SEPTEMBER 2021

# Submission:

# FEC Inquiry into cryptocurrencies

## About this submission

This is a submission from the Financial Markets Authority - Te Mana Tātai Hokohoko (FMA) to the Finance & Expenditure Committee's inquiry into the current and future nature, impact, and risks of cryptocurrencies.

### Terms of Reference

The terms of reference for the inquiry are:

1. to inquire into, and establish the nature and benefits of cryptocurrencies:

- to establish how cryptocurrencies are created and traded
- to understand the environmental impact of 'mining' cryptocurrencies
- to identify risks to users and traders of cryptocurrencies.

2. to identify the risks cryptocurrencies pose to the monetary system and financial stability, including tax implications, in New Zealand.

3. to establish how cryptocurrencies are used by criminal organisations.

4. to establish whether means exist to regulate cryptocurrencies, either by sovereign states, central banks, or multi-lateral co-operation.

# Introduction

The Financial Markets Authority - Te Mana Tātai Hokohoko (FMA) is New Zealand's conduct regulator for financial markets.

The FMA does not regulate cryptocurrencies. However, some activities concerning cryptocurrencies can fall within the regulatory remit of the FMA. Also, some conduct relating to cryptocurrencies can have an impact on the financial markets.

The impact of digital technologies has been profound across the finance sector and financial markets. New technologies today enable the ability to create 'digital' or 'virtual' representations of most types of assets in the traditional world. A cryptocurrency is a form of 'digital' asset or 'virtual' asset.

This submission outlines for the Committee the impact that the FMA has seen cryptocurrencies have in terms of retail investor behaviour. It also highlights the activities relating to cryptocurrencies that are currently subject to some degree of regulation under financial markets legislation.

# Retail Investors & Cryptocurrencies

The retail investor landscape in New Zealand has changed significantly over the last 18 months, with new platforms, new products, and new investors entering the market.

The FMA recently commissioned Colmar Brunton to research investors on retail platforms, to help us to understand the behaviour and intentions of new investors who have started investing in the past few years.

While this research was aimed at investors' experiences of online share-trading platforms, it also asked about investing in higher risk financial products, such as derivatives, and in cryptocurrencies.

The research was undertaken by Kantar Public (formerly Colmar Brunton) of 1997 people using online investing platforms including Sharesies, InvestNow, and Hatch, as well as members of the New Zealand Shareholders Association using online platforms. The margin of error of the research is +/-2.2% at the 95% confidence interval. The full research report is available on the FMA's website, **here**.

The headline finding of the research was that the emergence of online platforms has made it easier for people to access financial markets and to learn about investing – 34% of investors said that they now have a better understanding of markets after using the platforms. It also showed that most investors have good intentions around how they should invest, with around 80% buying shares or other investments and holding them for the long term. Only a minority of investors were "day-trading", or buying and selling multiple times a day, though 14% of investors said they were comfortable to risk a lot of money if there is a big reward.

This research found that 27.5% of respondents have invested in cryptocurrencies using online platforms, though cryptocurrencies tend to form only a small proportion of these investors' portfolios (on average, 3.2%).

Investors were also asked about their future intentions. If investors follow through on their expressed intentions, the proportion of investors investing in cryptocurrencies could rise 6 percentage points (27.5% to 33.8%) over the next 12 months.

As discussed further in the section on "Regulatory framework and approach", retail investors can also gain exposure to cryptocurrencies through investment in managed funds that either specialise in cryptocurrency investment or that hold cryptocurrencies as part of their investment portfolios. We are seeing this emerge in New Zealand, but it is not yet widespread.

### FMA investor messages

Although the FMA does not regulate cryptocurrencies, because they are of interest to retail investors, we publish guidance for investors on some of the risks of cryptocurrency trading, and how these can be managed. This is available on the FMA's website **here**.

The FMA's five main messages for investors on cryptocurrencies are:

- They're high risk and highly volatile – the price can go up and down very quickly
- They're not regulated in New Zealand
- If you want to purchase cryptocurrencies, then use a New Zealand based trading platform as this offers a minimum level of protection
- New Zealand based trading platforms must be registered on the financial service providers register (FSPR) and belong to a dispute resolution scheme
- Cryptocurrencies, crypto trading platforms and the people that use them are often the targets of hacking, online fraud and scams

As we describe further in the next section, investor interest in cryptocurrencies has made them an attractive cover for investment scams – which often do not involve any real cryptocurrency at all.

# Regulatory framework and approach

The Financial Markets Authority (FMA) is the conduct regulator for New Zealand's financial markets. As the conduct regulator, the FMA is directly interested in digital assets (including cryptocurrencies) to the extent they relate to the issuing of a "financial product" or the "provision of a financial service". However, we also have an interest in how these innovations are affecting financial markets more generally.

## FMA's approach to innovation

The FMA's main objective under the Financial Markets Authority Act 2011 is to promote and facilitate the development of fair, efficient, and transparent financial markets.

