Response to the Consultative Document "Second consultation on the prudential treatment of cryptoasset exposures - June 2022"

Flow Traders appreciates the opportunity to comment on the consultative document titled "Second consultation on the prudential treatment of cryptoasset exposures - June 2022" (hereafter: CD-CAE). Flow Traders is an investment firm, licensed by the Dutch Authority for the Financial Markets for trading on its own account, and holds a registration by the Dutch Central Bank as a cryptoassets service provider.[1] We are a global liquidity provider in cryptoassets. The discussions within the Basel Committee (hereafter: BC) and this CD-CAE are again very timely. As stated last year, and despite volatile market conditions, we find ourselves at a pivotal moment for the adoption of innovative technologies that will improve capital markets by verifiable and transparent information, higher efficiency of clearing and settlement and more liquidity. Collectively, this will lead to more stability in the financial system.

Assurance of progress

Cryptoassets possess a range of characteristics. Certain cryptoassets serve as payment tokens or coins, while others are manifestations of currently tradable, regulated, financial instruments. Flow Traders sees great potential and societal benefit in security tokens that serve as tradeable digital assets, comprising an exposure to underlying traditional assets. Viable traditional instruments have emerged that provide investors with exposure to underlying digital assets, such as exchange-traded derivatives and Exchange Traded Products (hereafter: ETP). Over the past years, we have witnessed this wider adoption of cryptoassets in the financial sector, notably through the approval and listing of ETPs in Canada, Brazil, Germany, France and Switzerland. Whilst the SEC has been notably more reluctant to approve a spot based ETP, the launch and success of US Crypto Investment funds like Grayscale and the listing of Coinbase stock on the NASDAQ in April 2021 are an additional testament to this movement of institutional adoption.

Digital assets and distributed ledger technology (hereafter: DLT) platforms will substantially improve transparency of information, automation, distribution and liquidity, thanks to the emergence of new digital assets that promise greater stability, wider acceptance and increase the number of possible use-cases.[2] Adoption of cryptoassets is expanding beyond the first niche application of cryptocurrencies, with DLT removing many sources of inefficiency. We also note a movement towards decreasing potential environmental impact, most recently with 'The Merge' of Ethereum, in which the two main Ethereum blockchains merged into one and became 99.95% more energy efficient.[3] Market participants, as well as regulators and legislators should focus on enabling, participating and fostering these innovative and groundbreaking developments because there is a large societal benefit for many connected to these new technologies, such as self-determination of means of payment, financial inclusion and wealth building, direct international transfer of assets and participating in economic development in regions and worldwide through investments.[4]

[1] As an investment firm operating in the EU we have to comply with IFR and IFD. These regulatory prudence standards were derived from and contain many similarities with the Basel banking framework. We are therefore of the opinion that our insights can contribute to possible new standards for cryptoassets for banking. We are afraid that without further impact assessment, these rules will go against the proportionate approach envisaged therein.
[2] See for: 'For Digital Assets, Private Markets Offer the Greatest Opportunities', Bain & Company, Mike Kühnel, Thomas Olsen, John Filder and Karl Gridl, 16 December 2020; 'How to audit the next generation of digital assets', EY, Jeanne Boillet, 30 January 2020; 'Are you reframing the future of asset management or is it reframing you?', EY, Alex Birkin, Mike Lee, Natalie Deak Jaros, Jun Li and Elliot Shadforth, 15 June 2021.
[3] 'The Ethereum Merge is Done, Opening a New Era for the Second-Biggest Blockchain, Coindesk, Sam Kessler, 15 September 2022.
[4] 'How governments can harness the potential of blockchain', McKinsey, Ameep Pandey, 6 November 2020.

Technology and Regulatory evolution

In this comment letter we will highlight our main observations and concerns, address the request for specific feedback from the CD-CAE and present our recommendations. We appreciate the opportunity to contribute to the ongoing discussions in the BC regarding an adequate prudential treatment for cryptoassets. Generally, we believe an iterative approach to develop the framework is important to account for the pace at which the crypto asset markets and the technologies evolve. We share the BC's observation that the cryptoasset market remains small relative to the size of the global financial system, but that its absolute size is meaningful and the increased attention from a broad range of stakeholders shows its potential. Moreover, this would also allow a differentiating assessment of individual types of cryptoassets for which currently no common taxonomy is established. Considering the many characteristics of cryptoassets is essential for a sound regulatory framework. Commonly, cryptoassets use cryptography, peer-to-peer networks and DLT to create, verify and secure transactions. Tokens exist today that earn interest or provide another kind of return on investment which makes cryptoassets more similar to, for example, equities or commodities. We also share the opinion that having a relevant regulatory framework is important while at the same time acknowledging the need to create a level playing field for investments in different asset classes and support technological innovations. Cryptoassets can have different functions and characteristics: they may be used as a medium of exchange; a way to store value; or for other business purposes, like investment, or any expression of interest (like art or fan-coins). Cryptoassets can also display rights, responsibilities or additional ownerships, both one-off and repetitive. Lastly, the Basel Committee should also monitor and take into consideration developments in its member jurisdictions to ensure a level playing field across jurisdictions and to avoid regulatory and taxonomy mismatches with applicable law.

