PRESS RELEASE

Need to Implement Clear Regulations of Cryptoassets: CFA Institute Report

Report Reveals Investment Manager's Perspectives on Digital Finance

[MELBOURNE, AUSTRALIA] 9 February 2023—As digital assets regain favour with investors, a new report by CFA Institute, the global association of investment professionals, finds that cryptoassets demand a strong and clearly defined regulatory framework to protect investors, and without such a framework, cryptoassets will be unable to gain mainstream acceptance in markets.

The report, Cryptoassets: Beyond the Hype: An Investment Management Perspective on the Development of Digital Finance, summarises the findings from CFA Institute interviews with investment professionals and crypto experts. Given the inherently cross-border and decentralised nature of blockchain processes and cryptoassets, regulators must find ways to harmonise regulatory frameworks at an international level, the report finds.

Already, some regulators are acting. The Bank of International Settlements last month outlined policy approaches to ban, contain and regulate cryptoassets,[1] while the US House Republicans has set up a committee to oversee the cryptoasset industry.[2]

Olivier Fines, CFA, Head, EMEA Advocacy, CFA Institute, says a strong regulatory framework needs to be established to benefit crypto providers and users. Crypto platforms combine many of the functions that in mainstream finance are kept separate, such as the roles of brokerages, exchanges, market makers, custodians and clearing agencies. As a result, regulation is needed to ensure the safety of investors' assets.

"The debacle at FTX shows the harm that can come to investors and platform participants when client assets are not kept safe. The example of FTX further underlines the importance of custody issues and the responsibility of investors to base their decisions on the investment case and not on hype and speculation," Fines said.

"Policymakers must either agree on the application of existing laws to various components in the crypto ecosystem or craft new laws to fill in any gaps. Trust in the integrity of crypto markets is essential to attract investors and build crypto networks to scale," he said.

"Existing regulations that intend to prevent traditional finance firms from using customers' assets to fund their own or affiliated businesses may not always provide similar protections for investors in terms of cryptoassets or the regulation of crypt platforms."

[1] https://www.theblock.co/post/201636/bank-of-international-settlements-outlines-policy-approaches-to-ban-contain-or-regulate-crypto?utm_source=substack&utm_medium=email
[2] https://www.cnbc.com/2023/01/13/house-republicans-move-to-regulate-crypto-with-new-subcommittee.html

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The report offers several recommendations for fiduciaries, investors, and policymakers. These include:

- **To the extent possible, policymakers should harmonise regulatory frameworks at an international level.** Agree on definitions and supervisory programs that take account of the specific nature of cryptoasset services.

- **Determine if cryptoassets are securities, other forms of financial instruments, commodities, or currencies and harmonise this definition at the international level.** CFA Institute believes that several cryptoassets would meet the definition of securities under US Securities laws, for example, while in the European Union, this debate is taking place in the context of MiFID II. CFA Institute would argue against designing new extensive regulation as a simplistic response to the difficulty of qualifying cryptoassets.

- **Regulation on cryptoassets and digital finance should remain technology neutral.** Regulators should not adjudicate which technological developments or orientations offer markets, investors, and consumers the most benefit. Nor should policymakers compromise investor and consumer protections because a technology is new.

- **Regulate Stablecoins for systemic risk potential.** Stablecoins, one subset of cryptoassets, should be properly regulated from a prudential, business conduct, and investor protection standpoint. The method employed to maintain the peg should be scrutinised and their collateral verified independently. These instruments create ties and ramifications with traditional financial markets in ways that may represent systemic risk to financial stability if left improperly supervised.

- **Monitor the cryptoasset market to ensure it remains driven by sound competition forces and avoids undue consolidation.** Monitoring programs should be established with a specific focus on costs, fees, and business practices. The potential for consolidation should not result in a new value chain working in the interests of a selection of technologically advanced companies.

- **Monitor and control market abuse risks.** Regulators should harness advanced forms of data science to monitor such activity to maintain market integrity. The fragmented nature of the cryptoasset market will require regulators to establish information sharing mechanisms to ensure a coherent and comprehensive understanding of transactions in this market.

- **Monitor and measure financial risk build-up in the DeFi sector.** Depending on the pace of the development of decentralised finance (DeFi) services, regulators should develop metrics to measure and quantify the build-up of risk. It is possible that lending and borrowing in the DeFi sector will require similar prudential measures to those related to financial institutions for their securities lending business dealings.

- **Custody of cryptoassets needs to be regulated and secure.** Policymakers should place a high priority on enacting a framework of laws and regulations to ensure the safe custody of customers' cryptoassets. Crypto platforms should not be allowed to use customer assets to fund their own businesses. Customer assets should be segregated and protected even if the platform or firm becomes bankrupt.

Recommendations for fiduciaries and institutional investors:

- **Hype is not a sound basis for an investment case.** Proper analysis of value, merits, and risks remains necessary for fiduciaries to comply with their duties of prudence, loyalty, and care.

- **Basic principles of portfolio construction continue to apply.** In line with CFA Program® teachings, it is recommended that investors continue to take a holistic and strategic portfolio construction view on their investments by balancing short-, medium-, and long-term objectives.

- **Careful analysis of value and portfolio benefits is necessary.** It is recommended that fiduciaries provide grounded analysis of intrinsic value, volatility, correlation effects, momentum, or technical features of their proposed investment within the overall portfolio context, whether directly into tokens or indirectly through the equity of an enterprise, before claiming that such an investment satisfies their usual standard of care.

- **Intrinsic value should be related to an in-depth understanding of use cases.** It is recommended that fiduciaries interested in the fundamental value of cryptoassets conduct an in-depth and rational analysis of the use cases for the tokens, project, or enterprise.

- **Careful analysis of the sustainability of the business model and client acquisition strategy is necessary.** It is recommended that fiduciaries pay particular attention to the potentially circular nature of the cryptoasset project being analysed, focusing on the project's intrinsic and distinguishing qualities, along with its client acquisition model.

- **Fiduciaries need to ascertain the custody chain and safekeeping of client assets.** Fiduciaries should require the same standard of quality or care as they apply to all other assets, or to contract with a third party that can provide this quality standard.

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Notes to Editors
Investment professionals and aligned professionals wishing to develop their knowledge in the areas addressed in Cryptoassets: Beyond the Hype: An Investment Management Perspective on the Development of Digital Finance, can access a new CFA Institute short online course DeFi: Introduction to Blockchain and Cryptocurrency. For all short course information, visit Professional Learning.

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