L'ASSOCIATION POUR LE DÉVELOPPEMENT DES ACTIFS NUMÉRIQUES

ADAN's contribution

Addressing the regulatory, supervisory and oversight challenges raised by "global stablecoin" arrangements

Consultative document by the Financial Stability Board

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Introduction

Adan is a 1901 non-profit organisation whose mission is to bring together and animate the digital assets industry in France and in Europe. With 40 corporate members, including Ark Ecosystem, Blockchain Partner, Coinhouse, Coinhouse Custody Services, ConsenSys France, iExec, Kaiko, Ledger, LGO Markets, Nomadic Labs and Woorton, Adan is the most important French organization in the digital assets field.

Adan is thankful to the Financial Stability Board (FSB) for allowing the expression of industry players in this open consultation. The Association's objectives are to help create the more favourable environment in the EU for the development of a crypto-asset industry competitive with other regions of the world. The Association is available for any additional commentary or work related to digitalisation and digital assets.

Questions

1. Do you agree with the analysis of the characteristics of stablecoins that distinguish them from other crypto-assets?

We agree with the first characteristic that have been identified by the FSB to distinguish stablecoins and other crypto-assets that is the existence of a stabilisation mechanism.

We partially agree with the second characteristic - the combination of multiple functions and activities - as apart from the issuance redemption and stabilisation of the value of coins, other “core functions” - transfers, custody - are not specific to stablecoins but common to all crypto-assets.

We strongly disagree with the last characteristic aiming at differentiating so-called “global stablecoins” (GSCs) from other stablecoins. **Generally speaking, there should be no distinction between GSCs and other stablecoins.**

All stablecoins are likely to qualify as GSCs at some point in time. Most stablecoins are actually designed to be used by the largest scope of people. Current operational stablecoins - such as DAI, Tether, USDC, etc. - have actually achieved a global scale. Therefore no difference should be made in a regulatory perspective or risk-based approach.

Rather than comparing stablecoins and GSCs, **a more relevant distinction when appraising their potential risks and regulation framework could be their underlying stabilization mechanisms**. Current analyses worldwide (G7, IOSCO, ECB, etc.) focus on fiat-collateralized stablecoins only. However it is likely that collateralized and non-collateralized/algorithmic stablecoins do not involve the same risks. Even within collateralized stablecoins, differences could arise from the nature of assets that back stablecoins. For example, one risk that is not mentioned here is that, for fiat-collateralized stablecoins, the collateral management must be operated by regulated credit institutions. The current negative rate environment makes such activity quite difficult from an economic perspective.

Although we consider that the distinction between stablecoins and GSCs is artificial at best, **the objective criteria of distinction would probably be the availability of the stablecoin outside of the reference asset area**. e.g. a stablecoin against the euro that would be widely available outside of the eurozone would be considered a GSC.

4. What criteria or characteristics differentiate GSC arrangements from other stablecoin arrangements?

As explained in our answer to question 1, **there should be no distinction between GSCs and other stablecoins.**

Rather than comparing stablecoins and global stablecoins, a more relevant distinction when appraising their potential risks and regulation framework could be their underlying stabilization mechanisms.

7. Do you have comments on the potential regulatory authorities and tools and international standards applicable to GSC activities presented in Annex 2?

7.1 Generally speaking, stablecoins should qualify as new assets that do not exist in the current regulatory landscape. Stablecoins should belong to a new legal category: “**tokens**” or “**programmable crypto-assets**”. This is a wide asset class that refers to crypto-assets deployed on the blockchain by their owner(s) who is/are the identified issuer(s) of these tokens and who determines their characteristics by encrypting them in smart contracts.

Tokens / “programmable crypto-assets” distinguish from :

- Crypto-assets that are currently covered by EU financial services legislation, that is “security tokens”.
- “Cryptocurrencies” i.e crypto-assets governed by the blockchain protocol itself (e.g bitcoin, ether). As they are ruled by the protocol that defines all their technical characteristics, they are not controlled by a single central operator and their economic function is not determined by a specific issuers. Instead, different groups of participants of the networks use them for different economic functions : payment, investment, collateral, store of value, etc. They are traded on a peer-to-peer basis.

