ISDA Safe, Efficient Markets

ISDA RESPONSE TO HM TREASURY CONSULTATION AND CALL FOR EVIDENCE ON THE FUTURE FINANCIAL SERVICES REGULATORY REGIME FOR CRYPTOASSETS

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Response to HM Treasury Consultation and Call for Evidence on the Future Financial Services Regulatory Regime for Cryptoassets

Summary

1. The International Swaps and Derivatives Association, Inc. ("ISDA") welcomes the opportunity to respond to this consultation.

2. We agree that cryptoasset markets continue to develop with increasing pace and complexity, bringing risk as well as opportunity. Crypto derivatives are now widely available in both exchange-traded and over-the-counter (OTC) format. As in any wholesale market, derivatives have a vital role to play in broadening market access, facilitating risk management and price discovery, deepening liquidity, and providing greater certainty and flexibility to market participants. ISDA is playing a vital role in bringing standardization and digitization to promote the growth of safe, efficient and liquid markets in digital asset derivatives.

3. Equally, the collapse of crypto exchange FTX with the apparent loss of billions of dollars of customer assets, and the subsequent failures of several other high-profile crypto firms, have raised some fundamental legal questions. For example, what rights do investors have following a bankruptcy and who legally 'owns' customer assets held by a crypto exchange or other intermediary? These questions should have clear answers, and ISDA's work to develop legal definitions for the trading of digital asset derivatives, alongside the publication of new Whitepapers that explore the legal issues exposed by the collapse of FTX and others, are important steps towards achieving that for the digital asset derivatives market.

4. ISDA – alongside other trade associations – is also contributing to the development of international prudential standards that support enhancing financial stability while avoiding overly restrictive limits to innovation.

5. This response does not address questions in the consultation directly but provides an overview of the work ISDA has completed and continues to develop to support safe and efficient digital asset derivatives markets. We hope you find it helpful in understanding the broader context of crypto assets and the regulatory and legislative landscape in the UK.

6. We would welcome further discussion on any of these matters.

Managing risks – the legal issues exposed by the collapse of FTX and others

7. Fundamentally, we believe investors should always be clear on the rights they have following a default and should be confident their assets are protected. In most derivatives markets, many of these rights are set out in industry standard documentation, including the ISDA Master Agreement, which establishes a globally consistent contractual framework with clear provisions for execution, close out and settlement. ISDA has extended that to the nascent digital asset derivatives market with the publication of our Digital Asset Derivatives Definitions in January.[1] These establish an unambiguous, standardized contractual framework for digital asset derivatives under the umbrella of the ISDA Master Agreement that, among other things, spells out the rights and obligations of both parties following a market disruption.

8. In January, we also published the first of two whitepapers that delve into legal issues exposed by the recent crypto market failures. The first paper – Navigating Bankruptcy in Digital Asset Markets: Netting and Collateral Enforceability - focuses on the importance of close-out netting and collateral arrangements for digital asset derivatives as a means of reducing counterparty credit risk.[2]

9. The second paper - Navigating Bankruptcy in Digital Asset Markets: Digital Asset Intermediaries and Customer Asset Protection – to be published shortly, focuses on digital asset intermediaries and customer asset protection.

10. These papers underscore the centrality of enforceable property rights as a fundamental principle of customer asset protection, particularly in bankruptcy scenarios. Such rights are core tenets of the global financial system and central to the risk mitigation techniques and practices promoted by ISDA as part of our mission to foster safe and efficient derivatives markets. The papers recommend that rules governing ownership of digital assets on insolvency be made as clear as possible in order to protect customers, and that such rules afford customers the equivalent rights and protections that they would expect to have in respect of traditional assets.

11. The key findings from the papers are:

- **Enforceable property rights are a fundamental principle of customer protection, particularly in bankruptcy scenarios.** National authorities should have clear legal frameworks for defining the property status of digital assets and clear rules for the creation of security interests over digital assets. Fortunately, various jurisdictions, including England and Wales, have recognized digital assets as capable of being the subject of property rights.