Essential design for regulation

This brings Flow Traders to a crucial comment regarding the CD-CAE, which we have also made regarding the previous Consultative Document. We are convinced that the general principle **'Same risk, same activity, same treatment'** is essential in designing a balanced prudential treatment for cryptoassets exposures. Unfortunately, we believe that the elaboration of this general principle in the CD-CAE is still inconsistent. Even though we know that the Basel Framework proposals are aimed at banks, in some jurisdictions, such as the EU, the scope of the proposed framework might also be extended to investment firms such as Flow Traders. We would like to emphasize that investment firms trading on own account have a much lower risk profile than banks. Investment firms trading on own account do not hold client or third-party assets, which is accompanied by a fundamentally different risk profile. Consistent use of the general principle, although reversed (different risk, different activity, different treatment), would support an appropriate regime for these types of investment firms. Moreover, in the European context we would urge caution against applying these rules one-for-one to investment firms, without proper impact analysis and expediency assessment. A consideration in this respect from the BC would be very welcome for many stakeholders.

I. Main concerns and recommendations

As a principle, Flow Traders believes that where there is an equivalent exposure or function, digital assets should be treated the same as their non-digital equivalents. This holds for market regulation as well as prudential regulation. Above all, applying the currently proposed prudential approach to cryptoassets will

lead to overly onerous capital requirements pushing the services and activities relating to cryptoassets - including the opportunities for innovation - away from the regulated financial industry into unregulated entities and sectors. Notwithstanding the CD-CAE's apparent stance that the industry around crypto-assets should be curbed, such an innovative, forward-looking societal trend cannot be meant to be completely unregulated and away from lit markets.

This second consultation document already shows improvement in particular areas, such as in the recognition of the trading versus banking book. However, the CD-CAE does not show improvement in other areas, on which we would like to share our view supported by the following points:

1. The 1%-exposure Tier 1 limit on Group 2 cryptoassets
2. 100% capital charge
3. Capitalizing net positions
4. Infrastructure risk add-on
5. Refinement of classification conditions

In the CD-CAE we identified three specific feedback requests:

i. The Committee would welcome feedback on the structure and specification of these tests (in SCO60.12 to SCO60.16) - This question is addressed in paragraph I.5.

ii. The Committee welcomes feedback on the alternative to the basis risk and redemption risk tests, including the type of regulation that should be applied and level playing field considerations - This question is addressed in paragraph I.2 and I.5.

iii. The Committee would welcome feedback on: (1) what modifications to the classification conditions would be required to permit the inclusion in Group 1 of cryptoassets that use permissionless blockchains; (2) the risk such modifications would raise; and (3) ways to mitigate such risks - This question is addressed in paragraph I.4 and I.5.

Based upon our assessment of risks and opportunities to improve the proposal, we include our recommendation for each of the points.

1. The 1%-exposure Tier 1 limit on Group 2 cryptoassets

The most concerning and perhaps most devastating proposal in the CD-CAE is the newly added provisional exposure limit of 1% of Tier 1 capital. According to SCO60.122, a banks's exposure to Group 2 cryptoassets should be limited to 1% of the institution's Tier 1 capital. And according to SCO60.124, this exposure should be measured as the sum of all individual gross long and short positions. The CD-CAE does not provide any rationale or justification for this low maximum exposure limit, how such a number was reached or why such a drastic measure was deemed appropriate. This measure will prevent many established institutions from entering the market for cryptoassets. As an example, an institution with EUR 1 billion in Tier 1 capital would already reach its exposure limit with EUR 5 million in long positions in cryptoassets, hedged with EUR 5 million in short positions in related instruments, ultimately going flat on its real market exposure. We do not understand why the calculation of the total exposure to Group 2 cryptoassets does not take into account netting rules similar to the netting rules of the calculation of market risks. It is worth mentioning that the similar financial sector entity exposure limit of the Basel III regulation

has much higher limit value (10%) and allows for netting in the exposure calculation. Similarly, the EBA Guidelines on shadow banking exposures and hedge funds, for example, which could be considered as addressing equally risky and speculative investments as cryptoassets, do not impose such a strict limit but have a limit of net exposures equal to 25% of the Tier 1. Therefore, we consider that this limitation to 1% of Tier 1 capital does not reflect current supervisory practices and has not been fully substantiated in the CD-CAE.

