

# The case for self-regulation for the digital assets industry

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## Alma Angotti

Partner, Financial Crime, Fraud & Investigative Services, Guidehouse, USA

## Tracy Angulo

Director, Financial Crime, Fraud & Investigative Services practice, Guidehouse, USA

## Gene Bolton

Director, Guidehouse, USA

## Gabriella Kusz

Chief Executive Officer, Global Digital Asset & Cryptocurrency Association, USA

*Alma Angotti is a Partner in the Financial Crime, Fraud & Investigative Services (FFI) group at Guidehouse. Alma is a recognised expert in anti-money laundering (AML), combatting the financing of terrorism (CFT) and economic sanctions compliance. With over 25 years of experience in regulation and enforcement, Alma has held senior enforcement positions at the US Securities and Exchange Commission (SEC), US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) and FINRA (Financial Industry Regulatory Authority). In these positions, she was responsible for investigations and enforcement of the Bank Secrecy Act, the federal securities laws, and FINRA rules. At FinCEN and FINRA, she designed and led the AML enforcement programmes. Alma is responsible for preparing Guidehouse's financial services clients for emerging risks resulting from the fast changing regulatory and technology environments, and for changes in technology and risk. As a consultant, she has managed gap analyses, compliance programme reviews, risk assessments, remediation efforts, investigations and historical transaction reviews. Her clients include large, complex, global financial institutions, global payments institutions, mid-sized banks, broker-dealers, FinTech and digital assets companies, hedge funds, casinos and multinational corporations. Alma has held interim senior compliance leadership positions at several*

*global and regional financial institutions providing day-to-day management of their compliance programmes and assisting them with remediation efforts, often in the context of a regulatory or criminal enforcement action. Alma is a prolific thought leader and sought-after speaker at conferences and webinars internationally. She has trained regulators, governments, boards of directors and industry participants globally.*

*Tracy Angulo is a Director in the Financial Crime, Fraud & Investigative Services practice at Guidehouse. She is an accomplished attorney, certified fraud examiner (CFE) and certified anti-money laundering specialist (CAMS) with over 20 years' expertise in administrative law and investigations, the last 15 in securities law and regulation, financial crime compliance, anti-money laundering (AML) and sanctions compliance, and financial fraud investigations, allowing her to bridge the worlds of regulation, auditing, compliance and litigation. At Guidehouse, Tracy has provided a wide compilation of financial compliance services including projects for virtual asset services providers (VASPs), broker-dealers, trust companies, digital asset companies, digital asset trust and custody institutions and cryptocurrency trading platforms. In addition to acting as the Global KYC Director for a global crypto exchange and leading independent assessments of global payment*



Alma Angotti



Tracy Angulo



Gene Bolton



Gabriella Kusz

processing companies, Tracy's areas of experience include: internal audits; gap analyses; AML and sanctions risk assessments; independent testing; AML programme reviews and assessments; development of policies and procedures; management of a financial intelligence unit and transaction monitoring look-backs; conducting AML compliance and suspicious activity report filing training; assessments of customer identification programmes, know your customer and due diligence programmes. Prior to joining the private sector, Tracy served as a principal attorney investigator in FINRA's Enforcement Department for over six years. As an institutional integrity officer at the World Bank Group, Tracy was engaged as a lead investigator in a variety of complex, high-profile fraud and corruption investigations.

**Gene Bolton** is a Director in Guidehouse's FFI group. He works with financial services clients, including banks, broker-dealers, cryptocurrency exchanges, FinTech's, money services businesses (MSB), and insurance companies, to address their anti-money laundering (AML), counter-terrorism finance, and Office of Foreign Assets Control (OFAC) sanctions compliance challenges. While at Guidehouse, Gene has helped clients build and enhance compliance programmes, including developing risk assessment methodologies, executing financial crime risk assessments, conducting training, and preparing and delivering presentations to executive committees and independent consultants. Gene has been seconded to clients where he worked directly with chief compliance officers to enhance and sustain compliance programmes and prepare for regulatory exams. Gene has executed coverage assessments, transaction monitoring lookbacks, independent monitorships and targeted due diligence programme reviews. Gene has also conducted Bank Secrecy Act/AML and OFAC risk assessments for an institutional broker-dealer, insurance company, cryptocurrency exchange and global money transmitter, to help identify and mitigate financial crimes risks specific to their businesses. He has presented risk assessment findings to executive committees,

senior management, independent consultants and internal auditors, as well as conducted risk assessment training for several clients. Gene has also helped clients develop target operating models to enhance compliance programme effectiveness. Gene also has experience in performing independent AML/sanctions programme reviews for global money services businesses, domestic and foreign financial institutions and peer-to-peer cryptocurrency platforms and exchanges. Prior to Guidehouse, Gene was an AML compliance analyst at JPMorgan Chase, where he was responsible for quality assurance and user acceptance testing as part of system implementation.

**Gabriella Kusz** MBA, MPP, CPA, CGMA serves as Chief Executive Officer of the Global Digital Asset and Cryptocurrency Association, a global voluntary self-regulatory association for the industry. Prior to this role, she served as the Principal for Strategic Initiatives at the International Federation of Accountants (IFAC) where, in addition to other areas, she supported the profession's leadership and innovation in the digital era. Her background has largely included working in international financial sector and economic growth including working with the World Bank Group Governance Global Practice where she was responsible for leading the Corporate Governance and Financial Reporting (CGFR) workstream for the Middle East and North Africa (MENA) region and advancing the dual goals of the World Bank: poverty reduction and shared prosperity.

#### ABSTRACT

The concept of self-regulation and the use of self-regulatory organisations (SROs) as a feature of legal and regulatory frameworks has been adopted to support effective and efficient capital market development in a number of countries around the world. Most notably, the International Organization of Securities Commissions (IOSCO) set forth through its SRO Consultative Committee a 'model for effective self-regulation', the general principles for self-regulation and why self-regulation should be incorporated into regulatory frameworks. Since

Guidehouse,  
1200 19th St NW #700,  
Washington, DC 20036,  
USA  
Tél: +1 202 481 8398;  
E-mail: alma.angotti@  
guidehouse.com

Guidehouse,  
1676 International Dr,  
McLean, VA 22102,  
USA  
Tél: +1 202 973 3193;  
E-mail: tracy.angulo@  
guidehouse.com

Guidehouse,  
685 3rd Ave 14th floor,  
New York, NY 10017,  
USA  
Tél: +1 646 227 4852;  
E-mail: gene.bolton@  
guidehouse.com

Global Digital Asset &  
Cryptocurrency Association,  
USA  
Tél: +1 847 644 3686;  
E-mail: Gabby.kusz@  
global-dca.org

2000, this has served as the outline for SRO development. Today, many countries are struggling with the question of how to regulate cryptocurrency and digital assets — including the US. The rapid evolution, high degree of expertise and understanding needed, and decentralised, cross-border nature of digital assets presents unique challenges for regulators. In the wake of the failure of the centralised finance (CeFi) digital asset exchange FTX, this research explores whether an SRO may be suited to the nature of the digital asset industry and how it may provide a strong complement to formal US government regulation. Such a complementary relationship may offer United States regulators and legislators a mechanism for providing a high degree of regulatory coverage which balances the need for consumer protection and market integrity with the need for innovation. In exploring this subject, researchers undertook desk study on the IOSCO Framework for Effective Self-regulation and explored existing and emerging national SROs in the digital asset space. Desk study was coupled with individual one-on-one interviews with global digital asset industry leadership and public roundtable forums. This research concludes that an SRO may serve to provide the US legal and regulatory framework with a high-quality solution to the challenges of legislating and regulating in the ever-changing environment of digital assets.