Regarding such features - and considering that they may evolve over time, that the FSB raises in the consultative document[1] - and the underlying stablecoin infrastructures that are strongly different from existing payment and financial ones (starting with the stabilisation arrangements), stablecoins hardly qualify under the current regulatory landscape. Persevering in this latter approach will create instability and regulatory frictions.

That is why creating the new “**tokens**” or “**programmable crypto-assets**” asset class - among them stablecoins - is the opportunity to build a dedicated regulatory regime that would be fully adapted to their specificities. Such a bespoke regime is crucial to enable a sustainable crypto-asset ecosystem in the EU. Legal uncertainty is detrimental to the long-term vision of business then prevents from the broad adoption of crypto-assets. This is also the opportunity for the EU to set a clear and favourable regulatory land where Asia and North America have not taken the lead yet.

But this regime should meet some essential conditions to be able to inspire confidence for users and business partners with the crypto industry while allowing actors to foster their innovative potential. To this end, such regime should lean on the following principles:

- **Flexibility and scalability**. “Tokens/programmable crypto-assets” should be subject to adjustable requirements depending on the activity/service provided, the intrinsic features of assets and their risk profile.
- **Proportionality**. Some key facts should be kept in mind when designing their regulation. For example, crypto-crypto activities raise less risks in terms of AML-CFT than crypto-fiat ones. Also, the provision of tokens to clients in order to make them access to their services should not be a regulated activity.
- **Efficiency**. Regulatory frameworks for crypto-assets should not only focus on the features of crypto-assets, but also on activities/services and the specific risks arising from the combination of the assets’ features and the activities/services provided on these assets. To this end, efforts to move away from traditional regulations that can inspire regulatory works and granularity in determining roles and responsibilities of new actors are critical.

Only a flexible, proportionate and efficient regime will allow the EU stablecoin ecosystem to develop and compete with non-EU actors while ensuring confidence of users and traditional actors as rules would better tackle the risks raised by stablecoins that current rules would do.

[1] See 3.1 page 15.

For example, an obligation for the assets or funds to be held in custody with credit institutions in the EU is not pragmatic for the moment considering the reluctance of such institutions to investigate crypto-asset activities. In France for instance, actors encounter serious difficulties when they try to establish a business relation with the French banking sector. That is why this obligation would only put the brakes on the development of stablecoin projects.

7.2 Regarding "AML/CFT and sanctions controls" mentioned as one potential tools to address the vulnerabilities in Annex 2, Adan does agree with the need to guarantee financial security in the crypto universe but would like to provide some clarifications.

For crypto-assets that do not qualify as existing instruments, applying the whole AML/CFT package designed for banks and financial institutions would be inefficient because crypto-asset activities do not bear the same level of ML/FT risks, - as it has been recognised by the French Treasury - (a) **and do not materialize through the same practices** (b).

a) In their "National Analysis of Money Laundering and Terrorist Financing Risks in France" published in September 2019, the French Treasury attributes a "moderate level of risk" (on a scale of "low" to "high") to crypto-assets. They make the following observations:

- The illicit use of crypto-assets for M/FT purposes is not a preferred option by criminals. Indeed, some factors - such as the specific knowledge and technical expertise required to use them, as well as their volatility - deter them from using these assets. For this reason, very few cases where crypto-assets were used for illicit purposes have been reported.
- "Crypto-crypto" activities are less exposed to BC-FT threats than "crypto-fiat" activities, as they do not imply the re-injection of funds into traditional economic channels.
- In many scenarios, the information stored on and off chain allow for the identification of customers and the monitoring of transactions.

Moreover, the conclusions of a public consultation led by Adan on the crypto-crypto activities carried out from France corroborate this analysis[2].

Adan is currently drafting a dedicated paper to explain why the financial AML/CFT requirements are not suitable for the crypto-asset industry and how they could be adjusted to better apply to this specific ecosystem.

b) **The risk estimation is largely ill-estimated as far as crypto-assets are concerned**. The main reason why is that the same matrix used for money is being applied, assuming that the only and main purpose of crypto-assets is payment means. This is a wrong assumption. Crypto-assets represent a new asset class on their own that will continue to shape up in the future.

