



# THE GLOBAL CHALLENGE OF DIGITAL ASSET REGULATION



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### **Crypto Needs Common Sense Financial Regulation – Suggestions for 2022**

By Sean Stein Smith



### **The Global Challenge of Digital Asset Regulation**

By Bianca Kremer & Kevin Werbach



### **Can Crypto Fix Itself in Time?**

By David S. Evans



### **Cryptocurrency Regulation and an Economic Classification of Tokens**

By Lin William Cong & Claire Wilson



### **Defining Relevant Markets in the Crypto Economy**

By Florian Deufhard & C.-Philipp Heller



### **Can WEB3 Bring Back Competition to Digital Platforms?**

By Christian Catalini & Scott Duke Kominers



### **Crypto Love is a Battlefield**

By Richard B. Levin, Craig Nazzaro, Brian Russ & Kevin Tran



### **The Global Challenge of Digital Asset Regulation**

By Bianca Kremer & Kevin Werbach

Digital assets add complexity to an already complex global financial system. Jurisdictions around the world are adopting measures to respond to ongoing developments. As activity grows, bespoke legal regimes are either in place, in development, or under discussion around the world. Regulatory interest now extends beyond token offerings and exchanges to include stablecoins, decentralized finance (“DeFi”), non-fungible tokens (“NFTs”) and decentralized autonomous organizations (“DAOs”). In this article, we take a bird’s eye view of the global state of digital asset regulation. While some countries have adopted a hostile posture, most regulators are attempting to balance concerns about potential harms against potential benefits. Despite concerns about uncertainty and fragmentation, the regulatory environment is gradually adapting to the novel challenges of digital assets and blockchain-based financial services.

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# 01

## INTRODUCTION

The financial system has become increasingly global and intertwined over the past century. While this has produced tremendous benefits, it also raises the stakes on the risk side of the equation. Higher volumes, greater velocity, and increasing sophistication of financial engineering open opportunities for unintentional crashes as well as intentional manipulation. And failure in one market can ultimately have cascading effects into others. More digital and global money also raises the stakes around illicit financial activity, such as money laundering and terrorist financing. For these and other reasons, as global finance has evolved, so has global financial regulation.

The development of digital asset markets, in particular the rise of decentralized finance (“DeFi”) can be viewed as a new and significant stage in this process. Over 100 million people worldwide now hold cryptocurrencies.<sup>2</sup> In addition to pure digital asset exchanges such as Coinbase, traditional financial platforms such as PayPal and Square are embracing cryptocurrency transactions. Funds locked into DeFi protocols grew from US\$1 billion in early 2020 to US\$250 billion in late 2021.<sup>3</sup> And traditional financial institutions are becoming increasingly active players in digital asset markets.

Contrary to popular discourse, blockchain-based finance is neither a regulatory “Wild West” where anything goes, nor a world that has successfully replaced the need for law with immutable code. The market failures, information asymmetries, and abuses that give rise to the need for traditional financial regulation do not all disappear in DeFi and other digital asset markets; in some cases, they are magnified. Effectively addressing these regulatory challenges, however, is difficult. Part of the difficulty lies in the complex convergence of systems involved: the blockchain technology itself and its derivative applications, the global financial system, and the many regulatory agencies that have varying interests and mandates. In addition, digital assets and blockchains are inherently global, while regula-

tion operates, in the first instance, at the national or sub-national level.<sup>4</sup>

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There is a long way to go to address these challenges. However, there is reason for optimism. The dramatic increase in adoption and sophistication of digital asset markets since 2017 has occurred against a backdrop of extensive regulatory activity around the world. With a few important exceptions, governments have not attempted to shut down cryptocurrencies, but to ensure they are appropriately regulated to address significant public policy concerns. Regulation has not prevented the flowering of innovative activity. Furthermore, there is growing coordination and harmonization among jurisdictions, suggesting that the global nature of digital assets need not stand in the way of appropriate regulatory accommodations.<sup>5</sup>

# 02

## THE STATE OF DIGITAL ASSET REGULATION

Blockchain-based innovations may represent a paradigm shift in the very nature of financial services, facilitating transactions without the need for intermediaries, allowing for more user control through self-custody, and automating activity through smart contracts. Digital assets represent a new asset class that simply did not exist before. While they promise tremendous benefits, they also pose risks, some of which are novel.