**Keywords:** self-regulation, digital assets, crypto, cryptocurrency, regulation, the International Organization of Securities Commissions (IOSCO), National Futures Association (NFA), Japan Financial Services Agency (JFSA), Japan, Switzerland, USA, securities, commodities, Commodities Futures Trading Commission (CFTC)

## INTRODUCTION

Cryptocurrency and digital assets are now at the forefront of investment activities. Despite this, regulatory clarity and regulatory agency oversight have not kept up with the increased adoption of the new asset class

and the growth of the broader crypto industry as a whole. The need for appropriate regulation has also been amplified by recent events. Throughout 2022, several cryptocurrency firms failed, and many are at risk of bankruptcy. In their wake, millions of retail customers lost their savings, adjacent businesses were left teetering and the viability of the entire industry has been called into question. In light of the regulatory gap that exists, self-regulatory organisations (SROs) can provide the policy guardrails and regulatory clarity the industry needs. This body of research seeks to present an outline of an initial framework of an SRO best suited for the current industry and regulatory landscape in the US.

### Why does the cryptocurrency and digital assets industry need regulation?

As most digital asset firms, cryptocurrency exchanges and virtual asset service providers (VASPs) are money transmitter institutions, or money services businesses (MSBs), under federal regulation<sup>1</sup> and state law, they are subject to anti-money laundering (AML) and counter terrorist financing (CFT) laws and regulations, such as the Bank Secrecy Act (BSA) and the USA PATRIOT Act, enforced by the US Department of Treasury, Financial Crimes Enforcement Network (FinCEN). Firms are also subject to regulations related to consumer protection, such as the Consumer Protection Act enforced by the Federal Trade Commission's Bureau of Consumer Protection. Adherence to these laws, rules and regulations requires some combination of oversight, monitoring, examination and testing, and enforcement of the rules via disciplinary actions — functions typically provided by a regulatory authority.

### What is self-regulation?

As a first step, it is important to provide a common understanding of what is meant by

self-regulation. One of the leading resources in understanding the modern philosophy and approach surrounding self-regulation is the International Organization of Securities Commissions (IOSCO) SRO Consultative Committee Report entitled 'Model for Effective Regulation'.<sup>2</sup> As defined by this report, self-regulation typically involves a unique combination of private interests with government oversight and provides an effective and efficient form of regulation for the complex, dynamic and ever-changing financial services industry. In its most complete form, self-regulation encompasses the authority to create, amend, implement and enforce rules of conduct with respect to the entities subject to the SRO's jurisdiction and to resolve disputes through arbitration or other means.

#### **What is an SRO?**

SROs are the entities that facilitate self-regulation. As noted by the same IOSCO report, typically, this authority is derived from a statutory delegation of power to a non-governmental entity. The report goes further to highlight that, at the time of its publication, there were a number of organisations on the IOSCO Consultative Committee that provided valuable industry input in terms of codes of good conduct and master agreements, and performed important roles in the standardisation of common practices without any formal regulatory status. In fact, historically, in several jurisdictions around the world, effective self-regulation existed before any form of statutory regulation. This is also true of emerging economies or sectors where financial sector transformation is rapid and outpaces the speed of legislation and formal government regulatory development.

In its further report on the 'Objectives and Principles of Securities Regulation',<sup>3</sup> IOSCO has endorsed the use of SROs within statutory oversight frameworks for

financial markets as part of a broader set of thirty principles. The report recommends appropriate use of SROs with direct responsibilities in their areas of competency, to the extent appropriate to the size and complexity of the markets, to assist regulators in meeting their regulatory objectives of investor protection: fair, efficient and transparent markets and reduction of systemic risk.

#### **Are there examples of SROs in traditional financial markets?**

Some of the best examples of SROs have developed within the securities and commodity futures industries, including all national securities and commodities exchanges. In particular, in the case of the securities industry, the Financial Industry Regulatory Authority (FINRA), an SRO, regulates firms and individual brokers across the country. FINRA is overseen and delegated authority by the Securities and Exchange Commission (SEC) and is authorised by Congress to protect US investors by making sure the broker-dealer industry operates fairly and honestly to protect investors and promote market integrity. Though an SRO, FINRA performs all the functions expected of a regulatory authority including promulgating and enforcing rules governing the activities of all registered broker-dealer firms and registered brokers in the US, examining firms for compliance with those rules, recovering money for harmed investors and removing bad actors from the brokerage industry.<sup>4</sup>

Similarly, the commodities and futures industry, also known as the US derivatives industry, is regulated by the National Futures Association (NFA), an SRO. Designated by the Commodities Futures Trading Commission (CFTC) as a registered futures association, the NFA safeguards the integrity of the derivatives markets, protects investors and ensures member firms<sup>5</sup> meet their regulatory obligations. The NFA regulates

	<b>Securities industry</b>	<b>Commodities and futures industry</b>
<b>What is the SRO name?</b>	<b>Financial Industry Regulatory Authority (FINRA)</b>	<b>National Futures Association (NFA)</b>
<b>What does the SRO regulate?</b>	<b>3,500 firms and 620,000 brokers across the country</b>	<b>3,000 firms and 42,000 associates</b>
<b>Who oversees the SRO?</b>	<b>Securities and Exchange Commission (SEC)</b>	<b>Commodities and Futures Trading Commission (CFTC)</b>
<b>What does Congress authorise the SRO to do?</b>	<b>Protect US investors by making sure the broker-dealer industry operates fairly and honestly to protect investors and promote market integrity.</b>	<b>Safeguards the integrity of the derivatives markets, protects investors and ensures member firms meet their regulatory obligations.</b>
<b>What is the SRO's function?</b>	<b>Rulemaking, enforcement, market regulation and other investor protection programmes.</b>	

Figure 1 Self-regulatory organisations in traditional US financial markets

firms (commodity trading advisors, futures commissions merchants, commodity pool operators, introducing brokers, etc) and individual associates. Like FINRA, the NFA also engages in rulemaking, enforcement, market regulation and other investor protection programmes (Figure 1).

## ANALYSIS AND METHODOLOGY

Governance institutions must not only reflect financial sector realities, but the broader economic, political and social context of a given jurisdiction. It is in this way that a system may be designed to be inclusive and equitable as well as effective and efficient in both its structure and operation. Ultimately, when designed and operating appropriately, SROs can advance credible, flexible and responsive regulation which enhances

consumer and investor protection and facilitates innovation and industry development. As such, a four-pronged approach was taken to analyse and formulate the appropriate initial structure and function of an SRO for the cryptocurrency and digital assets industry:

1. industry and stakeholder input;
2. policy roundtables;
3. IOSCO 'Model for Effective Regulation' (Self-Regulation/SROs); and
4. global best practices and benchmarking.