- **The rules governing ownership of customer digital assets on insolvency of an intermediary should be as clear as possible in order to protect customers.** Digital asset investors expect the equivalent rights and protections that they would expect to have in respect of traditional assets

[1] https://www.isda.org/book/isda-digital-asset-derivatives-definitions/
[2] https://www.isda.org/a/mIxgE/Navigating-Bankruptcy-in-Digital-Asset-Markets-Netting-and-Collateral-Enforceability.pdf

(such as securities) or financial products (such as derivatives).[3] From an English law perspective, our analysis found that existing private law concepts (such as trusts) can be applied to protect customer assets upon insolvency and that existing insolvency regimes in the UK will apply to digital asset intermediaries, although the specific regime will depend on the nature of their legal and regulatory structure.

- **The risk reduction benefits provided by close-out netting rely upon clear treatment of digital assets in insolvency.** Initial analysis of relevant insolvency laws indicates that close-out netting in respect of digital asset derivatives is likely to be enforceable in certain major jurisdictions (including England and Wales). ISDA will help to provide that clarity to the market by working with opinions counsel to identify any areas where further clarity on the treatment of digital assets relating to derivatives is needed.

12. Both papers acknowledge that DLT presents some novel legal and practical questions as compared to traditional financial assets:

    - The operation of DLT may not always be consistent with the operation of existing laws that determine ownership of traditional financial assets, for example whether and when a DLT ledger entry will be conclusive of legal ownership and how a security interest can be perfected.

    - Identification and recovery of assets could be more challenging. For example, control of an intermediary's private keys for customer assets held on-chain will likely have special relevance in an insolvency scenario, requiring consideration of an operational issue that does not have a ready analogy in traditional finance.

    - Given their decentralised nature, it may not always be clear which governing law applies to the digital asset or how a proprietary claim to a digital asset be enforced in the relevant jurisdiction.

13. ISDA supports ongoing efforts of policy makers to understand and address these areas of tension to effectively adapt the legal framework to digital assets. Work by bodies such as the Law Commission in the UK is very welcome. On the conflict of laws issues specifically, ISDA supports efforts of international organizations to develop principles to determine which rules will govern the use of digital assets in derivatives and other financial products in the event of conflicts.

14. We encourage national authorities to work with international organizations (such as UNIDROIT) and industry stakeholders to develop coordinated approaches. ISDA has previously published analysis on this topic - Private International Law Aspects of Smart Derivatives Contracts Utilizing DLT (January 2020).[4] This whitepaper considers the conflict of law aspects of derivatives contracts involving DLT including those governed by the laws of England and Wales.

Promotion of digital standards

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[3] While sophisticated market participants – including participants in the privately negotiated derivatives market – may decide to accept a lower level of protection, they should always be clear on how their assets will be protected in insolvency.

[4] https://www.isda.org/a/4RJTE/Private-International-Law-Aspects-of-Smart-Derivatives-Contracts-Utilizing-DLT.pdf

New technologies

15. The operating structure of financial markets has been fundamentally altered by regulatory reforms introduced in the wake of the 2008 financial crisis. With the completion of these global regulatory reforms and the emergence of multilateral markets and operating infrastructures, market participants are turning their attention to how they can use new technology solutions to optimize their systems, processes and data. Such solutions include distributed ledger technologies (DLT) and smart contracts.

16. We expect increased and more widespread implementation of automated, straight-through processing of financial transactions to increase efficiency and reduce costs for market participants. Well-implemented digitization and automation will also bolster regulatory oversight and compliance (for example, by promoting the consistent creation, processing, and aggregation of global financial data) and strengthen the operational resilience of market participants and financial markets infrastructure. This in turn will reduce systemic risk and create a safer and more robust global financial system.

17. On 28th July 2020, ISDA and several other trade associations sent a letter to the Financial Stability Board, the International Organization of Securities Commissions and the Bank for International Settlements asserting our joint commitment to defining and promoting the development of a digital future for financial markets.[5] The letter sets out a series of principles and objectives aimed at promoting the development, distribution and adoption of digital standards within the financial markets, as the foundation for transformational change. These principles and objectives address three key areas - Standardization, Digitization, and Distribution – which ISDA covered in more detail in our response to HM Treasury's Consultation and Call for Evidence on the UK Regulatory Approach to Cryptoassets and Stablecoins, submitted in January 2021.[6]

18. ISDA's response also includes an overview of the potential benefits (para 2.1) and drawbacks (para 2.2) of DLT for wholesale markets and FMIs from the perspective of ISDA's member, as well as how FMI regulation/ legislation can be optimised for DLT (para 2.3).