Additionally, we strongly recommend not to use the methodology of a cap on exposure for *trading* cryptoassets. An investment firm trading on own account has several ways to mitigate the risk of trading. For example, positions can be crossed against each other or hedged. A trade can also take place directly at zero risk because a counter trade takes place or an opportunity of arbitrage between venues occurs. Market making in cryptoassets does not differ from the same activity in other asset classes. Bearing in mind the principle of 'same risk, same activity, same treatment', and noting other assets classes also do not use exposure caps as a risk limiting factor, we see no reason to apply the methodology of cap on exposure for trading cryptoassets.

As stated, this exposure limit will prevent many institutions from entering the market for cryptoassets at all. We feel however that the participation of established financial institutions in the market for cryptoassets is exactly what this market needs for it to become a more mature market where regulated firms and institutions play a large role. This would increase stability in the market and will create better self-steering risk mitigating market practices. Regulators should support this development of the crypto asset market instead of ending an era of innovation by preventing established financial institutions to assist in building a mature market showing societal benefits. We also believe that the addition of *"…indirect holding (i.e. those via investment funds…)*" on the scope of this exposure limit is too limiting. Many financial institutions, Flow Traders including, take an equity stake in FinTech start-ups or building innovative DLTs. We are concerned, that this role in the ecosystem of enabling innovation should not be captured by the CD-CAE.

The above leads to our first and most essential recommendation.

We recommend withdrawing the proposal for an exposure limit. Alternatively, an exemption for proprietary trading firms which deal on own account, do not have clients and work with a much smaller balance sheet, would also address the problem of the overly burdensome and detrimental exposure limit for proprietary trading firms.

2. 100% capital charge

Although now framed as a 100% capital charge for group 2 cryptoassets, the risk weight of 1250% remains the basis assumption in the CD-CAE. As also raised by many market participants in response to the previous Consultative Document, this assumption should be re-assessed and aligned with current Basel Framework risk weights for other, equivalent, assets as it is not proportionate to the underlying risk and does not reflect the overall impact of cryptoassets on the global financial markets and of cryptoassets that are matured, established and traded on liquid markets and have internal governance controls. A risk weight has been chosen to be 100% for all Group 2a cryptoassets in the standardized approach (60.71-60.78) which means a simulation of a +100% increase and a decrease to 0 value needs to be carried out for the

calculation of the curvature risk. Such extremely prudent market risk scenarios for all Group 2a cryptoassets, including the most liquid Bitcoin and Ether, seems to be unjustified.

We would suggest classifying cryptoassets as 'equity' or, depending on the characteristics of the cryptoasset, as 'commodities' within the Basel Framework. Over the years, several regulators have expressed their opinions regarding the classification. The US Securities and Exchange Commission (SEC) by its chair's testimony in front of the Banking Committee in the US Senate presented the view that cryptoassets should mostly be seen as equity.[5] In an enforcement action by the US Commodities Futures Trading Commission (CFTC) in 2015, cryptoassets have been defined as commodities under the US Commodity Exchange Act (CEA).[6] The CEA's text defines commodity generally and categorically 'not by type, grade, quality, brand, producer, manufacturer or form'.[7] The CFTC considers Bitcoin and Ether as commodities because they can be freely traded on traditional asset markets as well as cryptocurrency exchanges. The Bank of England Prudential Regulation Authority echoes this approach, stating that firms may look to the commodity framework to inform appropriate diversification and hedging methodologies.[8] We agree with these regulators that the characteristics of the cryptoassets, mentioned in our paragraph 'Technology and Regulatory evolution', primarily defines its classification.

Our recommendation:

Based upon the characteristics of a cryptoasset, an appropriate classification within the Basel Framework would be under the 'equity' or 'commodity' approach.

For operational risk, an add-on should be considered which would not exceed the risk weight of existing risk weight calculations for other asset classes. This is particularly important as the advanced modelling approach (AMA) has been replaced by the new standardized approach (SMA) under Basel II. There is limited discretion for banks and other firms to use AMA models for the purposes of the internal capital adequacy assessment (ICAAP) or similar processes. The new SMA approach does not appropriately account for digital assets as it is based on more traditional banking business models. In addition, the SMA utilizes a combination of a rudimentary business indicator component (BIC) and an indicator incorporating the firm's loss history; this does not incorporate any of idiosyncrasies of the digital asset class or its underlying technologies.