### Industry and stakeholder input and policy roundtables

Several public and private discussions and policy roundtables were held with over 100 company executives and representatives, individual industry stakeholders, current and

former regulators and academics.<sup>6</sup> These conversations were intended to reflect the needs of the industry as well as the broader financial sector, economy and society. Discussions were oriented towards understanding the challenges to industry regulation and stewardship, enterprise and personal pain points deriving from the current regulatory landscape, areas in which immediate regulatory clarity is needed, and the form and nature of any resulting entity that could serve to guide credible, transparent and accountable development of the industry. The following four areas were core themes expressed by discussion participants:

1. Defining and maintaining a taxonomy for the industry;
2. Supporting responsible stablecoin and payment token development;
3. Advancing digital asset custody in a fair and equitable manner; and
4. Self-regulation of the industry.

The identified ‘building blocks’ reflect the key regulatory issues that were regarded as priorities and that require addressing to ensure achievement of responsible innovation.

### IOSCO rationale for SROs

Self-regulation is advantageous in the regulation of digital assets, and the industry also lends itself quite naturally to an SRO model. Figure 1 maps key characteristics of the digital asset industry with the application of IOSCO’s various rationales for

self-regulation to SROs in traditional US financial markets.<sup>7</sup>

An SRO can serve as the nimble and agile regulatory entity needed to keep up with the rapid changes in technology. This capability will enable any such entity to deliver effective industry stewardship and would simultaneously serve to guide credible, transparent and accountable development for the industry in a manner that fulfils the US regulators’ mandates around market integrity and consumer protection.

### Global best practices and benchmarking

In order to best advance consumer protection, a right-sized formal government regulatory structure may be best complemented by the existence of a private-sector led SRO. This complementary approach (where formal government regulators work in harmony with SROs) should be designed in-line with the IOSCO ‘Model for Effective Self-Regulation’ and international good practice and should leverage the lessons learned from more recent (modern) experiences around the world in developing self-regulatory models.

In recent decades, the philosophy guiding self-regulation has adjusted and changed to view the role of an SRO in aligning holistically with the financial sector, economy and society at large. In recent years, different countries have explored and attempted to implement self-regulatory systems for the crypto industry. Figure 2 provides attributes of the cryptocurrency SRO models in Japan, South Korea and Switzerland.



Figure 2 Attributes of cryptocurrency SROs in Japan, South Korea and Switzerland

In each of the three models, there is a primary class of members who are legally mandated to participate in the SRO and are subject to the inspection and oversight mechanism of the model. The primary membership class is largely intended to consist of companies directly involved in or central to the industry, such as centralised exchanges. Non-primary member firms that fall outside of the legal mandate may participate on a voluntary basis and are not subject to inspection or oversight. Companies that constitute an auxiliary or peripheral position in the industry, such as consulting and law firms, may participate through a non-primary membership status.

The tiered model ensures that a diverse and expansive base of membership is reflective of the different verticals that constitute the cryptocurrency ecosystem. It also provides an on-ramp and ‘blueprint’ for non-crypto companies to enter the industry in a manner that is gradual and reflective of their own business goals and initiatives, thus enabling efficient, yet safe, go-to-market strategies.

In recognition of the nascent stage of development of the overarching digital asset industry, each SRO has sought to bring firms into the system early by implementing a sliding scale membership cost structure. A graduated fee scale reduces the financial barriers to entry and permits micro, small and medium enterprises (MSMEs) to more easily access and gain the benefits of either mandatory or voluntary (as legally required or permitted) membership. Further, capping membership dues and any additional fees reduces the ‘power of the purse’ and helps to mitigate against regulatory capture by any one large (or group of larger) firms within the SRO, which also protects the SRO from any fallout or failure of any given member firm.

Each of the three SRO models emphasises capacity building and strengthening firms under their purview — not merely creating standards and then inspecting and enforcing compliance. Shifting focus from reactivity

to proactivity, generally, reflects a more modern approach to self-regulation where it is recognised that preventative measures are both more cost efficient as well as more effective at advancing industry adherence and ultimately protecting consumers. Further, such an approach is more appropriate for an industry that impacts key dimensions of broader US policy and strategic governing pillars, including national security, global positioning, economic opportunity and enhanced social outcomes.

As such, a dual focus on consumer protection and responsible innovation and industry stewardship is core to these models. For example, both Switzerland and Japan have consulting and advisory services that they offer to members at a reasonable fee. These services support the development of systems in-line with emerging standards, guidance and requirements. The shift towards proactive interventions, which include direct technical assistance in building highly compliant firm systems, advance quality, market integrity and probably consumer protection. It also offers regulators deep insight into the governance, structure and functions of firms in this emerging space. Such deep insight can be leveraged to build sophisticated, precision-driven inspection and oversight systems that do not overburden members, particularly MSME firms. Finally, if a significant number of firms obtain technical assistance and advisory support in the design and development of their systems, resulting inspection and oversight systems may be able to build efficiencies from the consistency of systems across the industry.

Additionally, none of the SROs maintain more than 40 people in staff. Although this is likely to grow, it is notable as it gives an indication of the rough starting point as well as the human and technical capacity that should be expected in an emerging digital asset SRO. Further, there is likely to be a strong proclivity to heavily leverage the underlying blockchain technology to improve efficiencies

and effectiveness of the oversight system. Finally, there may be an interest in leveraging secondments, volunteerism, as well as third-party service providers instead of internal staff. This may be due to the rapid speed at which the industry moves, which requires extreme nearness, flexible staffing models and structures and the ability to contribute to the elaboration of private sector solutions (as opposed to SRO largesse).

Additional detail on each of the country SRO models explored is presented in Appendix A.

### Shortcomings of SROs

SROs are not without their shortcomings and criticisms. One disadvantage often cited is the complexity and cost required to run the SRO. Imposing regulatory controls, rulemaking and enforcement can be time-consuming and complex, requiring resources and staffing with requisite expertise and understanding of the industry. SROs have been accused in the past of a revolving door between the industry and the SRO which could call into question the independence of the SRO in the performance of its functions. Additionally, there is a concern that there is not enough incentive for the SRO to robustly discipline its own membership. For example, the concern is that the SRO may fine, but not bar from further doing business in the industry, a firm to ensure that the firm continues registration and membership with the SRO. Or that the SRO may lower the fine against a member firm based on what the firm can afford, rather than objectively assessing the penalty for a violation.

Additionally, in the 1990s the SEC's 'Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market' criticised the National Association of Securities Dealers (NASD [now FINRA]) for failure to comply with its own rules without reasonable justification and for failure to better enforce

its rules related to market makers.<sup>8</sup> Similarly, in 2005 the SEC called out NASD for its failures in managing the inherent conflicts between its role as a market and its role as a regulator.<sup>9</sup> While FINRA has since remediated these issues identified by the SEC, it is worth noting that the SEC continues to monitor the SRO to ensure its compliance with its own rules and obligations as a regulator.