Crypto derivatives

19. The growth of crypto assets has been one of the defining trends in global financial markets in recent years. While this growth was initially driven by retail investors, institutional investors and banks have also gravitated to this asset class in response to client interest and demand This increased institutional participation has brought with it demand for the same risk management tools available in other wholesale markets.

20. Market participants can access crypto derivatives through listed futures and options on centralised exchanges and by entering into bilateral OTC derivatives. As in any wholesale market, both forms of derivative have an important role to play in broadening market access, facilitating risk management and price discovery and deepening liquidity. The OTC market in particular helps to provide flexibility

[5] https://www.isda.org/a/MGmTE/Digital-Future-for-Financial-Markets-Letter.pdf
[6] https://www.isda.org/a/UkATE/ISDA-response-to-HMT-cryptoasset-and-stablecoin-consultation.pdf

to market participants by allowing for greater customisation of economic terms and contractual features.

21. As this market develops, there is a need for increased standardization, and as for equity, credit and commodity derivatives in the past, ISDA has a role to play. The benefits of standardizing contractual terms for crypto derivatives are the same as for other asset classes. Standardization leads to more efficient negotiation between parties, reducing the time it takes to negotiate a transaction. It limits basis risk between similar products that might otherwise arise due to the use of bespoke documentation, and it optimizes risk and capital management by allowing parties to net their exposures across different transactions.

22. In December 2021, ISDA published a Whitepaper on Contractual Standards for Digital Asset Derivatives (the "Digital Assets Whitepaper").[7] The paper identified the key issues that must be addressed in any contractual standards for OTC derivatives – including disruption events, valuation mechanisms, and interaction with other ISDA documentation - and set out a roadmap towards the development of those standards.

23. In January 2022, ISDA published the ISDA Digital Asset Derivatives Definitions (the "**Digital Asset Definitions**"). The Digital Asset Definitions provide standardised contractual terms for non-deliverable (or cash-settled) forwards and options on Bitcoin and Ether. It is expected that the Digital Asset Definitions will be expanded over time to include additional terms relevant for other derivatives products and digital asset types.

24. The Digital Asset Definitions establish foundational contractual standards in certain key areas and to address certain novel issues or events that can occur with respect to digital asset underliers and markets, including:

    - **Valuation Sources**. There is generally no primary venue for trading a specific digital asset. While this issue also applies to certain other asset types, it is a distinctly significant feature of digital asset markets.[8] The Digital Asset Definitions include a settlement price source matrix which sets out a list of certain price sources for both Bitcoin and Ether that can be used for valuation purposes.[9] The Digital Asset Definitions also provide a framework for determining how adjustments can be made to a transaction in a scenario where a price source is disrupted, including through the application of designated fallbacks.

    - **Disruption Events.** In common with other asset classes, digital assets may be subject to such one-off or periodic events that could interrupt or disrupt a digital asset derivatives transaction. Some of these events are unique to digital asset markets. For example, a blockchain fork could result in the creation of two distinct digital assets, making it difficult for the parties to determine which of

[7] https://www.isda.org/a/QVtgE/Contractual-Standards-for-Digital-Asset-Derivatives.pdf

[8] For example, Bitcoin is traded on several hundred different exchanges, and trading volumes can move swiftly between them, leading to variability in prices observed across multiple trading venues.

[9] Although parties are free to choose alternative price sources that are not included in the matrix

the successor assets will act as the reference asset for the transaction. The Digital Asset Definitions provide contractual mechanisms for responding to such events.

- **24/7 markets**. Another novel feature of digital asset markets is that valuations can be obtained 24/7. The Digital Asset Definitions allow parties to specify that valuations can take place either on business days (with standard business day convention terms to address unexpected market closures and public holidays) or calendar days.

25. ISDA has also structured and drafted the Digital Asset Definitions in a manner that supports digitisation and automation. To achieve this, the key operative provisions within the Digital Asset Definitions have been drafted using a controlled semantic structure, by expressing most contractual provisions as a series of parameterised conditions and consequences. This allows the operational mechanics of the Digital Asset Definitions to be distilled into a series of IF/THEN statements, facilitating its translation into computer code and future implementation within DLT-based infrastructure and smart contracts.

