

Designating Crypto as a Financial Product: A Perilous Approach to Regulation

The Treasury is currently considering submissions on appropriate regulation of CASSPrs (Crypto Asset Secondary Service Providers) who provide the main gateway for individuals and firms to interact with the crypto sector. This stems from the Morrison government accepting recommendations from a Senate Committee Inquiry which had accepted the overblown hype about the important future role of “crypto”.

One option proposed is to designate crypto currencies and tokens as financial products, such that financial regulation can be applied to products, services and operators in the crypto eco-space.

This (I have argued in a submission) is not a desirable course of action, and that focusing first on regulation of CASSPrs is putting the cart before the horse. Crypto products are diverse and CASSPrs may deal in a range of such products – some of which may warrant designation as financial products although many do not.

Although touted by their promoters as a future form of private money to challenge fiat money, crypto currencies are not a financial asset. A purchaser of BitCoin or other crypto currencies is simply paying to take a gamble. They win if someone else is subsequently willing to pay a higher amount to have their name substituted (in an anonymous form) on the blockchain record.

Crypto currencies can be used for some buying and selling transactions amongst willing parties (much like barter activities), but they will never be able to replace a fiat currency. For one thing, the highly resource intensive verification processes make them incapable of scaling up to provide the instantaneous settlement that consumers expect in the multi-million transactions which occur each day when using currency or debit cards etc.

Some crypto products, like stable coins and initial coin offerings attempt to mimic or provide variants on financial sector products and activities, and may justify designation as a financial product or activity. Identifying what may warrant such a designation and what does not is a more appropriate starting point for regulation.

Perhaps more importantly, the notion that a special regulatory approach is relevant for any such crypto assets is misguided. The blockchain and cryptography arrangements which are the distinguishing characteristic, should be thought of as simply a different form of “back office” for recording ownership and transactions.

Just as a regulator might apply different operational risk regulation to providers of a product where one has a paper-based ledger and processes and the other is computer-based, so it should be with crypto. It is the economic functions performed by a product or service which should be the key consideration for how to regulate, not the back office arrangements.

A further problem arises from an “institution focused” approach to regulation (as with proposed CASSPrs regulation) compared to a “functional approach”. The “institution” approach is relatively easy, but runs two main risks.

One is that the same functions provided by different institutions will be regulated differently, creating a non-level playing field.

The second is that other institutions can emerge outside the regulated sector to provide the same functions, such as shown by the growth of “shadow banks” engaged in similar (but slightly different)

credit creation activities to regulated banks. (In this case, providers of such shadow (or “ghost”) activities might be referred to as “CASPERs” – although they might not be friendly ghosts!)

There is no question that the crypto eco-space requires some form of regulation to protect poorly informed and gullible individuals (and institutions) from unwarranted engagement and unsuspecting risk taking. The potential for profiting (or losing) from gambling in crypto currency positions does not reflect any skills or superior knowledge – unless one is skilled in predicting the “madness of crowds”.

Because entry into the eco space as a creator/supplier of different crypto currencies and tokens is relatively easy and low cost, the sector has burgeoned. Success requires attracting interest in the new product, and hence marketing and advertising extolling the virtues of the product and potential gains proliferates.

Clamping down on misleading advertising, marketing and advice is definitely needed. Perhaps this is easier if the activities are subject to financial product and service regulation. But designating pure gambling activities as financial products would give them a credence that they do not deserve, possibly encourage unwarranted growth, and make the regulatory task in dealing with poorly informed consumers that much harder.

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