



State Street Corporation

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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Via electronic submission: www.bis.org/bcbs/commentupload.htm

Re: Designing a Prudential Treatment for Crypto-Assets

Dear Sir/Madam:

State Street Corporation (“State Street”) appreciates the opportunity to respond to the Basel Committee on Banking Supervision’s (“Basel Committee”) discussion paper on designing a prudential framework for the treatment of crypto-assets (“discussion paper”).¹ The discussion paper seeks views on the various features of crypto-assets, including factors that could affect their risk profile, and general principles and considerations to help inform the design of a framework for banks’ exposures to crypto-assets.

Headquartered in Boston, Massachusetts, State Street is a global custodian bank which specializes in the provision of financial services to institutional investor clients. This includes the provision of investment servicing, investment management, data and analytics, and investment research and trading. With \$34.358 trillion in assets under custody and administration and \$3.116 trillion in assets under management, State Street operates in more than 100 geographic markets globally.² State Street is organized as a United States (“US”) bank holding company (“BHC”), with operations conducted through several entities, primarily its wholly-owned, state-chartered depository institution subsidiary, State Street Bank and Trust Company. As such, our primary prudential regulators are the Massachusetts Division of Banks and the US Federal Reserve System.

Custody banks, such as State Street, employ a highly specialized business model focused on the provision of operational services to institutional investor clients. These clients, which include asset owners, asset managers and official institutions, contract with custody banks to ensure the proper safekeeping of their investment assets, as well as the provision of a broad range of related financial services. These services include: access to the global settlement infrastructure in order to complete the purchase or sale of

¹ Available at www.bis.org/bcbs/publ/d490.pdf.

² As of December 31, 2019.

investment securities; various asset administration functions, such as the processing of income and other interest payments; corporate action events; tax withholding and reclamations; and the provision of banking services, notably access to deposit accounts used to facilitate day-to-day transactional activities.

The custody bank client base is diverse and includes regulated investment funds, such as US mutual funds ("40 Act Funds"), European Union ("EU") Undertakings for Collective Investments in Transferable Securities ("UCITS") and other similar national equivalents; alternative investment funds; corporate and public retirement plans; sovereign wealth funds; insurance company accounts; charitable foundations; and endowments. At its core, the role of the custody bank is to safekeep assets in order to protect investors from potential misappropriation of their assets. In many cases, the use of a custody bank is mandated by law or regulation. This includes the requirements which apply to '40 Act Funds under the Investment Company Act of 1940, to EU UCITS under the UCITS Directive, and to EU alternative investment funds under the Alternative Investment Fund Managers Directive. In other cases, the use of a bank custodian reflects well-established client preference to hold investment portfolios with banking entities which are subject to stringent prudential requirements and regulatory oversight.

As one of the world's largest global custodian banks, State Street is actively working to understand the way in which digital assets may change the traditional custody function. We strongly support, in this respect, the development of an appropriate regulatory regime for digital assets which promotes fair, efficient and transparent financial markets, and which ensures a high level of investor protection. This includes the development of an appropriately structured prudential framework which properly accounts for various potential areas of risk. Broadly speaking, we believe that a principles-based regulatory framework is more suitable for digital assets, versus a highly prescriptive framework, since a principles-based approach allows for the necessary flexibility to adjust to the rapidly evolving landscape for digital assets.

In our response, we use the term "digital assets" to refer to all assets that are cryptographically stored on distributed ledgers. As defined by the Basel Committee in the discussion paper, our use of the term digital assets covers various functions that digital assets are able to provide, such as payments and exchange services, investments and securities services and utility access.

We highlight below key considerations that we believe the Basel Committee should take into account when developing a principles-based regulatory framework for digital assets. This includes:

- Key features of digital assets;
- Benefits of digital assets to the banking system;
- Adherence to the principle of same risk, same activity, same treatment; and
- Promotion of investor protection and the safeguarding of assets.