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<sup>2</sup> See Paul Vigna, Bitcoin’s ‘One Percent’ Controls Lion’s Share of the Cryptocurrency’s Wealth, (Wall Street Journal, Dec. 20, 2021), <https://www.wsj.com/articles/bitcoins-one-percent-controls-lions-share-of-the-cryptocurrencys-wealth-11639996204>.

<sup>3</sup> See <https://defillama.com/>. Google trends show that the interest for DeFi had its onset with the start of the Covid-19 pandemic in the Western world. See <https://trends.google.com/trends/explore?cat=7&date=all&q=defi>.

<sup>4</sup> Supra-national regulators such as the European Commission or World Trade Organization gain explicit mandates through voluntary accession of sovereign states.

<sup>5</sup> See Kevin Werbach, Regulating Cryptocurrency Markets: First, Do Something (Medium, 2021), <https://kwerb.medium.com/regulating-cryptocurrency-markets-first-do-something-cc84a3424fa4>.

The traditional financial system (“TradFi”) is subject to a variety of laws, regulations, and “soft law” constraints within and across jurisdictions. Major goals of financial regulation are to: (i) combat financial crime and terrorist financing, (ii) protect consumers to investors, (iii) ensure market integrity and efficiency, (iv) maintain financial stability by avoiding systemic risk and ensure a stable monetary system; (v) enable innovation and promote capital formation; and (vi) ensure tax compliance. Digital assets raise questions in virtually all of these categories.

Countries all over the world are designing frameworks or are at least planning to address the unique challenges that blockchains and digital assets pose for financial regulation. Regulatory activity increased as a response to the initial coin offering (“ICO”) boom in 2017; following Facebook’s 2019 proposal for a global stablecoin, originally called Libra; and in 2021, with increased institutional adoption.<sup>6</sup>

The spectrum of initial regulatory approaches across countries is quite broad, from adopting bitcoin as legal tender in the case of El Salvador, to outright banning certain cryptocurrency activity, such as in China, India, and Nigeria.<sup>7</sup> However, most of the major financial and digital asset activity hubs have taken a broadly similar approach: (i) identifying where cryptocurrency and DeFi activity fits with existing regulatory obligations, in order to achieve major public policy goals; and (ii) where gaps or conflicts are evident, developing new regulatory frameworks appropriate to the unique attributes of digital asset markets.

In the United States, digital assets have received regulatory attention both at a federal and state level by various agencies, such as the Securities and Exchange Commission (“SEC”), the Financial Crimes Enforcement Network (“FinCEN”), the Office of the Comptroller of the Currency (“OCC”), the Internal Revenue Service (“IRS”), the Commodity Futures Trading Commission (“CFTC”), the Federal

Deposit Insurance Corporation (“FDIC”), the Office of Foreign Asset Control (“OFAC”), and the Consumer Financial Protection Bureau (“CFPB”). At a state level, approaches to digital assets encompass the whole spectrum from crypto-favorable, such as in Wyoming, to more restrictive, such as in Maryland.<sup>8</sup> This has produced a fragmented regulatory landscape, but also one experimenting with a large number of possible approaches.

Digital assets can serve many functions. Because the U.S. financial regulatory structure is divided among specialized agencies and offices, digital assets are classified in a variety of ways. FinCEN, which focuses on financial crime, designated virtual currencies as “money” and in 2020 suggested that large virtual currency transactions needed to adhere to Know Your Customer (“KYC”) requirements and had to be reported.<sup>9</sup> The IRS treats digital assets as property for income tax purposes.<sup>10</sup> The Commodity Futures Trading Commission (“CFTC”) has found digital assets to be commodities when traded,<sup>11</sup> and the Securities and Exchange Commission (“SEC”) has suggested that most digital assets fall under securities law.