At the same time, crypto-assets are entering in collision with some aspects of existing financial activities. The risks of disruption are very real. Those activities being regulated, unfortunately the trend is to apply the same regulations to disruptive technologies. But this often makes no sense. For instance, how to apply existing rules to decentralised exchanges? While crypto-assets do need regulation, applying existing regulations to them is the best way to:

2 https://uploads-ssl.webflow.com/5dfaa2b2c716435b9b9c4a1f/5e8209bf1fde7d949cfa79b8_ADAN-Rapport-Activite%CC%81s-entre-actifs-nume%CC%81riques-re%CC%81alise%CC%81es-depuis-la-France.pdf

- **Overestimate the risks of crypto-assets.** For example, many financial reports are inducing a very high level of illegal activities on crypto-assets because they are not respecting traditional financial activities rules on tracking the funds, which makes no sense for "crypto-crypto" actors that do not deal with legal money.
- **Increase illegal activities on crypto-assets**. While people and companies will reduce their activities on crypto-assets, outlaw people - that do not want anyways to respect laws - will use the crypto-assets quite freely because the regulator will be looking somewhere else.
- **Leave the necessary parts unregulated**.
- At the very end, **prevent innovation**.

That is why our main recommendations are:

- **Focus the regulator on the deep analysis of how illegal activities are technically leveraging crypto-assets to perform transfer of funds.** Numerous companies and tools are now available that have been successfully used by different policies (FBI, CIA, OCRGDF from the French Ministry of Interior, etc.) in the world. This can be done through a task force that will gather and be on the vanguard in terms of technical knowledge.
- Through best practices, **iterate on the best ways to counter illegal activities by detecting the use of crypto-assets.**
- When best practices are consensually agreed as efficient, **transpose them into the regulations via regular updates of the EU directives on the AML/CFT**.

Adan is currently writing a set of best practices that are technologically compatible with the crypto-asset class that would serve as a base to upgrade the regulations in a meaningful and efficient way.

8. Do you agree with the characterisation of cross-border issues arising from GSC arrangements?

As explained in our answer to question 1, cross-border considerations are common to all stablecoins: there should be no distinction between stablecoins and so-called GSCs as stablecoins are designed to be used widely.

Adan agrees with the FSB's analysis that one major challenge for stablecoins is to adopt a unified, non-fragmented regulatory approach in order to design a consistent regime (within the EU first but also worldwide) to be really efficient and avoid regulatory arbitrage. This analysis should actually be extended to all crypto-assets.

To this end, regarding the EU level, Adan's regulatory proposal can address such an issue. As explained in our answer to question 7, all "**tokens**" or "**programmable crypto-assets**" including stablecoins should be regulated under a new dedicated EU regime.

This framework solves one crucial problem arising from the heterogeneous legal analysis of stablecoins led by regulators and their efforts to qualify them under many different asset classes as depicted in the FSB's Graph 2 of Annex 3 (e.g electronic money, currency, security, depositf, etc.) showing that stablecoins cannot perfectly fit into any existing definition (moreover, stablecoins can change over time). As the FSB underlines that "*different regulatory classifications of stablecoins [will induce] hence difference regulatory, supervisory and oversight approaches*"[3], one bespoke regime for all crypto-assets (including stablecoins) is the most efficient approach to avoid inconsistency among jurisdictions.

[3] See 4.1 pages 20-21.

This EU regime for crypto-assets must be really unified among Members. National initiatives to clarify the regulatory treatment of crypto-assets can be lauded but raise risks in terms of regulatory arbitrage between Member states. That is why from a practical perspective, at the EU level, we would recommend:

- the supervision of actors in crypto-assets (including stablecoins) at a national level, with coordination at the EU level in order to ensure a certain level of harmonization between practices. Indeed direct supervision by the European Authorities would not be efficient nor cost-effective.
- for such coordination at the EU level, the creation of a new European Supervision Authority (ESA along with EBA, ESMA and EIOPA) dedicated to crypto-assets (including stablecoins), possibly in relation with a self-regulatory body that could help keep processes and create a first level regulation delegated by member States. This new ESA is the best option to ensure that devoted expertise and resources are allocated.
  In line with the FSB's clarification that central bank digital currencies (CBDCs) are separate issues, the supervision framework of CBDCs should not be enforced to stablecoins.
- a EU regulation to be transposed into national laws directly. As a directive is only giving objectives to State members that then develop their own national provisions to achieve them, experience has proven that national regulatory frameworks could diverge a lot among State members creating conditions for unfair competition and regulatory arbitrage. A regulation would be a preferred option as it is transposed into national laws directly.
- the creation of a "28th regime", as an alternative to this regulation. Recital 14 of the Rome 1 Regulation allows for designing an "optional instrument" (or "28th regime") that would be a second regime "providing parties with an option between two regimes of domestic contract law". According to article 3 of the Rome 1 Regulation, parties can choose the law by which their contract shall be governed. In this scenario, national regimes when there are (such as the French PACTE Law) could co-exist with an EU crypto-asset regime.

In the long term perspective of building this framework, Adan recommends close dialogue with the national regulators, industry players and associations. From there, good practices can be inferred and adapted tools chosen or developed at the EU or national level. As a professional association, Adan is dedicated to ensure good practices from the industry players and are already working on guidelines for both the regulators and the players.

9. Are the proposed recommendations appropriate and proportionate with the risks? Do they promote financial stability, market integrity, and consumer protection without overly constraining beneficial financial and technological innovation?

According to Adan, FSB's recommendations are heading in the right direction.

a. Are domestic regulatory, supervisory and oversight issues appropriately identified?

As explained in our answer to question 1, there should be no distinction between GSCs and other stablecoins.

b. Are cross-border regulatory, supervisory and oversight issues appropriately identified?

Please refer to our answer to question 8.

c. Do the recommendations adequately anticipate and address potential developments and future innovation in this sector?

Recommendation n°2 that promotes proportionality should be the central pillar for all others in order to ensure that the coming regulatory treatment applicable to stablecoins achieves the right balance between ensuring security (for both the financial system and consumers) and promoting innovation. Please refer to our answers to questions 7 and 12.

10. Do you think that the recommendations would be appropriate for stablecoins predominately used for wholesale purposes and other types of crypto-assets?

Adan considers "wholesale stablecoins" to be a new settlement layer between the financial institutions. The regulatory treatment should be adapted to this very specific use case, that widely differs from the commonly accepted notion of stablecoin.

11. Are there additional recommendations that should be included or recommendations that should be removed?

One additional recommendation should be : *Authorities should get a better understanding of the potential of those assets by engaging with local and global "crypto" ecosystem and initiating dialogue with actors on their activity, and their risk analyses. Authorities should also ensure that actors can have access to support and communication from them, to design and develop their innovative projects. Authorities should be an open point of contact for the industry: this would help stimulate innovation and reduce risks as a whole.*

12. Are there cost-benefit considerations that can and should be addressed at this stage?

Adan does regret that this consultative paper deeply analyses stablecoins through a strong risk-based approach and does not balance their conclusions by investigating all the benefits that they can offer to consumers and the financial systems.

In recent years, stablecoins have been seen as the opportunity to build the payment leg that blockchain applications lacked at the beginning. Contrary to cryptocurrencies such as bitcoin and ether, the stability of stablecoins makes them a more credible alternative as a means of payment. By guaranteeing users to redeem them at any time against legal tender currency, stablecoins could attract new consumers of blockchain-based products and services.

But perspectives around stablecoins go further than the crypto-asset ecosystem. The interest of stablecoins differs according to their "wholesale" or "retail" scope.

- Wholesale stablecoins, ie. for use by financial institutions and large companies, can improve the efficiency of traditional financial infrastructures from payment to settlement. The main revolution is the immediate finality of transactions settled by the stablecoin (where it can take up to two or three days via traditional payment systems).