The FMA also has responsibility for regulating conduct under the Financial Markets Conduct Act 2013 (FMC Act). The purposes of this legislation include both promoting innovation and flexibility in financial markets, and promoting confident and informed participation of businesses, investors, and customers in financial markets. Therefore, the FMA seeks to facilitate innovation in our financial markets while safeguarding investor interests. Innovation in financial markets can provide New Zealanders with better, cheaper, or more convenient access to financial services and products. However, it can also challenge regulatory protections and frameworks, and expose investors to risks, such as those associated with dealing in unregulated financial services or products.

The FMA has put considerable investment into being proactive, open and willing to engage early with industry and with other government agencies on financial technology (FinTech) and other innovation matters. We maintain an open-door policy and engage with people and sectors involved in innovation to help us to understand emerging trends in product and service development. We also engage with the International Organization of Securities Commissions (IOSCO), the international body for securities markets regulation, which has set up a FinTech network to facilitate information sharing, knowledge and regulatory experience.

The FMA is also the lead agency for the FinTech forum (www.fintech.govt.nz) of the Council of Financial Regulators (www.cofr.govt.nz). This forum meets regularly to identify emerging trends in technology enabled financial services, discuss appropriateness of regulatory frameworks as well as to provide a multi-agency regulatory guidance service for the fintech community.

## Cryptocurrency regulation in New Zealand

The FMA only regulates cryptocurrency issuers or service providers, such as exchanges, to the extent they are issuing cryptocurrencies that are financial products, or if they are in the business of providing a financial service.

A financial service includes operating a 'value transfer' service or 'issuing and managing the means of payment'. In such cases, the service or products fall within Part 2 of the FMC Act (the fair dealing provisions), which applies to both financial products and financial services. This prohibits misleading or deceptive conduct and making false, misleading or unsubstantiated representations.

*Financial services*

Providers of financial services or products must also comply with the requirements of the Financial Service Providers (Registration and Dispute Resolution) Act 2008, which includes being registered on the Financial Service Providers Register and belonging to a Dispute Resolution Scheme.

Anti-Money Laundering/Countering the Financing of Terrorism (AML/CFT) obligations also apply to cryptocurrency service providers. The Department of Internal Affairs (DIA) is the lead contact for these providers and is the AML/CFT supervisor for the majority of them. However, the FMA also supervises a small number of cryptocurrency service providers for AML/CFT purposes (depending on what type of financial service is being provided).

Internationally, cryptocurrencies (and digital assets more broadly) are increasingly being seen as a potential investment for fund managers, with a small number of managed funds now specialising in cryptocurrency portfolios. We have recently seen this interest reflected in the New Zealand market. Where managed funds invest themselves in digital assets this provides exposure to those assets for investors in the managed funds. Retail offers of interests in managed funds in New Zealand must be made by licensed fund managers, and are subject to specific disclosure requirements, so this activity is regulated. The FMA has engaged with some fund managers to ensure that their disclosure to investors adequately reflects the nature of the risks involved in investment by such funds.

*Financial products*

FMC Act disclosure, governance, and financial reporting obligations apply if the instrument is a financial product (i.e., equity, debt, managed investment product or derivative) offered to retail investors. The FMA also has the power in certain circumstances to designate that some cryptocurrency ‘coins’ or ‘tokens’ as financial products, subject to certain requirements and thresholds.

Offers to wholesale investors and overseas offers are only subject to Part 2 fair dealing requirements.

The FMA also regulates the markets that financial products are traded on. If a cryptocurrency exchange were to list coins or tokens that are financial products, it would need a licence from the FMA to operate as a financial product market. However, to our knowledge, there are presently no financial products offered on any New Zealand-based cryptocurrency exchanges. The obligations associated with a financial product market are extensive and a licence requires Ministerial approval.

Internationally, regulators in a number of mainstream jurisdictions have also clamped down on cryptocurrency exchanges that may be trading in cryptocurrencies that fall within the local legal definition of a ‘security’.

## FMA’s work to date

In line with global developments over the past few years, there has been heightened interest in cryptocurrencies from investors and customers.

The FMA has published guidance for crypto-related businesses, setting out how their activities fit within the FMC Act regime: **Cryptocurrencies - Compliance | FMA.**

This guidance broadly aligns with that issued by our international counterparts, including the Australian Securities and Investment Commission. To promote best regulatory practice, we have engaged with overseas regulators about their approach to cryptocurrencies and digital assets in general.

As a general observation, most offers of cryptocurrencies and most cryptocurrency exchanges deliberately structure themselves to operate outside of the reach of mainstream markets or securities regulation.

There has not been a regulated offer of cryptocurrencies yet in New Zealand nor is there a regulated financial product market here. We have however seen a number of offers made in other jurisdictions that may have been taken up by people in New Zealand. The regulatory protections available in such circumstances are very minimal.

## FMA views on risks and issues with cryptocurrencies

The key risks and issues we are concerned about relate to investor protection.