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The SEC brought more than seventy cryptocurrency-related enforcement actions since 2013, mostly involving claims of fraud and unregistered securities issuances. SEC Chair Gary Gensler has urged Congress to clarify the SEC’s regu-

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<sup>6</sup> Coinbase’s successful initial public offering in 2021 was a watershed moment for institutional acceptance of digital asset markets. See Landon Manning, Coinbase IPO Exceeds All Expectations, Showing More Promise For Bitcoin, (Nasdaq, Apr. 19, 2021), <https://www.nasdaq.com/articles/coinbase-ipo-exceeds-all-expectations-showing-more-promise-for-bitcoin-2021-04-19>.

<sup>7</sup> In the case of Nigeria, that attitude, however, backfired, and instead of preventing Nigerians from engaging with cryptocurrencies the adoption has increased. See Chijioke Ohuocha & Libby George, Crypto trading thrives in Nigeria despite official disapproval (Reuters, Oct. 12, 2021), <https://www.reuters.com/business/crypto-trading-thrives-nigeria-despite-official-disapproval-2021-10-12/>.

<sup>8</sup> See Joe Dewey, Blockchain and Cryptocurrency Laws and Regulations 2022 - USA, <https://www.globallegalinsights.com/practice-areas/blockchain-laws-and-regulations/usa>.

<sup>9</sup> See Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets, 85 FR 83840 (Dec. 23, 2020), <https://www.govinfo.gov/app/details/FR-2020-12-23/2020-28437/summary>.

<sup>10</sup> See IRS Notice 2014-21, 2014-16 I.R.B. 938, Guidance for Individuals and Businesses on the Tax Treatment of Transactions Using Virtual Currencies, <https://www.irs.gov/pub/irs-drop/n-14-21.pdf>. See also IRS, Frequently Asked Questions on Virtual Currency Transactions, <https://www.irs.gov/individuals/international-taxpayers/frequently-asked-questions-on-virtual-currency-transactions>.

<sup>11</sup> See CFTC Release Number 7820-18, Federal Court Finds that Virtual Currencies Are Commodities (Oct. 3, 2018), <https://www.cftc.gov/PressRoom/PressReleases/7820-18>. See also CFTC, Digital Assets, <https://www.cftc.gov/digitalassets/index.htm>.

latory power over digital assets and exchanges.<sup>12</sup> However, Gensler has also stated that “[c]ertain rules related to crypto assets are well-settled. The test to determine whether a crypto asset is a security is clear.”<sup>13</sup> This view is not widely shared in the digital asset community. Resolution of pending litigation between the SEC and Ripple, which the SEC claims engaged in unregistered securities trading through the XRP token, may provide greater clarity. Moreover, Congress appears highly interested in passing legislation to address the securities classification of digital assets, or to provide a more comprehensive framework. Several hearings were held in late 2021, and several serious legislative proposals are being developed. There is active dialogue underway between policymakers and major digital asset firms or investors.

There are now a number of collaborative efforts across federal agencies. For example, the President’s Working Group on Financial Markets (“PWG”) together with FDIC and the OCC earlier in November 2021, released a report on stablecoins,<sup>14</sup> alerting to the risks associated with this type of digital asset and calling on the U.S. Congress to pass legislation.<sup>15</sup> An Executive Order on cryptocurrencies, which would encourage further coordination, is reportedly under discussion in the White House.<sup>16</sup>

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In Europe, the regulation of digital assets is similarly moving from initial fragmentation toward a coordinated approach. Almost all European Union Member States have significantly increased their regulatory activity since 2018, applying both tax and AML/CFT laws to crypto assets.<sup>17</sup> According to Article 47 (1) of the 5<sup>th</sup> Anti Money Laundering Directive, Member States must ensure that exchange service providers between virtual currencies and fiat currencies, and custodian wallet providers are registered.<sup>18</sup> In a new proposal for a 6<sup>th</sup> Anti-Money Laundering Directive, the goal is to harmonize AML/CFT across the European Union further and establish a new EU anti-money laundering authority.<sup>19</sup>