### SRO FRAMEWORK PROPOSAL

In drawing upon the discussions and interviews, research, global comparisons and open-policy roundtables, the following SRO framework is recommended. Through this framework, the digital asset industry may advance a balanced approach to self-regulation that credibly protects consumers, advances market integrity and allows for the maturation and elaboration of the industry. The below sections provide an overview of the reporting lines, structure and function of the SRO and the succeeding paragraphs provide additional detail.

#### Operating voluntarily versus achieving legal mandate

An SRO should pursue a legal mandate from the US Congress but, given the speed of development of the digital asset industry, also continue self-regulatory efforts voluntarily. From a standpoint of state-building and the development and growth of governance institutions — at a minimum — credible systems of self-regulation typically take between three to five years to reach maturity. When the development of a regulatory system is far outpaced by industry development and strength, this opens the system to risk of regulatory capture. For this reason, it is recommended that voluntary self-regulation efforts continue in order to complement formal government regulatory efforts as well as to steward responsible development of the industry.



### Positioning and reporting lines

Given the evolving nature of digital assets, there needs to be a direct reporting line to a single US regulatory agency. The US agencies that could be considered for this role are the CFTC and the SEC.<sup>10</sup>

It is recommended that formal channels of communication and coordination be drawn between the SRO and other regulatory agencies that are not responsible for the direct oversight of the SRO, including the US Department of the Treasury. Though, it is important to distinguish and emphasise that these would not be in the form of direct reporting lines, rather in the form of ‘dotted’ lines. Given the expansiveness of the digital asset industry and its coverage of security tokens, payment tokens, stablecoins and more, formal channels of coordination between and among these entities will be extremely important to ensuring sufficient regulatory coverage for the US financial sector.

Further, the SRO should work to advance memorandums of understanding (MoUs) with US and international agencies relevant to the digital asset industry to facilitate formal channels of communication, collaboration and knowledge sharing. Given the rapid development of the digital asset industry, the SRO should evaluate on an ongoing basis its MoUs and relationships with relevant agencies to ensure the provision of information vital to the functioning of the US government and international organisations.

### Principles versus rules-based approach

A principles-based approach to regulation is a more appropriate way to advance constructive development of the sector. Further, around the world, standards and guidance are set using a principles basis as opposed to a rules basis (eg International Financial Reporting Standards [IFRS]). Given the desire to not only set legal and regulatory requirements for the US, but also to act as a replicative model and influence standards

setting around the world, a principles-based approach lends itself more naturally to global acceptance, adoption and replication. This approach may also help to minimise the ability of firms off-shoring to gain advantage from jurisdictional legal and regulatory arbitrage.

### Membership model

It is recommended that an SRO membership model include and delineate between mandatory and voluntary member firms. Companies that serve as digital asset intermediaries would be mandated members of the SRO. While all other firms would have the option to be voluntary members.

Expanded membership of the SRO permits the costs of oversight and inspection (which may be extreme) to be borne by a larger membership base. This in turn may reduce the individual digital asset intermediary firm cost of participating in the oversight and inspection system. Such a reduction in burden of the cost of oversight and inspection may engender enhanced growth for small and medium digital asset intermediaries, may help resist over-consolidation in the market and may stimulate competitive market forces to allow for diverse offerings by digital asset intermediaries that enhance quality, promote consumer protection and advance innovation in the industry.

Finally, the development of the digital asset industry marks not merely the development of a new asset class, but rather the ushering-in of financial sector and economic transformation. As such, the inclusion of all aspects of the digital asset ecosystem (direct firms as well as peripheral) is an important design choice as it allows for building capacity among key peripheral industries that are necessary to the responsible elaboration of the industry (ie financial reporting, auditing, legal and insurance). If these industries themselves are not well educated and able to provide high quality services to the digital

asset industry this provides potential for weakness in both the regulatory and self-regulatory model of a jurisdiction. Further, including both direct and peripheral firms helps with easier identification of bottlenecks and crucial policy pain points, which may be necessary to developing a solid runway upon which the digital asset industry may more responsibly mainstream and develop.

### **Board structure**

To build on the IOSCO model, global good practice suggests that SROs maintain at least one independent director role as well as director representation from the broader financial sector and economy. Greater diversity with regards to board and/or governing body experience and representation is important to ensure moderation, alignment and harmonisation with the broader financial sector and economy and appropriate orientation towards the public interest. When leadership (board director roles) are confined to SRO membership only, this creates a myopic view of industry stewardship, thereby reducing the ability to move beyond industry self-interest and towards the public interest.

### **Governance and decision-making**

There needs to be equal or at least equitable voting and decision-making rights among all members to help defray the potential issues surrounding regulatory capture (ie a model where one or a few entities become so large and powerful as to dominate and control the entity that regulates them).

According to the World Trade Organization, small-and medium-sized enterprises (SMEs) represent over 90 per cent of the business population, 60–70 per cent of employment and 55 per cent of GDP in developed economies such as the US. This is just as relevant in the digital assets industry

as it is for the broader economy. It is for this reason that SME representation should be maintained and not outweighed by larger incumbent players in both crypto and non-crypto industries.

As such, the SRO should operate under the ‘one firm, one vote, one voice’ principle, which entitles each firm to just one vote, regardless of firm size. In this manner, it ensures that standards, policy positions and organisational decision making is truly made by and for the whole of industry.

### **Taxonomy**

Presently there are challenges in the classification of digital assets as commodities or securities. The SRO should function as a single point of intake and should be granted authority to determine the nature of the product brought before it. The decision should rest with the SRO with a 10-day window for the regulatory agency overseeing the SRO to dissent on the decision. Under this model, the CFTC and SEC should have the ability to discuss and consult with each other, but ultimate authority to determine the nature of the digital asset itself should be retained by the individual agency responsible for overseeing the SRO. The voluntary and mandatory membership base included in the SRO would offer the entity the ability to draw a wide range of stakeholders into the discussion and determination as well as ensuring reflection on the four lenses of impact that are shaped by financial sector regulation in the digital asset industry (national security, geopolitical positioning, economic growth and job creation, and desired social outcomes).

### **Emphasising education and certification**

In a modern self-regulatory approach, there is recognition that proactive measures including proper awareness building, education and training form a first-line of defence

in advancing consumer protection. Blunt regulatory actions which are strictly reactionary do not address the driving force of non-compliance in an emerging industry. In an emerging industry such as the digital asset industry, many times non-compliance stems from ignorance. Further, the ability of poor-quality firms and products to gain traction in retail as well as institutional markets stems from a lack of awareness and understanding regarding how to determine and source sound, high-quality firms, products and services.

It is for this reason, that when looking to balance the constructive growth of the digital asset industry with the need to protect consumers, any forthcoming SRO should have at its core a heavy emphasis on engaging in awareness building, knowledge and learning activities, and professional education. The emphasis on what may be broadly defined as educational activities will allow both enhanced compliance by emerging digital asset firms as well as increased awareness and understanding in the market regarding quality. In turn, this will advance consumer protection goals. In the first instance, before you can adopt and implement a system of inspection, there must be an initial focus on developing standards, guidance and educational training and programmes. This more modern approach

to self-regulation may help to fulfil two functions:

- to ensure proper systems building and alignment with requirements which protect consumers; and
- to build up a dynamic, globally competitive and resilient digital asset industry in the US.

