
- Prohibition of market manipulation
- Prevention and detection of market abuse

As mentioned in the introduction, an alignment with MiCA regulation is advocated for and is an efficient leverage to promote a consistent regulatory framework.

One additional factor to consider is the impact of the use and promotion through social media platform including the impact it may have on the valuation and risk profile of virtual and digital assets. On this basis, a parallel can be drawn with the *Measure 3 - Responsibility for online marketing* of the *IOSCO Report on Retail Distribution and Digitalisation* establishing the responsibility of the accuracy of the information provided to potential investors on behalf of the firm. The last term (“on behalf of the firm”) makes it clear that management would only be obliged to assume responsibility where there is a contractual relationship (delegation/mandate) with influencers etc. If the latter acted independently, the management should not be responsible for what and how they communicate.

Question 13 – Which measures, or combination of measures, would be the most effective in supporting cross-border cooperation amongst authorities? What other measures should be considered that can strengthen cross-border co-operation?

Exchange of information and equivalence

Since the crypto and digital assets activity is, by essence, cross border, particular attention should be given to the supervision of such activities (e.g. authorisation, reverse solicitation). In this context, the exchange of information across national competent authorities in conjunction with the application of the “equivalent regime” concept can provide for the basis of a cross-border regulatory framework.

When answering to this question 13, clarification would be welcome as to the nature of information to be shared (entity level, instruments / transaction level).

Question 14 – Do the Recommendations in Chapter 7 provide for adequate protection of customer crypto-assets held in custody by a CASP? If not, what other measures should be considered?

Responsibility regime

Chapter 7 and associated recommendations set the principles to ensure that the custodian will be in a position to return the assets. However, the recommendations remain silent about the responsibility in case of loss of the assets. Custody related regulatory frameworks (e.g. Alternative Investment Fund Managers ‘AIFMD’) establish the responsibility in case of loss and clarify the limits of this responsibility. This legal provision would allow for clear predictability and set up the field for an appropriate regime of responsibility. A relevant notion

to delineate the responsibility of the custodian facing a loss of asset is the notion of “beyond reasonable control”. These are the principles also relied upon by the MiCA Regulation to define responsibilities as established in the Article 75.8

“Crypto-asset service providers providing custody and administration of crypto-assets on behalf of clients shall be liable to their clients for the loss of any crypto-assets or of the means of access to the crypto-assets as a result of an incident that is attributable to them. The liability of the crypto-asset service provider shall be capped at the market value of the crypto-asset that was lost, at the time the loss occurred.”

ALFI recommends to establish a clear responsibility regime for the custodian in case of loss of assets including the limit of this responsibility relying on the “beyond reasonable control” notion. In application of the “beyond reasonable financial exposure” principle, we would suggest to specify the responsibility limit as the exposure to the market value of the assets at the time the loss occurred.

In addition, it is noted that the current proposal provides an unusually broad definition as regards to “client assets”. It is explicitly stated in footnote 26 page 31 that the notion of “client assets” encompasses both 1) crypto-assets and 2) money. This scope in conjunction with the Recommendation 13

Regulators should require a CASP to place Client Assets in trust, or to otherwise segregate them from the CASP’s proprietary assets.

would extend the segregation requirement to money (such as cash in account). The segregation of crypto assets relates to proprietary rights. On the other hand, money should be captured by the framework of “claim” (debtor-creditor relationship). In virtue of this difference and in order to ensure consistency of the treatment of cash accounts across different activities, in line with current existing frameworks ALFI recommends to exclude money from the definition of “client assets” and associated segregation requirements.

Question 17 – Are there additional or unique technology/cyber/operational risks related to crypto-assets and the use of DLT which CASPs should take into account? If so, please explain.

Risk based approach

Repeatedly, it is relevant to highlight the large diversity and heterogeneity of DLT technical solutions and protocols (e.g. permissioned vs permissionless). In this context, the cyber and operational risks born would highly differ depending on the specified choices. To address this diversity the application of a risk-based approach to mitigate those risks would be particularly appropriate to capture different set-up with inherently diverging risks.

For illustration of risk-based consideration pertaining to different protocols, the CSSF has published a whitepaper highlighting these key consideration ([the whitepaper may be consulted here](#))

We would welcome a guidance with regards to the responsibility pertaining to the implementation and execution of the smart contract, as this would lay on the technical service provider and should not, in our views, be laying on the custodian.

In particular, it is suggested that, in accordance with his/her roles and responsibilities, the custodian should not be in charge of the review / assessment of the underlying smart contract supporting the digital asset in custody.

Such consideration should be given to the various types of crypto assets service providers.

Question 21 – Are there additional features of stablecoins which should be considered under Chapter 10? If so, please explain.

Definition, categorisation, scope

As introduced in question 2, it is believed that the proposed framework would benefit from a clearer legal definition of what crypto and digital assets are. Such definition should also involve a categorisation of the

different types of crypto and digital assets. Furthermore, a substance over form principle is advocated for and it is recommended to exclude tokenised financial instruments that are already captured by another regulatory framework.

Definition stablecoins

The semantic “stablecoin” has been widely adopted. However, this terminology is subject to interpretation and legal uncertainty. It is therefore recommended to adopt a formal definition for this category on the basis of economic and legal criteria. As an illustration, MiCA provides a legal definition for “asset-referenced token” (including in Article 3 and recital).

