



IOTA
FOUNDATION

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Bank for International Settlements
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Switzerland

By email: fsb@fsb.org

15 December 2022

Response to FSB Consultation on International Regulation of Crypto-asset Activities

Dear Sir or Madam,

We welcome the FSB's consultation on International Regulation of Crypto-asset Activities and we look forward to engaging with you on this important topic.

Our comments are set out below. We remain at your disposal should you have any questions.

Sincerely,

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International Regulation of Crypto-asset Activities A proposed framework – questions for consultation

General

- 1. Are the FSB's proposals sufficiently comprehensive and do they cover all crypto-asset activities that pose or potentially pose risks to financial stability?**

The IOTA Foundation welcomes the FSB's ongoing work to increase regulatory clarity in the crypto-asset industry. In general, the proposals appear to be sufficiently comprehensive and well thought out. However, there is a lack of clarity in relation to decentralised finance (DeFi). Certain recommendations and regulatory measures may be appropriate for centralised services but not for decentralised ones. Therefore, it is essential that the recommendations consider the differences between these two types of services, so that the regulatory measures to be implemented are appropriate for each case.

DeFi is characterised by specific benefits and challenges that are different from the ones associated with centralised services. Applications in DeFi rely on automated protocols built on top of distributed ledger technology, which eliminates the need for centralised intermediaries. Therefore, the regulatory approaches that apply to centralised services should not automatically apply to decentralised services. This aspect has not been clearly stated in the FSB's recommendations. The main question in this regard should be whether the risks attached to centralised services are the same as for decentralised services.

In the IOTA Foundation's view, regulatory approaches must recognise the differences between centralised and decentralised services, and avoid overly broad definitions and obligations that could inadvertently impede innovation in this space.

In addition, the IOTA Foundation wishes to highlight the transparency and traceability offered by distributed ledgers and DeFi. On-chain analytics provides unique benefits and opportunities compared to traditional financial services. It is therefore important to take into consideration the inherent benefits and opportunities provided by the technology in this area.

- 2. Do you agree that the requirements set out in the CA Recommendations should apply to any type of crypto-asset activities, including stablecoins, whereas certain**

activities, in particular those undertaken by GSC, need to be subject to additional requirements?

The IOTA Foundation supports regulation that is proportionate and appropriate for the activity in question. Activities undertaken by GSCs require specific regulatory responses that are appropriate for the specific risks associated with such financial activities, such as the sufficiency or volatility of the reserve assets.

However, while the IOTA Foundation agrees with the principle “same activity, same risk, same regulation”, the FSB’s recommendations should highlight more clearly that different aspects of the crypto-asset ecosystem have very different risk profiles and offer very different safeguards and mechanisms to prevent risks.

Crypto-asset regulations should clearly differentiate between different types of crypto-asset activities. For example, regulations that apply to centralised service providers should not and cannot be directly extended to DeFi protocols, DAOs or personal wallet providers for several reasons. While DeFi protocols may offer similar financial activities as some centralised service providers, DeFi protocols are inherently more transparent and auditable than closed, centralised services, and therefore have a different risk profile (please see questions 6 and 7 for further comments on this point).

3. Is the distinction between GSC and other types of crypto-assets sufficiently clear or should the FSB adopt a more granular categorisation of crypto-assets (if so, please explain)?

In general, the distinction between GSCs and other types of crypto-assets appears to be clear. However, please refer to the comments above in relation to decentralised services.

4. Do the CA Recommendations and the GSC Recommendations each address the relevant regulatory gaps and challenges that warrant multinational responses?

IOTA Foundation welcomes the FSB’s work to establish regulatory clarity and cross-border collaboration. The recommendations do address the relevant regulatory gaps that are of concern now. However, further cooperation is needed since new use cases and legal scenarios will arise as the crypto-asset market evolves.

5. Are there any financial stability issues that remain unaddressed that should be covered in the recommendations?

Please see the comments below regarding the need for a clearer distinction between centralised and decentralised activities.

Crypto-assets and markets (CA Recommendations)

6. Does the report accurately characterise the functions and activities within the crypto-ecosystem that pose or may pose financial stability risk? What, if any, functions, or activities are missing or should be assessed differently?

The characterisation of the issues and challenges within the crypto-ecosystem would benefit from a more detailed discussion about the benefits of self-custodial services and decentralised services. It is important to underline that the risks and safeguards associated with centralised services are different from the risks and safeguards associated with DeFi protocols and self-custodial crypto-asset services. Therefore, the regulatory approach should also distinguish between different types of crypto-asset services. For example, personal wallet solutions are integral for ensuring security of funds and to safeguard the privacy of users. Considering the recent failures by centralised service providers, such as FTX misusing customer funds, it is clear that personal wallets and decentralised services will continue to play an important role in the crypto-asset industry. Personal wallets also act as the gateway to innovative services such as decentralised applications and other Web3 services.

Decentralisation, transparency and the ability to self-custody crypto-assets add security, which may be lacking in the context of centralised services. Therefore, the risks in DeFi and self-custodial crypto-asset services are not the same and should not be regulated the same way as traditional, centralised finance services.