Key Features of Digital Assets

It is important, as an initial matter, to clearly distinguish between various types of digital assets when developing a corresponding prudential framework. This includes a careful consideration of the intended function and characteristics of the digital asset. For example, the discussion paper describes stablecoins as initiatives that include "redemption or repurchase assurances by a legal entity." We believe that this

definition is too broad as it encompasses blockchain-driven initiatives such as utility coins, which are distinct from other stablecoin initiatives that may seek to replicate certain features of fiat currency. For example, the utility settlement coin construct proposed by Fnality International, a global consortium of banks and exchanges, is designed to facilitate the flow of payments in the post-trade ecosystem using digital cash that guarantees convertibility into fiat currency at all times (*i.e.* each utility settlement coin is backed one-for-one by a fiat currency). This is achieved by various measures, including seeking regulatory status as a financial market infrastructure. By comparison, stablecoin does not benefit from a commonly agreed upon legal structure, including the mechanism for ensuring the maintenance of its underlying value. Consequently, the risk of whether a stablecoin can be redeemed against the underlying asset (*e.g.* fiat cash or other assets) may differ significantly from that of a utility coin. We believe that a common taxonomy that conveys these important distinctions in the features and risk profile of various types of digital cash is necessary in order to ensure that distributed ledger technology can meet the promise of greater efficiency and reduced risk in the provision of post-trade financial services.

Second, when designing a prudential framework for the treatment of digital assets, we believe that it is important for the Basel Committee to consider certain key structural features of the asset. This includes the governance of the distributed ledger protocol on which the digital asset exists, features of the digital asset itself, and the capabilities available to participants in the case of loss or theft of the digital asset. Specifically, the governance of the distributed ledger protocol on which the digital asset exists strongly impacts the legal and regulatory frameworks that would apply to the digital asset. Matters such as who has access to the distributed ledger, who has visibility of the underlying data, how decisions are made, and what responsibilities participants have will influence the robustness, and therefore risk profile, of the governance structure.

In our view, it is easier to consider, as a first step, governance elements for private or permissioned networks versus public or permission-less networks. In the current operating environment, private or permissioned networks provide the necessary control over digital assets for regulated financial institutions and therefore, are a more palatable first step for the development of post-trade functionality, such as the safekeeping and administration of digital assets. Nevertheless, we believe that public or permission-less networks should also be taken into consideration by the Basel Committee when developing the prudential framework for digital assets given the advantages that these networks provide for the liquidity and fungibility of different digital assets, and the likely development of greater risk controls and governance frameworks for such systems over time. Furthermore, future client demand may require contemplation of permission-less networks as a fundamental cornerstone of the post-trade infrastructure as the digital asset ecosystem evolves. In addition, it is important to consider whether a digital asset can be recalled, destroyed and re-issued, as required. This would typically mandate a clearly identifiable issuer and enforceable rights belonging to the investor. Clearly, crypto-assets, such as Bitcoin, do not have these features and therefore present a very different risk profile compared to other digital assets.

Finally, in order to facilitate the application of appropriately structured regulatory and legal frameworks, it is important to consider the characteristics of the underlying distributed ledger technology on which digital assets reside. While it is easier to understand the regulatory and legal framework for asset-backed tokens (*i.e.* digitally-issued tokens backed by already issued assets existing outside the distributed ledger), it remains our view that fully native security tokens (*i.e.* those financial instruments that are directly issued on the blockchain without further need to register those assets outside the distributed ledger) drive

important market efficiencies, and therefore should also be taken into consideration when considering the design of a prudential framework for digital assets.

Benefits of Digital Assets to Banking System

As the technology underlying distributed ledgers evolves, use cases will continue to unlock the potential benefits of digital assets to the banking system. Current use cases regarding the issuance, distribution and servicing of digital assets suggest that these assets will enable some functions to be embedded within the asset (*e.g.* triggering a coupon payment based on a set of pre-defined criteria), while other functions (*e.g.* reconciliation requirements between nostro/vostro accounts) can be eliminated without increasing risks to the market or the investor. These and other similar outcomes would substantially increase efficiencies across the post-trade ecosystem and reduce the potential for errors in the servicing of assets.

Treatment of Digital Assets that are Similar to Traditional Assets

State Street strongly supports the core principle of “same risk, same activity, same treatment,” when defining the prudential framework for digital assets. This extends to the digital version of existing assets where the economic structure and purpose of the instrument are the same. Indeed, we strongly believe that the prudential framework for banks should not disadvantage the use of digital assets that are the functional equivalent of traditional assets solely because of the technology which underlines such assets.