### Oversight and inspection

The SRO model should be given sufficient time to develop an oversight and inspection system with a phased approach (Figure 3).

Systems of self-regulation can be highly effective and efficient at emphasising member firm capacity building and learning, positioning the SRO as a partner in industry growth and development, and incentivising (in the first instance) alignment. The positioning of the SRO as a partner in constructive firm development tends to lessen the degree of pushback from member firms and advances proper adoption and implementation of standards and guidance.

Voluntary self-regulatory movements are especially strong at balancing the need for consumer protection with the desire to advance innovation, economic growth, job creation and global positioning as they act as a conduit for crowdsourcing industry

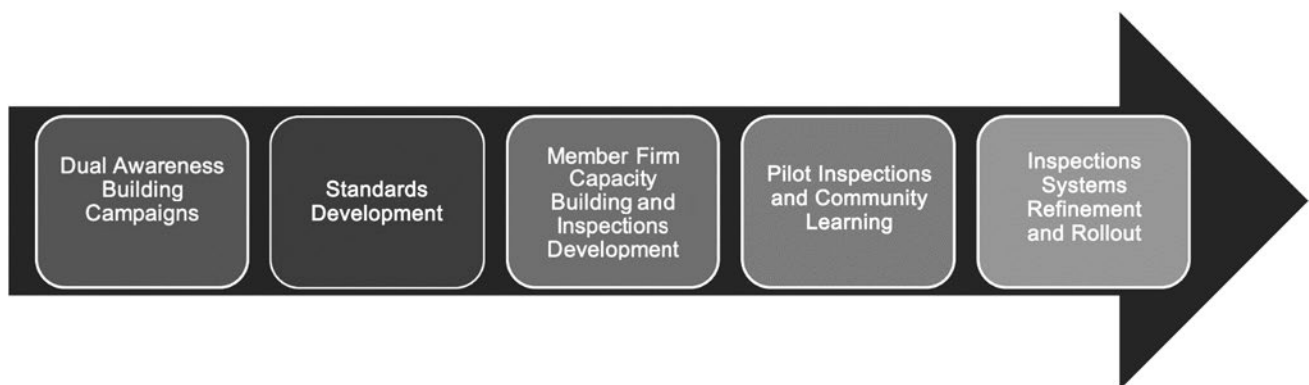


Figure 3 Development phases of a self-regulatory organisation

stewardship and resilient and globally competitive industry development. The typical timeline to develop such a movement is between three to five years in length when executed by skilled professionals in an amenable jurisdiction.

To provide further detail to the evolution of self-regulatory movements and each of the five phases detailed below.

#### *Dual awareness building campaigns*

After developing a robust system for organisational governance and transparency, inclusion and equitable decision making, voluntary systems of self-regulation begin with a dual-awareness building campaign targeting both industry firms and policymakers and regulators to share insight and understanding on the concept, trajectory and timeline for this process. This offers an opportunity to give comfort to legislators and regulators on association development as well as to create a channel for dialogue and feedback loops which will be necessary to ensure responsive systems design and suitability to the industry, financial sector, economy and society. Further, effective awareness building campaigns give comfort to industry actors who may be hesitant about voluntarily coming under a system of self-regulation.

#### *Standards development*

Before a jurisdiction can regulate or self-regulate there must be a set body of generally accepted standards and guidance. These must be high-level enough to be adopted (processes created) and implemented (processes functioning in practice). In addition to this, they must also be coupled with practical guidance as well as technical support to facilitate member firms understanding and application to their firms. Organisational governance will be tantamount to the development of high-quality standards that are accepted by the industry actors as

well as by regulators and legislators. Strong processes should include policy roundtables that extend beyond direct member firms, should follow an agreed upon due process and should ensure sufficient comment and feedback from industry, stakeholders and the public.

#### *Member firm capacity building and inspection system design*

In self-regulation, ownership and engagement of the member base is important to reducing pushback and enhancing the degree of adoption and implementation. The role of a voluntary self-regulatory body — in the first instance — is to steward and build an industry responsibly. As such, any programme for voluntary self-regulation evolution should have a heavy emphasis on building the capacity of an industry. This is especially important for the digital asset industry which is itself a nascent and evolving industry and needs systems design and implementation support. With a lag of roughly six to eight months and sufficient feedback and insight from capacity building efforts, the self-regulatory movement should begin to outline and design the system of inspection. The form and function of this system (it may be traditional, highly leveraging technology or a blend) should be decided on by the member base. Communal agreement and development of the system will again reduce pushback and encourage firms to step forward voluntarily to go through the pilot system of inspections.

#### *Pilot inspections and community learning*

Pilot inspections should be undertaken through requesting member volunteers to go through this process. Pilot programming allows for later refinement and tailoring of the system while at the same time engendering trust in the system from the member base. Results from this initial round of inspections

should be anonymised and generalised with a focus on bringing forward key lessons learned, identifying areas for the community as a whole (the full membership base) to review and enhance their systems in alignment with inspections recommendations. At no point should the first round (and sometimes even the first few rounds) of inspections be coupled with enforcement. Pilot round(s) are a strong and needed learning opportunity which will help build firm systems that are compliant and that can bring desired growth and development. Special attention should be given to supporting MSME firms in navigating firm systems and processes enhancement. At times, tailored tools and guidance may be needed. This is important to protecting innovation in the industry, advancing MSME contribution to jobs and economic growth, and mitigating anti-competitive behaviour.

#### *Inspection system refinement and rollout*

Results from the pilot inspections should feed into the final systems design. Again, member base engagement and active participation in the building of this system will be crucial to its overall acceptance and ultimately the degree of compliance seen in practice. The inspections system and procedures should be updated to reflect industry and consumer protection needs on an ongoing basis. Further, each year, an annual report which outlines and generalises key findings should be created and distributed to the member base. This should be used as a tool for knowledge and learning with emphasis on advancing the industry.

#### **Scope of oversight and inspection**

An SRO should seek, in the first instance, to focus oversight and inspection on the digital asset intermediaries that can have the highest direct and indirect impact on consumers.

In this respect, a risk-based approach should be the focus of initial oversight and inspection. Eventually, this should grow to include a size-suitable cyclical basis.

#### **Level of regulation**

Self-regulation should initially focus on targeting regulation at the firm level as opposed to the product level. This respects the need for sufficient human, technical and financial resources as well as the need to balance the cost and benefits to the financial sector, economy and society.

#### **Focus of self-regulation**

Firm-level self-regulation should seek to emphasise the three core elements of:

1. product level disclosure;
2. firm level systems compliance; and
3. retail consumer restitution.

If information regarding the risks, nature and function of digital assets are appropriately disclosed and firm-level systems are aligned with industry issued principles-based standards, a sufficient level of market integrity and consumer protection will be advanced. In a highly innovative and experimental industry such as the digital asset industry — the desire to innovate must be balanced with the need to ensure that in the event of any failures retail consumers are made whole. Further, similar to the insurance function of the Securities Investor Protection Corporation (SIPC), some form of industry-wide insurance should exist so that retail consumers, in particular, receive restitution in the event that there is company failure.