3. Capitalizing net positions

Also already included in the 2021 consultation response is capitalizing net positions in cryptoassets. This is appropriate, as market makers provide liquidity, trading with the price differences between the different types of crypto ETPs on the different types of trading venues while keeping the net exposures in the cryptoassets flat. Although the new proposal by the Basel Committee is helping market makers to execute their functions, it is still insufficient to rise to ultimate market efficiency. Especially the SCO 60.60 under 2,

5 'Testimony of Gary Gensler Before the United States Senate', Committee on Banking, Housing and Urban Affairs, 15 September 2022. Chairman Gensler also stated this in a speech on September 8, 2022; please see https://www.sec.gov/news/speech/gensler-sec-speaks-090822#_ftn2.
6 In the Matter of: Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29.
7 'Cryptocurrency as a Commodity: The CFTC's Regulatory Framework', GLI - Fintech 2020, Second Edition, Allen & Overy LLP, David Lucking and Vinod Aravind, 2020.
8 'Letter from Sam Woods 'Existing or planned exposure to cryptoassets', Bank of England, Sam Woods, 24 March 2022.

stating the reference to highly liquid underlying ETFs/ETNs, is too restrictive. With this requirement, many well-established cryptoassets are excluded.

Our recommendation:

We recommend creating at least an appropriate scale of liquidity levels which would be acceptable for this requirement diverged to the crypto asset, derivative or underlying ETF/ETN.

4. Infrastructure risk add-on

The infrastructure risk add-on to risk-weighted assets (RWA) for all Group 1 cryptoassets has not been requested by the market as the infrastructure risk of the group of cryptoassets because the use of DLT is limited and well identified in the market. There is no need for additional covering besides market-driven risk mitigating actions. This might only diminish the trading opportunities in these group 1 cryptoassets.

Our recommendation:

We recommend withdrawing this proposal for an infrastructure add-on. We agree with the statement made in the consultation paper that the technology is new and evolving, however we do not agree that this would necessarily entail the application of an infrastructure add-on. It is useful to remember that when other new technologies were introduced, i.e. cloud technology, institutions have never been subject to an infrastructure risk add-on. In our opinion, there are better ways to manage any risk arising from the technology then applying a flat 2.5% capital add-on. Especially given that the classification conditions for group 1 assets are already very strict.

5. Refinement of classification conditions

The refinement of the classification conditions, leading up to the redemption risk and basis risk tests might tackle some concerns raised previously. However, the 'narrowly passed' risk add-on seems to be overly burdensome in preventing the quality of the outcome of the basis test, erodes confidence in the basis risk test and might create less transparency and trust in the stablecoins in Group 1. It is very restrictive and it would be very difficult to 'fully pass', being the 'narrowly passed' or 'failed' the more probable outcomes. A clear set of criteria should define whether a cryptoasset classifies as a stable coin. The use of permissionless blockchain on itself should not be detrimental to be excluded in Group 1 and the peg-to-market difference in the basis risk test should be relative to market volatility over the same period. Otherwise, a short period of spikes in a period of 12 months could cloud the outcome of the basis test.

Our recommendation:

We recommend an appropriate adjustment of the redemption risk and basis risk tests (SCO60.12 - 60.14) (I) to ensure a fair and level playfield between regulated and unregulated firms and (II) to ensure that obligations that the banks or firms are able to perform these tests are not overly cumbersome, impractical and not subject to manipulation by unregulated entities providing cryptoassets.

The onus is on the bank to ensure that the cryptoasset arrangements are appropriate especially around the reserve assets and monitoring the market value of the cryptoasset. The first matter of reserve assets in regard to the redemption test is subject to information shared by the issuer of the cryptoassets. This information may not be audited, not easily available to cross-check or potentially misleading as it may be coming from a cryptoasset issuer that is not regulated.

The monitoring of market value on unregulated platforms and/or of unregulated cryptoasset issuers may be more open to market manipulation leading to a false positive classification by a bank as Group 1.

This leads to several potential unintended consequences. Firstly, the expansion of the supervisory perimeter by using banks or firms to supervise the unregulated part of the cryptoasset sector, where there is no legal power or enforcement actions available to the firm, only the ability not to classify as Group I, is unwanted. Secondly, each bank and/or firm will have to carry out these tests for unregulated cryptoassets and issuers. This leads to a significant duplication of effort and use of unnecessary resources, where this could be centralized into one repository or a few in key regions. This is not systematically efficient and will hamper growth in this innovative asset class.