



IT'S A BIRD, IT'S A PLANE, NO IT'S BITCOIN!

*Faster than a speeding bullet.
More powerful than a locomotive.
Able to leap tall buildings in a single bound.*

*Look! Up in the sky!
It's a bird. It's a plane. It's Superman!*

In this famous preamble to the original TV show, it was clear that average citizens didn't know what to make of a costumed man flying through the sky to fight crime. Superman, of course, was able to do pretty much anything in his constant battle for "truth, justice, and the American way".

Amusingly, if one listens to all the rhetoric surrounding crypto, one hears a similar refrain. Claims of how blockchain projects will revolutionize every industry, put the "bad guys" out of business, democratize investing, and, of course, make people wealthy, seem to battle each other for hyperbole...

While this comparison is amusing, there **are** a couple of striking similarities: First, blockchain technology **will** almost certainly be very disruptive to a variety of industries both with improved efficiency and democratized access.

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May 2018

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Second, people **do** have a hard time categorizing crypto-assets, hence the “bird, plane or Superman” reference in the title. In fact, a prime reason explaining crypto’s disruptive potential is that crypto assets are effectively polymorphic, meaning that different people will view the same asset as different things, depending on their unique perspective. When one is purchasing a crypto-asset on a market, they are an investment, when they operate inside of a network, they are more like a commodity, but when they are used to purchase goods or services outside of their native network, they are more like a currency.

Unfortunately, the flexibility provided by crypto-assets is a double-edged sword, as it creates a serious problem for regulators. This is because current regulations for investments (securities) hedging/speculative vehicles (futures/derivatives), tangible assets (commodities), payment mechanisms (currencies) and wealth storage (banking), overlap and often **conflict** with one another, making compliance with all of them difficult or impossible. In this regard, the flexibility and disruptive potential of crypto becomes its Achilles heel in the U.S., where regulation is an **existential** threat to many of the assets and the businesses reliant upon them. This should surprise no one, since this technology was totally inconceivable by the authors of the regulation which are in force today. As a result, we should all acknowledge that crypto-asset regulation requires a new approach.

Thankfully, if he meant it literally, [SEC chair Clayton provided guidance for the way forward in his latest speech](#). His call for a principle-based approach, so as to NOT stop innovation is particularly heartening:

“One of our key responsibilities as regulators is to strive to ensure that, as technology changes, our regulations continue to drive efficiency, integrity and resilience.”

In practice, this would mean a compromise solution between [self-interested calls from crypto-industry heavyweights for very lenient self-regulation](#), and full-blown adherence to the existing (conflicting) web of securities, derivatives, banking and commodities laws. As I have described in previous posts, new regulations should be adopted to streamline and sharpen disclosures for crypto-asset issuers and rules for secondary trading of those assets should be principles-based. In the meantime, however, there are some practical steps that regulators can take to move the market towards the outcomes they desire.

The most important step would be for the SEC to allow regulated broker dealers & ATSS to trade existing crypto-assets and treat that activity similarly to how OTC securities are traded. At the same time, they should provide a time-period for firms and “exchanges” that currently trade such assets, to become regulated entities. This could take the form of “no action” relief to broker dealers or ATS’s that want to trade Bitcoin, Ethereum, Ripple and other crypto assets. Such an action could be limited to those assets already trading on various non-regulated “exchanges” or a subset which meet certain minimum thresholds.

Considering that these assets are already trading, with widespread U.S. investor participation, but without the benefit of foundational regulatory principles, this would be extremely beneficial to crypto investors. Such critical ideas as best execution, fair & orderly markets, manipulation surveillance &

disclosure/management of conflicts of interest are important and the SEC should act to ensure they become the norm, rather than the exception in the crypto market. Since all brokers and Alternative Trading Systems (ATs) are held to these principles by the regulators, regardless of detailed asset-specific rules, the transition to becoming such entities would help protect investors. These principles have worked to make markets better and protect investors, issuers and traders for many years, and there is no reason to think that they would have a different result in the crypto-markets. Specifically, let's consider each of these principals:

Best Execution: Generally, best execution means that clients have a reasonable expectation that their agents, whether a retail broker, institutional agent or exchange will get them the best possible price within the parameters of their order. At CoinRoutes, we are focused on helping our clients achieve best execution via pan-exchange routing and algorithmic strategies and understand that best execution is not always simple to prove. Market conditions and the circumstances of each order need to be considered, but there are some clear guidelines that should be followed (and I will leave it to the readers to decide if they are being followed by current crypto-market participants):

- All available prices should be considered. It is ok to trade on specific venues if they are faster, more certain or trustworthy, but ignoring other markets completely without reason is extremely hard to justify.
- Clients should not take a back seat to a firm's own positions; If a trader is holding a client order that is executable at a price, it is not acceptable for that trader to trade their own principal positions in front of such orders.
- No undisclosed mark-ups of price should be allowed. It is fine to charge a disclosed commission or fee, but the price received by the client should be what was transacted on their behalf.

Fair and Orderly Markets: This idea, which is also called "just and equitable principles of trade" are used by regulators to incentivize behaviors and structures that promote the integrity of the market. Ideally, competitive forces and innovations from companies such as CoinRoutes will do most of the work, but sometimes the incumbent players are resistant. As a result, the regulators can help by enforcing these key principles:

- Fair access to markets, to ensure that no participants have undisclosed advantages in either speed of access to exchange data or matching engines or in the quality, use or amount of available market data. This should extend to the creation of execution or valuation benchmarks, where "side deals" between established players that restrict the ability of participants to have a full understanding of the market should be actively discouraged.
- Orderly markets, meaning that venues should take steps to protect against "flash events" and erroneous trading which often cause uninformed investors to lose money. Such steps can take the form of:
 - Market access rules to prevent "fat finger" errors that create erroneous orders
 - Rules to prevent firms from violating credit or exposure limits

- Policies to prevent markets moving too fast in an extremely short period of time, particularly when a SINGLE market moves out of sync with others
- Policies to prevent so-called "momentum ignition" strategies

Manipulation: Practices such as spoofing & layering on exchange books can distort price discovery and lower investor confidence. Wash trading that distorts reported volumes can create the appearance of demand for assets and trigger algorithms to be more aggressive. As a result, it is imperative for an SRO to have a clear policy that will surveil against such practices and encourage exchanges and brokers to have policies and procedures to do so as well.

Conflicts of Interest: We believe that the potential for significant conflicts of interest must be addressed by an SRO. To do so, there must be clear delineation & disclosure of the roles of Fund Manager, Retail Broker, Exchange, Principal Trading Desk, or Agency Broker as well as appropriate information barriers in place between them. To explain why, consider the following potential conflicts:

- Retail brokers, who have responsibilities to their end client, have a conflict of interest, if their firm makes additional profit when directing trading to their own venue, instead of competing venues with superior prices.
- Fund managers, who profit on their own trading venue when they rebalance their fund holdings, have a conflict of interest if their affiliated venue makes additional profit from the trades that result from those rebalances.
- Principal Trading Desks, who would be more profitable if they have access to Exchange data such as client holdings or identities related to orders, since that information could be used to harm the clients of their affiliated exchange.
- Agent or Principal Trading Desks who gain advantages, if they are provided faster data, market access or higher granularity of information by affiliated exchanges or trading desks.

These principles, which are all based on common sense, would improve the quality of the markets. If the SEC allowed current regulated entities to compete with unregulated ones in the trading of crypto assets, that would act to let the market push in that direction. “Encouraging” all the current exchanges to become regulated would also be helpful, as long as they did not force them to adhere to the full gamut of equity rules, some of which don’t apply and risk stopping innovation in the U.S. The principles-based approach suggested here, however, would provide significant benefit to investors while speeding up the maturation of the markets. If, at the same time, the SEC allowed a transition period to existing participants, to minimize disruption to existing investors, that would be a prudent approach.

Finally, I want to be clear that I wholeheartedly agree with the notion of forming a crypto SRO, as long as it includes these core principals within its mandate. It is also clear that there is a need for new crypto-asset specific regulations, but that will take time to implement and should be done in concert with the industry. That is why it is so important to take the simple steps I have suggested here. In addition to helping reform the markets, the clarity provided by such a direction would help overcome a potential “chilling effect” on innovation in the US with regard to crypto assets.