Different risks, different uses

Assuming that the definition of a stablecoin converges to a token aiming at maintaining a stable value in reference to another (basket of) currency/asset, this crypto and digital asset would diverge from others non-referenced asset in term of risks and uses. In the case of stablecoins, the stability implies an additional liability in maintaining the value of the token. The regulatory framework should be proportional to this feature in term of disclosure, risk management (including stress-testing), reserve of assets (including custody) among others. Furthermore, the stability would also imply a different use. The need for transaction/settlement tokens is increasingly present to achieve an integrated on-chain process reaping the full benefits of the technology (e.g. for transacting tokenised fund shares). The reliance on stablecoins as transaction/settlement tokens further differentiate this category from others in term of uses calling for a distinct framework (e.g. framework more related to transaction than investment and with associated transparency on the transaction/settlement tokens).

Accordingly, a distinct framework is recommended for stablecoins.

Annex I – Full list of questions

Chapter 1 – Overarching Recommendation Addressed to All Regulators

Question 1: – Are there other activities and/or services in the crypto-asset markets which Recommendation 1 should cover? If so, please explain.

Question 2: – Do respondents agree that regulators should take an outcomes-focused approach (which may include economic outcomes and structures) when they consider applying existing regulatory frameworks to, or adopting new frameworks for, crypto-asset markets?

Chapter 2: Recommendations on Governance and Disclosure of Conflicts

Question 3: – Does Chapter 2 adequately identify the potential conflicts of interest that may arise through a CASP's activities? What are other potential conflicts of interest which should be covered?

Question 4: – Do respondents agree that conflicts of interest should be addressed, whether through mitigation, separation of activities in separate entities, or prohibition of conflicts? If not, please explain. Are there other ways to address conflicts of interest of CASPs that are not identified?

Question 5: – Does Recommendation 3 sufficiently address the manner in which conflicts should be disclosed? If not, please explain.

Chapter 3 – Recommendations on Order Handling and Trade Disclosures (Trading Intermediaries vs Market Operators)

Question 6: – What effect would Recommendations 4 and 5 have on CASPs operating as trading intermediaries? Are there other alternatives that would address the issue of assuring that market participants and clients are treated fairly?

Question 7: – Do respondents believe that CASPs should be able to engage in both roles (i.e. as a market operator and trading intermediary) without limitation? If yes, please explain how the conflicts can be effectively mitigated.

Question 8: – Given many crypto-asset transactions occur "off-chain" how would respondents propose for CASPs to identify and disclose all pre- and post-trade "off-chain" transactions?

Chapter 4 – Recommendations in Relation to Listing of Crypto-Assets and Certain Primary Market Activities

Question 9: – Will the proposed listing/delisting disclosures in Chapter 4 enable robust public disclosure about traded crypto-assets? Are there other mechanisms that respondents would suggest to assure sufficient public disclosure and avoid information asymmetry among market participants?

Question 10: – Do respondents agree that there should be limitations, including prohibitions on CASPs listing and / or trading any crypto-assets in which they or their affiliates have a material interest? If not, please explain.

Chapter 5 – Recommendations to Address Abusive Behaviours

Question 11: – In addition to the types of offences identified in Chapter 5, are there:

- a) other types of criminal or civil offences that should be specifically identified that are unique to crypto-asset markets, prevention of which would further limit market abuse behaviours and enhance integrity?
- b) any novel offences, or behaviours, specific to crypto-assets that are not present in traditional financial markets?

If so, please explain.

Question 12: – Do the market surveillance requirements adequately address the identified market abuse risks? What additional measures may be needed to supplement Recommendation 9 to address any risks specific to crypto-asset market activities? Please consider both on- and off-chain transactions.

Chapter 6 – Recommendation on Cross-Border Cooperation

Question 13: – Which measures, or combination of measures, would be the most effective in supporting cross-border cooperation amongst authorities? What other measures should be considered that can strengthen cross-border co-operation?

Chapter 7 – Recommendations on Custody of Client Monies and Assets

Question 14: – Do the Recommendations in Chapter 7 provide for adequate protection of customer crypto-assets held in custody by a CASP? If not, what other measures should be considered?

Question 15: –

(a) Should the Recommendations in Chapter 7 address the manner in which the customer crypto-assets should be held?

(b) How should the Recommendations in Chapter 7 address, in the context of custody of customer crypto-assets, new technological and other developments regarding safeguarding of customer crypto-assets?

(c) What safeguards should a CASP put in place to ensure that they maintain accurate books and records of clients' crypto-asset held in custody at all times, including information held both on and off-chain?

(d) Should the Recommendations in Chapter 7 include a requirement for CASPs to have procedures in place for fair and reliable valuation of crypto-assets held in custody? If so, please explain why.

Question 16: – Should the Recommendations address particular safeguards that a CASP should put in place? If so, please provide examples.

Chapter 8 – Recommendation to Address Operational and Technological Risks

Question 17: – Are there additional or unique technology/cyber/operational risks related to crypto-assets and the use of DLT which CASPs should take into account? If so, please explain.

Question 18: – Are there particular ways that CASPs should evaluate these risks and communicate these risks to retail investors? If so, please explain.

Chapter 9 – Recommendation for Retail Distribution

Question 19: – What other point of sale / distribution safeguards should be adopted when services are offered to retail investors?

Question 20: – Should regulators take steps to restrict advertisements and endorsements promoting crypto-assets? If so, what limitations should be considered?

Chapter 10 – Box Text on Stablecoins

Question 21: – Are there additional features of stablecoins which should be considered under Chapter 10? If so, please explain.