As described already, the FMA has published information to help investors who are considering investing in cryptocurrencies, as we do for many other types of investments. We also carry out social media campaigns to inform people who may have been considering buying cryptocurrencies.

In addition to our work for investors and participants in relation to cryptocurrency as a legitimate, high risk, investment, the FMA receives regular complaints about cryptocurrency-related scams, which are often likely to be scams posing as cryptocurrency opportunities.

In the year to 30 June 2021 the FMA received 60 misconduct reports in this area.

Reflecting the global nature of these frauds and scams, we publish warnings and alerts on offers from overseas jurisdictions as well as when international regulators issue warnings. The FMA publishes information about warning signs of scams on our website at **https://www.fma.govt.nz/investors/scams/.**

# Annexe - Cryptocurrencies

A cryptocurrency is a form of 'digital' asset. It may be helpful to put this in the context of traditional assets.

## Traditional assets

In the traditional sense, 'Assets' may broadly be categorised into three, based on certain characteristics:

- Capital assets (such as shares, bonds etc. which can be priced based on present value of future expected returns and yields ongoing value)

- Consumable assets (such as commodities, which are used as inputs for producing other goods)

- Store of value assets (such as currencies, which can't be consumed and yet retains appeal as a store of value or means of payment)

## Digital (or, Virtual assets)

The ability to create digital representations of tangible or intangible assets is not new. But technologies such as 'distributed ledger' (more popularly known as blockchain), enable the ability to record 'ownership' of, 'store' and 'transfer' to peers these digital assets, in almost real-time.

Additionally, it allows for some of these digital assets to be programmed to have attributes of multiple types of assets.

Broadly this process is called 'tokenization' and does not typically involve any centralized authority or intermediary. In the above context, a 'token' is a piece of software with unique characteristics that represents an intangible or tangible asset.

Digital assets are stored online, in what are called digital wallets, each with a unique identifier. Individuals can own and operate multiple wallets using their privately held identifiers and credentials.

Trading in digital assets occur on online exchanges or platforms. Exchanges also typically allow for fiat currencies to be converted into any number of digital assets and back to fiat currencies.

Ownership changes when a digital asset is transferred from one wallet to another individuals' wallet and can be instantaneous.

## Crypto assets

A subset of digital assets utilises principles of cryptography (the science of encryption that secures a communication), to create the representative ‘tokens’ and these are broadly termed as crypto assets. There are multiple thousands of different types of crypto assets.

Where the crypto asset is primarily used as a ‘store of value’, ‘means of exchange’ or ‘unit of value’, it is typically called a ‘cryptocurrency’. It can be used to buy goods or services from anyone willing to accept it as payment.

## Cryptocurrencies

The most popular example of a cryptocurrency is Bitcoin, which was established as far back as 2009. There are many other cryptocurrencies that exist, although the two most traded currently are Bitcoin and Ether.

Cryptocurrencies come with a number of benefits as well as risks.

Some of the benefits include:

- **Cheaper options**— Unlike traditional forms of payment, cryptocurrencies often have no processing fees considering the entire process of transfer, settlement and ownership is enabled by software and without an intermediary or central authority.
- **Faster options**— With cryptocurrencies, transactions happen significantly quicker (within minutes) than the traditional settlement period of days. Transactions also happen to be permanent and not open for dispute.
- **Diverse options** — Cryptocurrencies enable an additional means of payment options, which can provide significant benefits to unbanked populations.

On the other hand, some of the challenges include:

- **Volatility** — Cryptocurrency prices can change dramatically over short periods of time. The lack of underlying value drivers means that this type of asset is susceptible to intense price speculation.
- **Security** — The ‘digital’ nature of cryptocurrencies means that the proof of ownership is often limited to the private key used to access the digital wallet used to store it. This makes it an easy target for hackers and cyber criminals.
- **Anonymity** — Compliance with regulations around know your customer obligations and identity verification can be challenging considering that while transactions are on a public ‘ledger’ (database of transaction records), names and locations of users are not identifiable.
- **Resourcing** – Given there is no centralised authority involved in the creation of cryptocurrencies the validation of transactions that occurs is enabled by various cryptographic techniques, examples being ‘proof of work’ and ‘proof of stake’. Different means of validation require different amounts of energy for carrying out the computations. For example, the ‘proof of work’ method used for mining bitcoins consumes a significant amount of energy. On the other hand, crypto assets that use ‘proof of stake’ validation techniques use considerably less energy.

## Stablecoins

Certain cryptocurrencies seek to provide a solution to the issue of excessive volatility by pegging the value of each unit to some collateral. This could be a fiat currency or a basket of fiat currencies. It may also be pegged against other crypto assets or real assets such as commodities.

There are also stablecoins that are non-collateralised, with the stability being achieved by mathematical (algorithmic) means.

While there are general risks discussed in the previous section that apply to stablecoins, there may also be specific risks associated with how each of them is designed and structured.

It is estimated that as at the start of 2021 there was over a $110 billion worth of stablecoins issued on public blockchain networks.

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