Indeed stablecoins are programmable "money". **Programmability** and **automation** could optimise the delivery versus payment (DvP) of transactions. According to a decentralized model, crypto-assets and payment assets are usually entered into an "escrow smart contract" until the two players confirm that they agreed upon their trading conditions. If such conditions are met, the smart contract automatically triggers the exchange of assets. Conversely, if the smart contract does not receive confirmation from the parties or contradictory information from the seller and the buyer, the smart contract does not execute the transaction and send back assets to each party (crypto-assets for the seller, the settlement asset for the buyer). That is why decentralized DvP requires both assets and means of payment to be "tokenized" to ensure the atomic execution of transactions. Otherwise, if the cash leg is not managed on chain, DvP involves that the off chain "cash leg" and the on chain "crypto-asset" leg of transactions are executed simultaneously, which can be very complex to implement. Stablecoins could then allow to fully process transactions on blockchain.

Decentralized DvP and the full integration of transaction processing on blockchain are likely to provide higher liquidity to crypto-asset markets. Liquidity materializes through the growing participants attracted by stablecoins as a safe means of payment, their possible instantaneous redeemability, the higher speed of transaction processing, the cost economy that results from automation of processes, and the annihilation of counterparty risk.

- Retail stablecoins are new payment methods that allow peer-to-peer exchanges, accessible to a wider public (including under- or unbanked populations) and thus support financial inclusion.

"Retail stablecoins", issued for individuals, could allow under- or even unbanked to overcome the difficulties encountered in order to transfer funds between individuals. Stablecoins fall within the growing trend of recent years to the digitization of cashless payments, led notably by Google, Apple, Facebook and Amazon. These new means of payment, which can be easily used with a mobile phone, support greater financial inclusion for populations where the banking system and payment infrastructures are the least efficient (or even do not exist). Today 1.7 billion adults are unbanked but 1.1 billion have a mobile phone (two thirds of them) and, in developing economies, 44% of adults use digital payments[4]. In addition, the **programmability** of those assets would allow for the use of blockchain-based applications with high levels of security, reliability, auditability and transparency.

- **Under all their forms, stablecoins are at the heart of substantial innovations that could optimise current financial processes and transactions.**

Stablecoins prompt the creation of crypto-assets payment networks such as Lightning Network (on Bitcoin) or Loopring, Raiden, Starkware, MatterLabs and Optimism (on Ethereum) These networks allow a much higher transaction throughput than the blockchain, and may eventually be used as alternatives to current networks such as Visa and MasterCard through the use of stablecoins. These new payment services foster innovation and the development of new use cases, as the integration of cash leg processing on the blockchain significantly accelerates the automation of the entire value chain and stimulates the use of the services and assets deployed on the blockchain. Among such innovations, this promotes the growth of decentralized finance, or open finance (known as "DeFi").

Stablecoins also galvanise the growth of Decentralized finance (DeFi) or Open finance. Decentralized finance (DeFi) is a new financial system based on blockchain and crypto-assets that is developed in parallel with the existing financial system. It differs strongly from traditional financial system because it is natively digital, it is built and runs on open source and permissionless infrastructures - so everyone can use it and participate in its improvement. DeFi allows for the emergence of new financing tools based on crypto-assets: exchanges, funds, savings, loans, derivatives, sustainable finance, predictive markets, portfolio management, etc. Those tools being open and interoperable by nature can easily be integrated with each other (so-called "composability"), allowing to overcome the limits of the current

[4] Figures from the World Bank's Global Findex Database 2017: Measuring Financial Inclusion and the Fintech Revolution : https://openknowledge.worldbank.org/bitstream/handle/10986/29510/211259ovFR.pdf?sequence=5&isAllowed=y

financial system (unequal access, counterparty risks, opacity, etc.). The DeFi field was born in 2018 and most of the existing products are still in development. As of today, there are still risks associated with their use but this is a fast-growing industry with approximately 1.5 billion USD of value (defipulse.com).

By allowing the full integration of processes on blockchain, stablecoins foster the interoperability between services. Indeed blockchain gives the possibility and freedom to the actors to create technological bricks and/or to use those developed by other actors. This interoperability is consistent with the current trend to open up traditional players to new entrants and thus promote the advent of innovative services: this is notably the idea of "open banking" in the second Payment Services Directive (PSD 2).

Finally, the settlement of operations on blockchain allows for peer-to-peer transactions and restores some form of financial sovereignty and ownership.

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