We recognize that the application of distributed ledger technologies within the financial markets is new and will result in important questions about the appropriate legal and regulatory treatment of various asset types. In our view, resolving these open questions would further facilitate the application of the “same risk, same activity, same treatment” principle and enable the markets, over time, to benefit from the efficiency and flexibility inherent in digital assets. This requires close collaboration among market participants and regulators globally, including cooperation between prudential and securities regulators.

Investor Protection

State Street believes that any prudential framework for digital assets must strive to maintain equitable treatment across both existing and future service providers for digital assets in order to avoid the potential erosion of existing mechanisms for the protection of the investor. This includes the proper safekeeping of assets, which we view as of utmost importance for the future development and acceptance of distributed ledger technology and its functionality. In our view, this requires both the development of industry best practices and supervisory guidelines, especially in relation to regulated funds which are intended for use by non-institutional investors.

In the case of crypto-assets, the safeguarding of assets currently involves a combination of hot and cold storage, potentially including third-party control of the underlying keys or third-party involvement for shared keys. This model has materialized in the context of Bitcoin and similar crypto-assets, and fundamentally differs from the market structure which currently supports securities issued into a central

securities depository (“CSD”). In the current environment, a number of steps must be performed to ensure proper control over assets held in custody. This includes:

- Segregation of the participants’ assets from the custodian’s own assets;
- Daily reconciliations of the participants’ assets held on the custodian’s books and records, incorporating the participants’ settled and pending settlement positions and other relevant event data;
- Marking of the custodian’s books and records to accurately establish underlying ownership rights;
- Maintenance of procedures to authenticate the validity of instructions received regarding the movement of assets in participants’ accounts, including on a delivery-versus-payment, receive-versus-payment or on an encumbrance of assets basis;
- Performance of asset administration functions to safeguard related entitlements: including income/dividend collection, corporate action notification and processing, proxy voting, and tax withholding and reclaims;
- Maintenance of robust information technology and governance standards, including procedures to address cybersecurity events or other disruptions to normal day-to-day functions; and
- Maintenance of sufficient financial resources to account for potential operational risk.

Bank custodians, such as State Street, currently operate on the basis of these and other similar practices which are designed to ensure the protection of investor assets.

Distributed ledger technology offers the potential for transformational change in the conduct of existing financial services and processes. For example, by offering one shared source of truth, distributed ledger technology will sharply narrow, if not eliminate, the need to reconcile financial assets across systems and among market participants. Additionally, the one shared source of truth may also reduce the need for, or modify the role of, CSDs. As such, distributed ledger technology systems will require a form of consensus mechanism that ensures agreed upon updates to the common ledger, and any provider of distributed ledger technology will need to ensure that validators are always available during operating hours to ensure settlement. Presently, there is no requirement for a distributed ledger provider to provide this validation and the market is using alternative means (*e.g.* economic incentives, private contracts, etc.). Furthermore, distributed ledger technology offers the promise of smart contract functionality where various events, such as the payment of income, are embedded in the token created through the smart contract, thereby negating the need for separate asset administration functionality.

Notwithstanding these important innovations, what remains essential to the future of digital assets is the ability to protect the investor from the potential misappropriation of their assets. A robust digital custody framework supporting this goal will be defined in line with advances in cryptography and distributed ledger technology, along with new consideration being given to cybersecurity and business continuity obligations. We believe that bank custodians are uniquely well-positioned to continue to play this role, including through the development of digital capabilities which support custody and post-trade services, digital cash, issuance and trading, and research and analysis.

Conclusion

Thank you once again for the opportunity to respond to the discussion paper. We appreciate the Basel Committee's engagement on this matter and stand ready to serve as a trusted and experienced resource as the prudential framework for crypto-assets is developed.

Please feel free to contact me at jjbarry@statestreet.com should you wish to discuss State Street's submission in further detail.

Sincerely,

A handwritten signature in black ink, appearing to read "JJ Barry", with a stylized flourish at the end.

Joseph J. Barry