#### **Fees**

Given the rapid pace of innovation, today's MSME may be tomorrow's billion-dollar

business. As such, the inclusion of MSMEs is especially important in the SRO. Engaging with MSMEs early in their evolution allows for a natural building of systems and procedures in-line with standards, guidance and best practice. Early self-regulatory intervention in the MSME sector is more easily accepted by business owners, is more cost efficient and effective over time, contributes to domestic industry resilience and global competitiveness and provides a higher degree of regulatory coverage. Accessibility in terms of annual fees assessed is important in ensuring strong technological and financial sector competition that drives quality and innovation, facilitating the capacity building and growth of an industry and reducing the instances of over-consolidation and financial instability.

## CONCLUSION

Expediency. Effectiveness. Efficiency. These are the characteristics of a self-regulatory mechanism oriented in the public interest and designed to both advance technological innovation and advance consumer protection and market integrity. Although government regulation is a necessity to mature the digital asset industry — there will continue to be a need to ensure regulations keep pace and enable responsible innovation in the space. It is in this manner that self-regulation and SROs may work in public-private partnership (P3) to complement government regulation and foster an equitable global financial future for us all.

## APPENDIX A

### SRO model #1 – Japan<sup>14</sup>

The Japan Virtual Currency Exchange Association (JVCEA) is an independent self-regulatory organisation (SRO) that oversees the cryptocurrency industry in the country. In 2018, JVCEA was formally recognised by the Japan Financial Services Agency

(JFSA). This recognition was enabled by the country's Financial Instruments and Exchange Act and the Payment Services Act. Through this, the JVCEA is authorised with the ability and responsibility to issue and enforce crypto-related regulations and rules for Japanese VASPs. This is intended to lay the foundation for sound industry development, while simultaneously protecting end-users and investors who rely on exchanges and other crypto platforms to buy, sell, and trade crypto assets and derivatives. To achieve this, the JVCEA is tasked with:

1. establishing self-regulatory rules;
2. conducting audits of the association members;
3. providing guidance, recommendations and disciplinary actions;
4. delivering business consultation services;
5. fielding, receiving and managing complaints;
6. informing the public of relevant information; and
7. managing and administering a statistical survey.

The regulations and rules established by JVCEA are generally regarded as being stricter than official Japanese laws. This is largely driven by the SRO's desire to mitigate the money laundering risks that are often associated with virtual assets. While the JVCEA operates as an independent organisation, it works closely with the JFSA to provide them with regular reporting and to share any relevant information that may arise. Prior to publishing any self-regulatory guidelines, the JVCEA also coordinates with the JFSA to ensure that any proposed rules are aligned with and communicated to other government agencies.

The JVCEA's three-tier membership structure is aligned with the country's requirements for VASPs. The membership structure and the corresponding company

type that would have to adhere to it are as follows:

- Type 1 members: cryptocurrency exchanges and crypto derivative trading platforms that are currently operating as a business.
- Type 2 members: businesses that have recently registered or plan to register as a crypto exchange and/or crypto derivative trading platform.
- Type 3 members: companies that do not fit the profile for Type 1 and 2 members, though they agree and support the intended purpose of the JVCEA.

JVCEA's revenue for operations is generated through membership fees. Type 1 and 2 members must pay a ¥2,000,000 admission fee, or approximately US\$15,000. A recurring annual fee must also be paid by both member types, which varies based on the type of services the members render.<sup>12</sup> These members must also pay other auxiliary fees, such as a new crypto asset confirmation fee, foreign agent registration fee and examination fee. The fees for Type 3 members remain undecided.

JVCEA has a sophisticated governance structure. Each member type has varying degrees of responsibilities and power within the association. All Type 1 members participate in the 'general meeting of members' group, which is tasked with making essential decisions.<sup>13</sup> Within this group, decisions are made through votes and every member has the right to one vote.

The board of directors group is responsible for the approval of member applications and the association's operational duties. This group must maintain at least three but no more than 13 participants. The current participants in the board of directors consist of four directors from the cryptocurrency industry, three from academia, one from the Nippon Association of Consumer Specialists (a Public Interest Incorporated Association that deals with consumer protection) and one attorney (Figure 4).<sup>14</sup>

JVCEA also has five departments that conduct administrative, legal, research, supervisory leadership and auditing tasks. The head of each department is a member of the 'Self-Regulation Steering Committee'. This committee falls under the Head of the Executive Office and holds a weekly meeting to share information. There are also committees that focus on unique aspects relevant to the industry, such as the Technical Committee. These committees may also rely on external specialists on a case-by-case basis.

Overall, the association employs a total of 28 employees, including two seconded audit and legal employees, and one outsourced employee. It is important to note that, in the past, the association has faced bandwidth constraints, and has not been able to keep pace with certain tasks, such as processing the massive volume of applications.<sup>15</sup>

#### **SRO model #2 – South Korea<sup>16</sup>**

The Korea Blockchain Association (KBCA) is a self-regulatory organisation that was established in 2018. Its establishment derives from a self-regulated proposal of a joint government task force, which also incorporated prior industry feedback and input. As such, the association operates in a manner that is aligned with existing government regulation. The association aims to:

1. improve the overall regulatory system by proposing policies and reforms;
2. increase the efficiency of the economy and financial system through the convergence of blockchain technology and finance;
3. conduct research that explores how to protect consumers and increase their financial well-being;
4. create an innovative ecosystem for a robust market that simultaneously protects the consumer; and
5. create a global environment through international industry cooperation.

