Regulatory Alert

Regulatory Insights for Financial Services

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Crypto and Digital Assets: Focus on supervision and regulation

KPMG Insights: *Amidst evolving public policy attention, and despite, or perhaps because of, recent downturns in the crypto and digital assets markets, regulators continue to caution on the associated risks as they seek to establish supervisory and regulatory guardrails and Congress considers bills to establish jurisdictional authorities. In a flurry of activity, U.S. and global regulators and standards setters have released, individually and collectively, a variety of reports, frameworks, roadmaps, guidance, and speeches on the need for enhanced oversight and regulation in the crypto and digital assets markets. Many advocate "same activity, same risk, same regulation" and call for a coordinated international approach, though few new legislative or regulatory requirements are yet in place or expected in the near term. Entities offering crypto and digital asset products or engaging in related activities should anticipate ongoing and likely increasing regulatory scrutiny, both domestically and internationally, as well as the potential for evolving and divergent expectations across jurisdictions.*

U.S. financial services regulatory agencies and international standards setters alike are recognizing a need to establish regulatory parameters and investor/consumer protections tailored to crypto and digital assets. Recent statements and actions from the following sources are highlighted below:

1. Federal Reserve Board (FRB)
2. U.S. Department of the Treasury (Treasury)
3. Financial Stability Board (FSB)
4. Committee on Payments and Market Infrastructures (CPMI)
5. Basel Committee on Banking Supervision (BCBS)
6. International Organization of Securities Commissions (IOSCO)

1. FRB. In recent remarks, the FRB suggests:

— Volatility in the markets has exposed vulnerabilities in the crypto financial system that make it susceptible to the same risks that are present in traditional finance, including leverage, settlement, opacity, maturity, and liquidity.

— Despite significant investor losses, the crypto financial system does not yet appear to be so large or so interconnected with the traditional financial system as to pose a systemic risk, making this the right time to establish strong guardrails for safety and soundness, market integrity, and consumer/investor protections while also accounting for the "novel challenges" that are unique to crypto activities.

— "Future financial resilience will be greatly enhanced if we ensure that the regulatory perimeter encompasses the crypto financial system and reflects the principle of same risk, same disclosure, same regulatory outcome."

— The cross-sectoral and cross-border scope of crypto platforms, exchanges, and activities reinforces the need for domestic and international regulators to work together, when considering the risks posed by crypto assets, stablecoins, and decentralized finance.

2. Treasury. In response to the Administration's March 2022 executive order on ensuring responsible development of digital assets, the Treasury, in collaboration with other regulatory agencies, published a framework for international engagement on digital assets. The framework outlines key international forums where the U.S. is actively engaged in work on digital assets and related technical innovations, including the G7, G20, FSB, Financial Action Task Force (FATF), and International Monetary Fund (IMF). The principal policy objectives of this work address:

— Consumer, investor, and business protection

— Financial stability and systemic risk
— Responsible development of payment innovations and digital assets
— Illicit finance and national security
— Financial system connectivity and platform and architecture interoperability
— Safe and affordable access.

3. FSB. Acknowledging the "intrinsic volatility," "structural vulnerabilities," and increasing interconnectedness of the crypto assets markets, the FSB warns that failures of crypto assets and stablecoins could potentially have spill-over effects on vital parts of traditional finance system such as short-term funding markets. The FSB advocates effective oversight and regulation for crypto assets and markets in line with the principle of "same activity, same risk, same regulation."

FSB plans to issue two reports to the G20 in October 2022:

— A review of the FSB's high-level recommendations for the regulation, supervision, and oversight of "global stablecoin" arrangements (see October 2020 report here)
— Proposed recommendations for "promoting international consistency of regulatory and supervisory approaches to other crypto assets and crypto asset markets and strengthening international cooperation and coordination."

4. CPMI and others. The Bank for International Settlements (BIS) CPMI, along with BIS Innovation Hub, IMF, and the World Bank, published a joint report on how central bank digital currencies (CBDCs) could potentially enhance cross-border payments. The report identifies relevant options for access and interoperability of CBDC systems and assesses those options in the context of five criteria: i) do no harm, ii) enhance efficiency, iii) increase resilience, iv) assure coexistence and interoperability with non-CBDC systems, and v) enhance financial inclusion. The report notes that a quarter of central banks are developing CBDCs primarily to meet domestic policy objectives and encourages all central banks to evaluate multiple options to prevent creating unintended barriers to cross-border functionalities.

5. BCBS. The BCBS issued a second consultative document on the prudential treatment of banks' crypto asset exposures, building on comments received in response to the initial consultation released in June 2021. The updated proposal would establish a new chapter in the Basel Framework for cryptoasset exposures and considers new approaches in the areas of capital requirements, hedging criteria, operational risk, liquidity risk, and exposure limits.

6. IOSCO. The IOSCO published its Crypto-Asset 2022-2023 roadmap noting plans to publish policy recommendations in 2023 related to market integrity and investor protection in the areas of:

— *Decentralized finance* (DeFi): looking at links between DeFi, stablecoins, and crypto asset trading, lending and borrowing platforms, and the broader financial markets. (The Securities and Exchange Commission will lead the project.)
— *Crypto and Digital Assets* (CDA): looking at (i) fair, orderly trading, transparent markets, suitability and market manipulation; and (ii) safekeeping, custody and soundness. (The UK Financial Conduct Authority will lead the project.)

IOSCO and CPMI. The IOSCO and CPMI published joint final guidance on applying the principles for financial market Infrastructures (PFMI) to certain stablecoin arrangements (SAs). The report suggests that when used as a means of payment, the transfer function of an SA is comparable to the transfer function performed by other types of financial market infrastructures (FMIs) thus application of the PFMIs is a step toward "same risk, same regulation."

You might also find these of interest:

— KPMG Regulatory Insights POV: Assessing crypto and digital asset risks
— KPMG Regulatory Insights POV: Mid-year regulatory reflections
— KPMG Regulatory Alert: Crypto and Digital Assets: Increasing regulatory momentum

For additional information, please contact Amy Matsuo or Damian Plioplys.

Contact the author:

Amy Matsuo
Principal and Leader
Regulatory and ESG Insights
amatsuo@kpmg.com

kpmg.com/socialmedia

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