The Secondary Market for Cryptos and Other Digital Assets: Regulatory and Technical Issues

HKU, 24 November 2018

SJ opening remarks

Good morning everyone and thanks for joining us.

In March this year, we held a similar half day conference here that looked at the primary market and focussed on ICOs. Today we are considering issues that arise in the secondary market.

We're going to discuss some of the technical issues in the industry as well as the challenges posed to regulators because they are fundamentally interrelated.

the building blocks of secondary market regulation of cryptographic consensus technology (CCTech)

It has been clear since at least the 1980's that computer technology will allow individuals and groups to communicate and interact with each other in a totally anonymous manner. Two persons may exchange messages, conduct business, and negotiate electronic contracts without ever knowing the True Name, or legal identity, of the other. I'm quoting from something that Tim May wrote in 1988.

wanting to be regulated is not always the same as being able to be regulated

over the past year or so we keep hearing a similar question from many participants in the secondary market – why don't the regulators regulate us? We invite regulatory oversight, they say.

While those players tend to move toward best industry practices, others may take advantage of the current situation by moving to the lowest commercially viable legal standard or jurisdiction. This takes economic activity away from regulatory oversight and opens channels of activity for investor abuse, money laundering, and so on.

Regulation of the financial services industry in the modern era is based around three primary choke points.

traditional choke points of regulation - products, venues and acts – can be collapsed into the operation of code

cryptographic consensus technology, or CCTech, enables venue, act and product to be collapsed into the operation of code via distributed networks, decentralized and dis-intermediated arrangements, and smart contracts in which the creator no longer has a role.

Human sentience in the marketplace has moved from human behaviour and is now embedded in the behaviour of computer code. In this regard, regulators have already had to respond to developments such as algorithmic trading and robo-advisory services.

Regulation of the industry has also been informed by the legacy system of laws, regulations and financial and commercial practices established in a pre-CCTech era.

Industry requests for regulators to specify the features that would determine which regulatory silo a crypto, token or related activity belongs to, such as money, security, futures contract, commodity, or other, arguably oversimplifies the new context presented by CCTech. It underestimates the related policy considerations and may constrain thinking about how best to deal with CCTech.

The SEC recently charged EtherDelta with operating an unregistered exchange. A co-director of enforcement said this:

"We are witnessing a time of significant innovation in the securities markets with the use and application of distributed ledger technology … But to protect investors, this innovation necessitates the SEC's thoughtful oversight of digital markets and enforcement of existing laws."

What is NOT mentioned in this quote is the question of whether CCTech requires regulatory development. Of course, this statement, coming from an enforcement director, is unsurprising.

As we all know, here in Hong Kong the SFC recently launched a new regulatory approach for what they called digital representations of value, or virtual assets. Part of that approach considers the potential regulation of crypto exchanges.

Here's what Ashley Alder said:

"We are not yet sure that virtual asset trading platforms are in fact suitable for regulation. They are technically, structurally and qualitatively different from traditional stock and futures exchanges. Our aim here is to explore how they might be regulated and then form a more definitive view after this exploratory stage."

And he's right. The issue for regulators is how to organise their policy thinking in relation to something that is very different and still developing. Mr Alder went on to say "This world moves too fast to be pinned down by a bespoke legal framework, an international consensus on standards is yet to emerge and there is still much to learn."

However, I believe that regulation will, and must, come in due course and when it does, there are some basic hurdles it will need to get across.

regulatory building blocks are a precursor for effective granular regulation to develop

Regulators are mandated to protect investors and market integrity. For effective granular regulation of CCTech to develop, factors such as these must be able to be meaningfully addressed. Integrity of ownership, audit standards, and the ability to implement effective oversight of market activity to name just a few.

integrity of ownership
integrity of transactions
issues related to account management
proof of ownership to public audit standards
custody and segregation

how record keeping is to be undertaken
how exchange regulation might work
the ability to assert market transparency and market abuse protections
how money laundering risks are to be addressed
other minimum standards

To this list one might add disclosure regulation. Does the underlying code do what it is expected or promised to do? Is the governance of the code appropriate (such as agreeing on roll-backs)? Have the security protocols been properly implemented? Not all codes are the same in this regard and coding errors have caused significant problems in the past, yet there are no established standards for audits of code writing.

Solutions to many of these issues are likely to come from the technology itself, but only if the regulatory environment allows the industry to develop.

[PICTURE OF COLLAPSED BRIDGE]

We already rely on technology. Its called engineering. When we consider the possibilities CCTech offer, is the current trajectory of regulatory thought and action working toward supporting the efficient allocation of risk and industry development, so that capital finds projects that offer, and have a reasonable prospect of delivering, economic and social improvement?

If it doesn't then the tech will take longer to develop and there will be more accidents along the way.

the best way to establish regulation may be to make it attractive

I've explored some of these issues in two papers I've released in the last month – a longer one and a shorter quick read version.

In it, I suggest that the reasons participants want to be regulated also offer assistance to regulators. The industry wants things like

- Validation and legitimacy
- The assurance provided to the market by regulatory oversight
- The reduction of risk to the industry as it develops
- To foster the development of standards
- To access a larger pool of development capital

But the ability of CCTech to subvert may mean that an approach to regulation that is primarily enforcement based might not be the best solution.

Making it attractive to be regulated might not be a regulatory end-point but a point from which regulators can begin to better work with the industry.

For that dynamic to work, it is essential that oversight controls do not presume specific models of activity, do not undermine the opportunities that CCTech offer to new ways of engaging in commercial activity, and that standards do not operate in an anti-competitive manner.

Regulations must be based on outcomes that are independent of specific technologies and activities, and focus on things like fair disclosure, the development of industry standards, and accountability for wrongdoing.

And in doing so, some care must be taken that oversight controls do not to operate as anti-competitive tools, or work to inhibit CCTech from developing new solutions to undertaking commerce.

TODAY'S SCHEDULE (with names/times)

Today's conference will pick up on some of these themes and raise others. It remains for me to introduce today's speakers and panellists, and these are shown on the screen.

Following a brief speech, there will be a panel discussion and we'll try to leave some time for Q&A at the end of each session.

Two reminders, if you could please put your phones to silent mode, and if there are any media in the room, please note that the Chatham House Rule applies.

CHATHAM SLIDE

With that brief overview of where we stand today, please allow me to introduce our first speaker, Mr Pindar Wong.