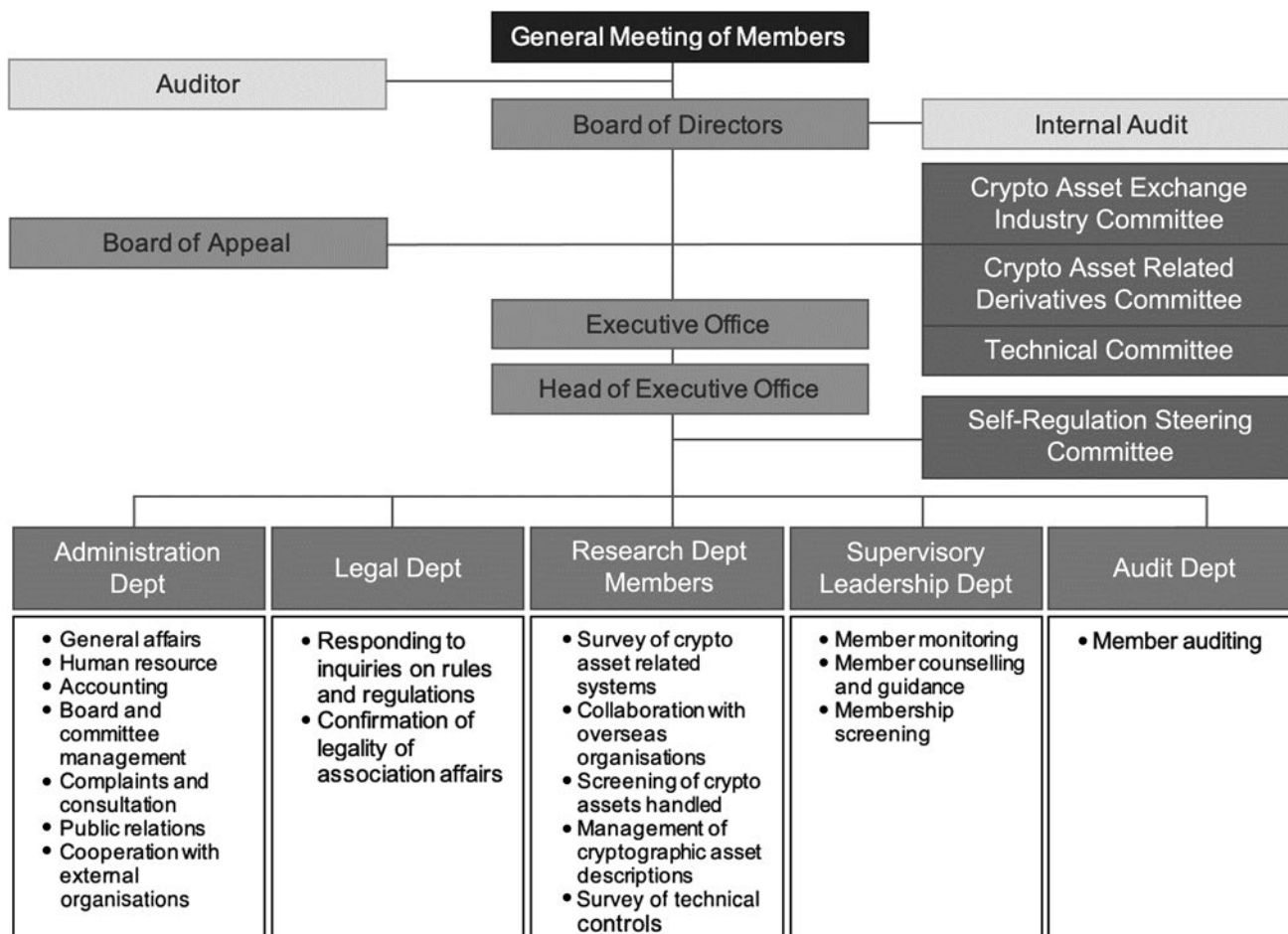


Figure 4 Japan's self-regulatory model for the cryptocurrency and digital asset industry

There are three different membership participation categories offered by the KBCA. These membership types and their corresponding parties are as follows:

- members – blockchain-related operators, financial institutions or IT companies;
- associates – research, academic and other public institutions involved in blockchain-related initiatives;
- 'special' members – experts and professional organisations that provide legal, accounting and tax services (Figure 5).

KBCA receives annual membership fees from its participants. Since its inception,

the total amount of fees it has collected in any given year has ranged from 2m won (approximately US\$1,500) to 10m won (approximately US\$7,600). It is important to note that some cryptocurrency exchanges and businesses do not participate and/or have left the association because they have been subject to high fees. Publicly available documents do not provide detailed information on the total fee amount, or whether these fees were the same amount as the ones mentioned above.

KBCA has specifically focused on establishing a strong investor-deposited asset protection system, strengthening the coin listing process and improving transparency.



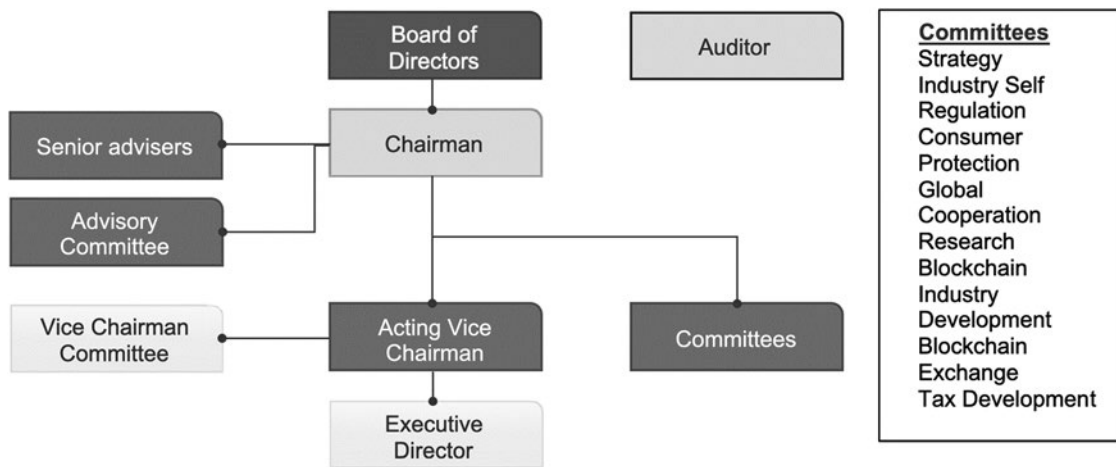


Figure 5 South Korea's self-regulatory model for the cryptocurrency and digital asset industry

It also places an emphasis on reinforcing personal account verification and proper deposit and withdrawal management. The association operates an offline civil complaint centre(s) and is responsible for ensuring members adhere to established requirements.

As part of the protection measures for virtual asset investors, KBCA has partnered with a blockchain security company and a member of the association to provide virtual asset phishing site prevention services. As part of the partnership, these services provide secure site verification, block dangerous sites and flag high-risk cryptocurrency wallet addresses.

### SRO model #3 – Switzerland<sup>27</sup>

Switzerland has multiple SROs. This section will focus on the Swiss Financial Services Standards Association (VQF), the country's largest SRO. Under private law, the VQF was established in 1998 and recorded under the Commercial Register of the Canton of Zug. It is recognised, regulated and supervised by the Swiss Financial Market Supervisory Authority (FINMA). FINMA's oversight of the VQF provides the basis for describing this system as being both self-regulatory and legally controlled.

The VQF does not solely focus on or specialise in digital assets. Rather, its scope largely concentrates on ensuring adherence to the Anti-Money Laundering Act (AMLA) across finance, which includes cryptocurrency. The VQF offers comprehensive services in the field of compliance management. The VQF is obliged to monitor problems related to AMLA and/or professional misconduct. In addition, the VQF carries out periodic audits on members, trains them in matters concerning AMLA and also represents their interests in the legislative and political arena.

Participation is categorised across two different types of membership. These membership types and their corresponding parties are as follows:

- active members — professional and non-professional financial intermediaries that are supervised by the VQF; and
- passive members — parties that support the VQF and its intended purpose.

The organisation generates revenue through a wide variety of fees, including those shown in Table 1.