In particular, the FSB's Recommendation 2 "General regulatory framework" would benefit from a clearer distinction between centralised and decentralised services. The IOTA Foundation recommends a more nuanced approach to the regulation of such services. Where the activities are different and the risk-profiles are different, the regulatory approach must also be different. In this regard, the IOTA Foundation regrets the FSB's overly broad statement at the end of Recommendation 2 that:

"Regardless of whether crypto-asset activities are conducted in decentralised structures or other ways that frustrate the identification of a responsible entity or an issuer of the crypto- assets, authorities should adopt or have in place a regulatory approach that aims at adequate protection for all relevant parties, including consumers and investors, and aims at achieving the same regulatory outcome."

While regulatory supervision and obligations are warranted in the context of centralised crypto-asset services, the same supervision and obligations should not automatically be

extended to decentralised services. For example, reporting and disclosure obligations may be necessary in the context of centralised crypto-asset services, but the same obligations may not be appropriate for decentralised services. For example, DeFi lending systems do not pose the same counterparty risk as in traditional financial systems, because the collateral is openly visible and liquidations take place automatically in accordance with pre-defined criteria. In addition, the use of smart contracts enables lenders to retrieve collateral automatically, without the need to involve third parties. Therefore, DeFi protocols inherently solve many of the trust and transparency issues that exist in traditional finance. With this in mind, regulatory proposals should adopt a nuanced approach that recognises the decentralisation, transparency and traceability provided by public distributed ledger technologies.

7. Do you agree with the analysis of activity patterns and the associated potential risks?

The IOTA Foundation agrees with the general analysis made by the FSB, but calls for a more considered review of the specific risks and safeguards applicable to DeFi.

As mentioned above, the transparency, automation and decentralisation offered by DeFi make it distinct from more traditional financial services. On the other hand, DeFi comes with a different set of risks. Below we present one way to categorise the risks in DeFi:

- 1) **Infrastructure risks:** these relate to the underlying distributed ledger technology, such as attacks or failures on the network itself.
- 2) **Protocol risks:** these relate to the errors in the smart contracts and problems with the information received from oracles.
- 3) **Market risks:** these relate to price volatility and overall market sentiment, as well as risks stemming from interconnectedness and potential cascade of liquidations. The pseudonymity of DLT transactions also creates its own set of risks, such as the risk of money-laundering which can be overcome with self-sovereign identity solutions.

8. Have the regulatory, supervisory and oversight issues and challenges as relate to financial stability been identified accurately? Are there other issues that warrant consideration at the international level?

In general, yes. However, the report would benefit from a more detailed assessment of the risks and safeguards associated with DeFi.

9. Do you agree with the differentiated requirements on crypto-asset issuers and service providers in the proposed recommendations on risk management, data management and disclosure?

We welcome the FSB's recommendation that authorities should differentiate between crypto-asset issuers and service providers and apply regulatory approaches that are appropriate and proportionate in each specific case. While certain regulatory and risk-management obligations may be warranted in relation to certain service providers, such as centralised crypto-asset exchange services and custodial financial services, the same regulatory obligations should not automatically apply to issuers, or decentralised and non-custodial services, because of the different risk-profiles associated with each one.

10. Should there be a more granular differentiation within the recommendations between different types of intermediaries or service providers in light of the risks they pose? If so, please explain.

Yes, the IOTA Foundation recommends a granular differentiation between different types of intermediaries and service providers in the crypto-asset industry. The different aspects of the crypto-asset ecosystem should not be treated the same since very different risk-profiles and levels are associated with the various number of crypto-asset service providers. Also, the definitions of decentralised finance and the scope of obligations applicable to different types of decentralised activities should be more granular.

Global stablecoins (GSC Recommendations)

11. Does the report provide an accurate analysis of recent market developments and existing stablecoins? What, if anything, is missing in the analysis or should be assessed differently?

The report provides a good overview of some of the developments in the market, especially regarding the collapse of Terra (UST) and Luna. However, we would urge the FSB to differentiate more clearly between different market segments. Most of the market turmoil that unfolded in 2022 was caused by failures and mismanagement by centralised market operators, such as Celsius and FTX. These failures and wrongdoings were enabled by a lack of transparency, which is endemic to centralised operators, unlike decentralised ones.

12. Are there other changes or additions to the recommendations that should be considered?

Please refer to the comments above.



13. Do you have comments on the key design considerations for cross-border cooperation and information sharing arrangements presented in Annex 2? Should Annex 2 be specific to GSCs, or could it be also applicable to crypto-asset activities other than GSCs?

In our opinion there is a need for further international collaboration and information sharing between authorities in different jurisdictions, not only in relation to GSC, but also crypto-asset activities other than GSCs, in order to provide clarity and avoid regulatory fragmentation.

14. Does the proposed template for common disclosure of reserve assets in Annex 3 identify the relevant information that needs to be disclosed to users and stakeholders?

In general, yes, however more clarity is needed about how the information should be disclosed. For example, the template does not mention how potential crypto-assets held by the GSC should be disclosed and whether such disclosure should include the wallet addresses of the relevant holdings.

15. Do you have comments on the elements that could be used to determine whether a stablecoin qualifies as a GSC presented in Annex 4?

We have no additional comments on this point.

We thank you for the opportunity to provide comments and stand ready to work with you on any future proposals related to the crypto-asset industry. If you have any questions regarding our comments, we would be pleased to discuss them with you directly. Please feel free to contact us at legal@iota.org for any further information.