26. The layout of the Digital Asset Definitions has also been designed to be more intuitive for those unfamiliar with the standard layout of existing ISDA documentation. For example, provisions dealing with product types and settlement terms have been included at the beginning of the definitions, and a more modular structure has been used such that key definitions are incorporated into the sections to which they relate rather than being confined to a lengthy 'general definitions' section. This modularity will make the definitions more user-friendly and will also make it easier to expand the scope of the Digital Asset Definitions to other product types and/or asset classes in the future.

27. This work is a logical extension of ISDA's work over several years to promote the development of more efficient, digital technology infrastructure in the financial markets. These papers include:

- The Future of Derivatives Processing and Market Infrastructure (September 2016). This whitepaper summarizes the need to develop new and efficient processes for the global derivatives market and highlights the importance of distributed ledger technology and smart contracts.[10]

- Smart Contracts and Distributed Ledger – A Legal Perspective (August 2017). This whitepaper sets out a framework for smart contracts in the context of ISDA's documents. It describes what smart contracts are and gives a preliminary and high-level description of the application of smart contracts within the ISDA documentation framework.[11]

- Smart Derivatives Contracts: From Concept to Construction (October 2018). This whitepaper proposes a practical framework for the construction of smart derivatives contracts.[12]

[10] https://www.isda.org/a/UEKDE/infrastructure-white-paper.pdf
[11] https://www.isda.org/a/6EKDE/smart-contracts-and-distributed-ledger-a-legal-perspective.pdf
[12] https://www.isda.org/2018/10/03/smart-derivatives-contracts-from-concept-to-construction/

28. One of ISDA's most important roles over the past 38 years has been to develop standardized legal documents as individual derivatives markets have grown in maturity, helping to ensure they function safely and efficiently. Our new definitions and the accompanying whitepapers are an extension of that critical work.

Digital Assets and Prudential Standards

29. The rapid growth of crypto assets and the increased interest from banks and institutional investors has led central bankers and policymakers around the world to consider the impact the sector might have on financial stability. The Basel Committee on Banking Supervision (BCBS) published standards for the prudential treatment of bank exposures to crypto assets in December 2022 with target implementation by January 2025, and ISDA provided a comprehensive response to its second crypto consultation in October 2022.

30. Despite heightened institutional focus on crypto assets and the exponential growth of the market in recent years, bank participation remains limited. That's partly due to the lack of clarity on the prudential framework but, faced with growing client demand to deal in crypto assets, banks are seeking greater certainty on the capital treatment.

31. It is now widely understood that distributed ledger technology, which underpins crypto assets, has the potential to deliver financial services more quickly, securely and economically than ever before. This, in turn, could create a more competitive market and bring benefits to the real economy.

32. While the rapidly growing institutional demand for crypto-asset exposure could be met by non-banks or entities operating outside of the regulatory framework, banks argue their long-running experience in intermediation, risk management and regulatory compliance could be beneficial to overall market development. Prudential supervisors would also get a window into this fast-growing market sector due to regulatory reporting requirements.

33. In October 2022, ISDA, along with the Global Financial Markets Association, the Futures Industry Association, the Institute of International Finance, the International Securities Lending Association, the Bank Policy Institute, the International Capital Markets Association and the Financial Services Forum, responded to the Basel Committee on Banking Supervision's (BCBS) second consultation on the prudential treatment of crypto-asset exposures.[13] There has been some evolution in the standards published by the Basel Committee in December 2022, while the Basel Committee in its recent press release noted the continuous focus on crypto assets that includes a set of targeted reviews of the prudential treatment.[14]

34. Bringing crypto-asset activities into the regulatory perimeter where institutions are subject to comprehensive regulation and supervision and have significant experience managing financial and operational risks would be beneficial for the stability of the financial system. Enabling banks to utilize

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[13] https://www.isda.org/a/sA3gE/Joint-Trades-Comment-Letter-Second-Consultation-on-Prudential-Treatment-of-Cryptoasset-Exposures.pdf
[14] https://www.bis.org/press/p230323a.htm

cryptography and DLT or similar technology would also allow bank customers and the broader sector to benefit from the advances in efficiency, transparency and speed that these innovations offer.

Yours Faithfully,

Scott O'Malia

Chief Executive Officer

International Swaps and Derivatives Association, Inc.