

# WFE Response to the Financial Conduct Authority – CP19/22: Restricting the sale to retail clients of investment products that reference crypto assets



## Background

We are grateful for the opportunity to respond to the Financial Conduct Authority's (FCA) consultation paper on restricting the sale to retail clients of investment products that reference crypto assets.

The World Federation of Exchanges (WFE) is the global trade association for regulated exchanges and clearing houses. We represent over 250 market-infrastructure providers, spread across the Asia-Pacific region (~37%), EMEA (~43%) and the Americas (~21%).

With extensive experience of developing and enforcing high standards of conduct, WFE members support an orderly, secure, fair and transparent environment for all sorts of investors and companies wishing to raise capital and manage financial risk.

We seek outcomes that maximise financial stability, consumer confidence and economic growth. We also engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in an internationally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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## Questions

**Q1: Do you agree with our analysis of the key risks and harm posed by these products? Is there any additional evidence or factors that we should consider?**

The World Federation of Exchanges welcomes the opportunity to feed into this proposal. It is apparent that there is a significant issue around consumer protection and some of the unregulated products which have been sold to retail consumers in the past. The FCA has identified what it believes to be some of the inherent issues relating to valuation of the underlying assets. It is right that consumer protection should be of primary concern, as the WFE has previously supported, when addressing any financial products, especially if they are new and relatively untested in the market. However, it is clear that crypto assets represent an evolving and growing market and one in which greater consumer participation is likely to increase as it evolves.

**Q2: Do you agree with our proposal to prohibit the sale, marketing and distribution of CFDs, futures, options and ETNs referencing relevant crypto assets to retail consumers?**

The WFE acknowledges and understands the reasoning applied by the FCA in concluding that a ban is important for retail consumer protection. However, as the market matures retail consumers' interest in crypto assets will only grow. As a result, it would be optimal to avoid an outright ban and to implement ways of mitigating for the lack of consumer protections so far identified. Should a ban be implemented, we would call for the inclusion of a review, within the regulation, to take place after a set period of time. We would also advocate for the flexibility to 'switch-off' any ban, efficiently, to enable the trading of such products on fully regulated, established exchanges in the future. Enabling the trading of such products on a regulated exchange is supported by the higher level of standards and regulatory requirements which regulated exchanges operate under.

These standards were explicitly acknowledged by the FCA in its July 2019 Policy Statement on 'Restricting contract for difference products sold to retail clients'<sup>1</sup>. In that Policy Statement, the focus was on what was happening in practice, particularly with regards to the degree of leverage actually present in the contracts being offered. In other words, the emphasis was on whether the sales process was well suited to the target market. This focus was appropriate, against a background of stringent regulation that already applies to exchange-traded derivatives (which, by definition, are also subject to the disciplines of central clearing).

Exchange-traded and centrally cleared derivatives are indeed subject to pre- and post-trade risk management standards set by the exchange listing and CCP clearing the trades. These risk management standards include practices that are designed to foster safe and efficient markets. Derivatives prices are transparent and typically based on central limit order book where a diverse set of market participants can transact with each other in a healthy pool of liquidity to ensure a robust, transparent and easily understood price. In fact, derivatives are fundamentally designed to provide price discovery for their users, particularly those seeking to hedge their business risks. In order to preserve market integrity, exchanges employ numerous mechanisms to prevent inappropriately excessive price movements.

On a post-trade basis, a CCP mitigates counterparty credit risk through becoming the counterparty to both sides of a derivatives transaction, while utilising risk mitigating tools such as the collection of margin, facilitating the daily

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<sup>1</sup> PS 19/18 - <https://www.fca.org.uk/publication/policy/ps19-18.pdf>

exchange of funds to account for mark-to-market price moves (i.e., settlement variation), and the establishment of a default fund to cover tail risks, among other risk management practices. These tools transform the concentrated counterparty credit risk of each transaction into a well-diversified and regulated risk supported by the risk management practices of a CCP.

We appreciate that one of the FCA's strategic objectives is to protect UK retail customers. However, we believe that in achieving this objective, customer protections should be designed to consider the specific characteristics of the market structure being covered. If any measures are applied to exchange-traded and centrally cleared derivatives, the differences between the market structure for these instruments and that for the underlying assets should be considered.

The market structure differences significantly change the risk profile for retail customers participating in these markets. Applying the same measures to exchange-traded and centrally cleared derivatives as to underlying crypto asset markets could create unintended consequences whereby spot crypto assets would become a more attractive option for retail customers as compared to the highly regulated and tightly risk managed centrally cleared derivatives markets. Such an eventuality could undermine the goals that the FCA is seeking to accomplish.