The VQF consists of a board of directors, general assembly and auditors. The

**Table 1: Switzerland's self-regulatory model participation fees**

Admission audit	Administration fee	CHF 2,000 + VAT
	Additional fee for LCD & CEO based on expenditure	CHF 250 bis; 6,000 + VAT
	Admission audit based on expenditure	CHF 750 to 3,000 + VAT
Membership fee and annual fees	Membership fee for active and passive VQF members	CHF 400 + VAT
	AMLA-file fee (rates per file per segment)	Based on the number of files
	AMLA-turnover fee	Based on the annual turnover
	Additional annual fee for VQF Industry Organization for Asset Management (IOAM) membership category	CHF 500 + VAT
AMLA training	Basic training as face-to-face event	CHF 600 + VAT (members); CHF 700 + VAT (non-members)
	Advanced training as face-to-face event	CHF 500 + VAT (members); CHF 600 + VAT (non-members)
	Basic and advanced training webinar	Basic: CHF 400 + VAT (members); CHF 500 + VAT (non-members); advanced: CHF 350 + VAT (members); CHF 450 + VAT (non-members)
	Re-test	CHF 60
	Company training	On-demand
Consulting services	Member	Specialist advice according to expenditure (CEO) / hourly rate CHF 280 + VAT; Specialist advice according to expenditure (LCD) / hourly rate CHF 250 + VAT; Administration according to expenditure / hourly rate CHF 100 + VAT
	Non-member	Specialist advice according to expenditure / hourly rate CHF 280 + VAT; Administration according to expenditure / hourly rate CHF 120 + VAT
Other services and expenditures	CEO according to expenditure / hourly rate	CHF 280 + VAT
	Legal & Compliance Desk according to expenditure / hourly rate	CHF 250 + VAT
	Administration according to expenditure / hourly rate	CHF 100 + VAT

*(Continued)*

**Table 1: (continued)**

Modifications	Changes of membership status/ category	CHF 250 + VAT
Audits	AMLA audits pursuant to rules of conduct for asset managers	CHF 500 + VAT
Measures and sanctions proceedings	Cost for measures proceedings	CHF 250 and 5,000 + VAT
	Cost for sanctions proceedings	Ordinary sanctions proceedings CHF 2,000 bis 4,000 + VAT; average sanctions proceedings CHF 4,000 bis 6,000 + VAT; above average sanctions proceedings CHF 6,000 bis 10,000 + VAT

board of directors is the largest responsible body and has a non-transferable obligation of supervision over all management bodies especially in regard to abidance by all relevant laws, statutes, regulations and policies. Furthermore, the board is also responsible for all decisions of exceptional interest and delegates the management of the VQF to the CEO. The CEO is responsible for the management of all operations of the VQF. Together with the Legal & Compliance Desk, the CEO is responsible for the supervision of the association's members. They employ a total of 15 permanent staff, including experienced specialists.

## REFERENCES AND NOTES

- (1) Financial Crimes Enforcement Network (n.d.) 'Legal Reference for Bank Secrecy Act Forms and Filing Requirements', 31 CFR 1010.100(t) (formerly 31 CFR 103.11(n)), available at <https://www.fincen.gov/legal-reference-bank-secrecy-act-forms-and-filing-requirements> (accessed 2nd December, 2022).
- (2) International Organization of Securities Commissions (2000) 'Model for Effective Regulation', available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf> (accessed 2nd December, 2022). The IOSCO SRO Consultative Committee undertook a project regarding the effectiveness of self-regulation. Conseil des Marchés Financiers and National Futures Association agreed to be the co-chairs of a subcommittee to develop a formal paper that would set forth the general principles for self-regulation and why self-regulation should be incorporated into regulatory frameworks. The subcommittee included a cross-section of self-regulatory organisations, in terms of geographic location, type of market and type of self-regulatory organisation. The subcommittee held a meeting in London to discuss the content material for the paper and to discuss important issues impacting the various marketplaces around the globe. The subcommittee also reviewed a large amount of material written on the topic of self-regulation. In order to obtain more detailed data regarding the activities of the SRO Consultative Committee members, a questionnaire was distributed to solicit specific information regarding the activities of each organisation. This paper was presented at the IOSCO annual meeting in May 2000. The purpose of this paper is to advocate the use, value and efficiencies of self-regulation as part of the overall regulatory structure in the financial services industry.
- (3) International Organization of Securities Commissions (2017) 'Objectives and Principles of Securities Regulation', available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf> (accessed 2nd December, 2022).
- (4) FINRA (n.d.) 'About FINRA', available at <https://www.finra.org/about> (accessed 2nd December, 2022).
- (5) NFA (n.d.) 'About NFA', available at <https://www.nfa.futures.org/about/index.html> (accessed 2nd December, 2022). The Commodity Exchange Act (CEA) requires certain firms and individuals that conduct business in the derivatives industry to register with the CFTC.
- (6) From July 2022 to October 2022, Global-DCA sent participation invitations via email to more than 100 C-suite members, executives, company representatives, regulators and legal professionals.

- (7) International Organization of Securities Commissions, ref 2 above.
- (8) United States Securities and Exchange Commission (1996) 'Report Pursuant to Section 21(a) of the Securities Exchange Act of 1934 Regarding the NASD and the NASDAQ Market', available at <https://www.sec.gov/litigation/investreport/nd21a-report.txt> (accessed 2nd December, 2022).
- (9) United States Securities and Exchange Commission (2005) 'Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 ('Exchange Act') Regarding the Nasdaq Stock Market, Inc. ('Nasdaq'), as Overseen by Its Parent, the National Association of Securities Dealers, Inc. ('NASD')', available at <https://www.sec.gov/litigation/investreport/34-51163.htm> (accessed 2nd December, 2022).
- (10) The authors do not take a position on which US regulatory agency should be assigned primary oversight responsibility over the SRO.
- (11) See JVCEA (n.d.) 'Home Page' available at <https://jvcea.or.jp/> (accessed 2nd December, 2022). Unless specified, the information for this section derives from the JVCEA webpage.
- (12) *Ibid.* The recurring annual fee for Type 1 members varies based on the type of services the member provides. The annual fee for Type 2 members is ¥3,600,000, or approximately US\$27,000.
- (13) Essential decisions include: (1) expulsion of members; (2) election or dismissal of directors and auditors; (3) amount and basis of payment of remuneration, etc for directors and auditors;
- (4) approval of business reports and business plans;
- (5) approval of the balance sheet and statement of net assets increase/decrease; (6) approval of the budget for income and expenses; (7) amendment of the articles of incorporation; (8) dissolution and disposition of remaining assets; (9) matters resolved by the board of directors to be submitted to the general meeting; (10) other matters provided for in laws and regulations or the articles of incorporation to be resolved at the general meeting of members.
- (14) JVCEA, ref 11 above. The board of directors: (1) makes decisions on the execution of the business of the association; (2) supervises the execution of the duties of the executive directors; (3) selects and dismisses the president, vice presidents and executive director; (4) selects and dismisses the executive directors; (5) determines proposals to be submitted to the general meeting of members; (6) delegates matters to the board of directors at the general meeting of members; (7) establishes and amends rules and regulations; (8) addresses other matters deemed necessary by the chair in connection with the management of the business of the association.
- (15) Lewis, L., Slodkowski, A. and Sugiura, E. (17th July, 2022), 'Japan struggles with self-regulation during crypto meltdown', *Financial Times*, available at <https://www.ft.com/content/75a05077-6ac8-4365-a8c5-28fc8928b505> (accessed 2nd December, 2022).
- (16) See KBCA, 'Home Page', available at <https://kblockchain.org/> (accessed 2nd December, 2022).
- (17) See VQF, 'Home Page', available at <https://www.vqf.ch/en/vqf> (accessed 2nd December, 2022).