ISDA® Safe, Efficient Markets

Developments in Crypto Derivatives
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Opening Remarks
Scott O'Malia, ISDA Chief Executive

Hello everyone, and welcome to ISDA's Developments in Crypto Derivatives event. Thank you for joining us today, and thanks to our speakers and panelists.

The crypto assets market has been growing at an astonishing pace and is increasingly attracting the attention of institutional investors and banks – and policy-makers too. Yesterday, President Biden signed an executive order calling for measures in six priority areas to ensure the US maintains technological leadership in this rapidly evolving space while also addressing potential risks.

Alongside this rapid growth in digital assets, we have seen strong interest in crypto derivatives. As in any market, over-the-counter (OTC) derivatives play a vital role in enabling participants to manage risk, deepening liquidity and broadening market access.

For more than 35 years, ISDA has worked with industry participants to establish the foundations to support OTC derivatives markets – for example, by developing legal standards and documentation and advocating for a risk-appropriate capital framework. We're now bringing this experience to bear in the crypto market.

As in the past, we're working with participants from all corners of the market, in this case including firms that are specifically focused on crypto assets. Our overall objective is also unchanged: to foster safe and efficient derivatives markets.

In my remarks today, I'll briefly touch on two specific aspects of our work – our efforts to develop contractual standards for crypto derivatives, and our work with regulators to establish an appropriate capital regime for crypto assets.

Contractual standards

I'll start with contractual standards.

Up until now, digital asset derivatives have been largely traded using amended versions of existing ISDA definitions and templates, or completely bespoke documentation. This lack of standardization is not sustainable and may mean the unique features of the crypto assets market are not adequately captured by the documentation.

Developing legal standards is in ISDA's DNA, but it's worth pausing to remind ourselves why standards are so important. Standardized documentation allows market participants to use agreed templates when negotiating trades, resulting in more consistency and less divergence. This, in turn, promotes greater efficiency, deeper liquidity and reduced risk. It also means users can reap the risk mitigation benefits of netting and collateralization.

Last year, we established the ISDA Digital Assets Legal Group and, in December, we published a paper that explores the key issues that need to be addressed in any contractual standards for OTC crypto derivatives.

For example, there are several distinctive features and events that need to be considered in any standard derivatives documentation. These include forks, where a blockchain is upgraded or modified, which can change the nature of the blockchain or lead to the creation of two distinct crypto assets. Depending on the type of transaction, these events could impact valuation or settlement. It is therefore important that the documentation takes these events into account, identifies and defines any scenarios under which contractual adjustments need to apply, and describes the impact on a transaction.

We're now looking closely at how these events and other specifics of crypto assets should be addressed in contractual standards, and how those standards should be integrated within the existing ISDA documentation architecture, particularly the ISDA Master Agreement.

Our priority is to develop standard terms for products that are already traded, such as cash-settled forwards and options referencing Bitcoin and Ether. We will then seek to expand these definitions to additional product types, such as physically settled trades on digital assets, depending on member demand.

These standards will be designed to integrate seamlessly within the infrastructure used to support this market, and in a manner that promotes interoperability between different distributed ledgers and platforms. As part of that, ISDA will aim to create templates and definitions that support the development of on-chain smart contracts for crypto derivatives.

This is a fast-evolving area, and I hope to further update you on our progress later in the year. In the meantime, we'll continue to engage closely with all market participants, including our newest crypto asset members, and we encourage other market participants interested in joining the conversation to get in touch by emailing ISDALegal@ISDA.org.

Capital

I'll now turn to the capital treatment of crypto assets.

We believe having an appropriate, risk-sensitive capital framework for crypto assets is essential. This provides suitable incentives for innovation and allows banks to meet customer demand for certain products, while ensuring capital levels are proportionate to the underlying risks. If capital requirements for a particular asset are too punitive, this will discourage banks from participating in that business and may stifle competition and innovation.

Unfortunately, we think the Basel Committee's proposals for crypto assets could do just that. Its June 2021 proposals would divide crypto assets into those that are broadly eligible for treatment under the existing Basel framework and those such as bitcoin that would be subject to a simple but deliberately conservative prudential treatment.

ISDA submitted a detailed response to the consultation together with several other trade associations and we expect a further consultation from the Basel Committee this year.

If the proposed conservatism of the framework is not modified, we should be in no doubt about the consequences – it will discourage banks from participating in this market. Bank clients wanting crypto exposure will therefore have no choice but to use firms not subject to prudential supervision.

As the Basel Committee further develops its proposals, we will continue to provide as much support and analysis as we can. We believe there is benefit for banks – with their long track record in managing risk and intermediating in financial markets – to play a meaningful role in this market, in line with increasing client demand.

Conclusion

In summary, this is a fast-evolving area, and ISDA is committed to working with members, policy-makers and those active in the crypto community to develop a safe and efficient crypto derivatives market. We are delighted to have welcomed several crypto firms to ISDA's growing membership in recent months and we look forward to working with them.

At today's event, we are fortunate to have a diverse group of market participants, policy-makers and legal professionals who will share their perspective on the key issues I have covered in these remarks.

To start with, I'm pleased to welcome Greg Damalas, senior manager for capital markets and digital assets at EY, who will give an update on the crypto derivatives market today.