Imposing regulatory regimes that are not tailored to the specific market structure in question is problematic in any circumstance, but it would be especially inappropriate to apply the same measures to exchange-traded and centrally cleared derivatives as to underlying crypto asset markets. The regulatory standards applicable to exchange-traded and centrally cleared derivatives significantly exceed the standards to which underlying crypto asset providers operate. Exchange-traded and centrally cleared derivatives are subject to protections defined under the international principles for CCP operations and risk management – i.e., the Committee on Payments and Market Infrastructures and International Organization of Securities Commissions' *Principles for Financial Market Infrastructures* ("PFMIs"). These are in addition to local regulatory standards applicable to CCPs, exchanges, and intermediaries participating in derivatives markets. This contrasts with the more limited regulatory oversight of brokers offering retail customers access to spot crypto assets.

Further, there may be room, as part of the wider discourse, for consideration to be given to the 'standards' to which crypto assets must conform in order to be viable products, traded on such established exchanges; and the WFE would welcome such a discussion in place of a ban.

It will also be important for the purposes of ensuring consumer choice and access to avoid a ban or, to have the option, to review the ban, especially as the market evolves into a more and more regulated environment. This is likely to be an important consideration from not only an international competitiveness stance but also in order to have the ability to respond to any forthcoming global regulatory approach to crypto asset regulation, promoted by international standard setting bodies. Enabling such a potential future international approach to be implemented in the UK market would be key to ensuring a level-playing field and in conforming to international standards which promote global trade and regulatory coherence. It should also be recognised that this is an innovative and new market which should be appropriately fostered in a key jurisdiction such as the UK's.

#### *Interaction with European Benchmarks Regulation*

Some exchange-traded and centrally cleared derivatives reference benchmarks that are provided in accordance with the European Benchmarks Regulation (BMR) by FCA-regulated benchmark administrators.

The legislative intent of BMR was to ensure a high level of consumer and investor protection, by establishing robust requirements for the provision of indices used as benchmarks for the provision of exchange-traded and centrally cleared derivatives.

BMR provides that a supervised entity may use a benchmark if the benchmark is provided by an authorised benchmark administrator<sup>2</sup>. There are no restrictions or other qualifications to this provision of the type that FCA has proposed in its consultation. It is therefore unclear whether the proposed prohibition is indeed compatible with BMR.

The FCA's proposal would appear to modify BMR by providing that a supervised entity may use a benchmark if the benchmark is provided by an authorised benchmark administrator, *except in circumstances where the benchmark references a crypto asset*. It would still be permitted for retail customers to have exposure to the same benchmark for other purposes, such as for measuring the performance of an investment fund or for determining the amount payable under a financial contract. In effect, the FCA would be prohibiting use of a regulated benchmark where that use involves activity subject to additional stringent regulation (the provision of exchange-traded and centrally cleared derivatives) but permitting use of the same benchmark where that use involves activity not subject to such additional regulation (measuring the performance of an investment fund or determining the amount payable under a financial contract). This would indeed be an odd outcome.

Furthermore, for the FCA to prohibit the sale, marketing and distribution of exchange-traded and centrally cleared derivatives referencing benchmarks provided by authorised benchmark administrators, would suggest that despite the FCA itself supervising those benchmark administrators, it does not consider the BMR framework, or its supervisory activity, to ensure a sufficient level of consumer and investor protection.

We suggest below amendments to the draft Handbook rules might address this anomaly.

**Q3: Do you have any comments on the draft Handbook rules and definitions we propose to achieve our policy intention?**

Yes. Below the following text:

“Annex A – Amendments to the Glossary of definitions

Insert the following new definitions into the appropriate alphabetical positions. The text is not underlined.”

*cryptoasset derivative* – a derivative where the underlying is, or includes, an *unregulated transferable cryptoasset* or an index **that is not provided by an authorised benchmark administrator** or derivative relating to an *unregulated transferable cryptoasset*.

**Q4: Do you have any comments on our CBA for these proposals as detailed in Annex 2?**

No.

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<sup>2</sup> Article 29 of Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014

**Q5: Do you agree with excluding derivatives on security tokens and tokens that meet the definition of e-money? If not, please explain why.**

The WFE agrees with the exclusion of security tokens and tokens that meet the definition of e-money from the ban as it is beneficial for the market to have the widest range of products and investors who are able to trade and operate in a growing and innovative market – in an appropriate and safe manner.

**Q6: Do you agree with our proposed approach to funds? If not, please explain why.**

We agree, in accordance with the reasons to that given in our response to Q.5.

**Q7: Do you agree with our proposed scope to exclude non-retail consumers from the prohibition? If not, please explain why.**

We agree, in accordance with the reasons to that given in our response to Q.5.

**Q8: Do you agree with our conclusion that alternative options would not sufficiently address the harm? If you disagree, please indicate any preferred option(s) and how it would better address the harms we have identified in a proportionate manner.**

The WFE recognises the concerns in applying alternative options, as highlighted by the FCA in the consultation paper. However, in accordance with the WFE's sentiments regarding the wider proposal, it will be important to consider all alternative options to a ban or, if imposed, to keep them under review as the market evolves and in order to encourage the market to grow in the direction of a more regulated and governed environment. Using tools such as 'leverage limits' might be one mechanism by which to do that, whilst not unnecessarily inhibiting a maturing market.