The European Securities and Markets Authority (“ESMA”) is the EU securities markets regulator and has issued warnings regarding ICOs in 2017,<sup>20</sup> it published advices on ICOs and crypto assets in 2019,<sup>21</sup> and in 2021 warned about the risks linked to still largely unregulated crypto assets.<sup>22</sup> In 2019 the European Banking Authority (“EBA”)

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**12** See Testimony of Gary Gensler (Chairman, SEC) before the Subcomm. on Fin. Serv. And General Govt. of the H. Appropriations Comm., 117<sup>th</sup> Cong. (May 26, 2021), <https://www.sec.gov/news/testimony/gensler-2021-05-26>.

**13** See SEC Chair Gary Gensler, Remarks Before the Aspen Security Forum, (Aug. 3, 2021), <https://www.sec.gov/news/public-statement/gensler-aspen-security-forum-2021-08-03>.

**14** See U.S. Department of the Treasury Press Release, President’s Working Group on Financial Markets Releases Report and Recommendations on Stablecoins (Nov. 1, 2021), <https://home.treasury.gov/news/press-releases/jy0454>.

**15** See PWG, FDIC, & OCC, Report on Stablecoins, (Nov. 1, 2021), [https://home.treasury.gov/system/files/136/StableCoinReport\\_Nov1\\_508.pdf](https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf).

**16** See Jennifer Epstein & Benjamin Bain, White House Weighs Wide-Ranging Push for Crypto Oversight, (Bloomberg, Oct. 8, 2021), <https://www.bloomberg.com/news/articles/2021-10-08/white-house-weighs-wide-ranging-push-for-crypto-oversight>.

**17** With the exception of Bulgaria. See US Law Library of Congress, Regulation of Cryptocurrency Around the World: November 2021, Update, <https://tile.loc.gov/storage-services/service/ll/lglrd/2021687419/2021687419.pdf>.

**18** See the 5<sup>th</sup> AML/CFT Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU, <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018L0843&from=EN>.

**19** See European Commission COM(2021) 420 final, Proposal for a regulation of the European Parliament and of the Council on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0420>.

**20** See ESMA, Warnings and Publications for Investors - ESMA highlights ICO risks for investors and firms, (Nov. 13, 2017), <https://www.esma.europa.eu/press-news/esma-news/esma-highlights-ico-risks-investors-and-firms>.

**21** See ESMA, Advice Initial Coin Offerings and Crypto-Assets, (Jan. 9, 2019), [https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391\\_crypto\\_advice.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf).

**22** See ESMA Press Release, ESMA sees high risk for investors in non-regulated crypto assets, (Mar. 17, 2021), <https://www.esma.europa.eu/press-news/esma-news/esma-sees-high-risk-investors-in-non-regulated-crypto-assets>.

published a report on crypto assets, in which it recommends the European Commission to take further measures.<sup>23</sup> In September 2020, the European Commission thus presented a comprehensive legislative proposal for a regulation on Markets in Crypto Assets (“MiCA”)<sup>24</sup> as part of its Digital Finance Strategy. The ambition is to harmonize this area across all Member States. The Digital Finance Strategy not only includes the MiCA regulation but also a new proposal for a Pilot Regime for Market Infrastructures Based on Distributed Ledger Technology (“PilotR”).<sup>25</sup>

MiCA creates a bespoke regime for markets in crypto assets, tackling issuers of crypto assets as well as crypto asset service providers (“CASPs”), such as wallet providers and exchanges. A distinction is made between three sub-categories of crypto-assets, the two latter categories essentially being sub-categories of stablecoins. MiCA defines these categories as (i) utility tokens which have no financial purpose, (ii) asset-referenced tokens, which maintain stability by referencing one or several legal tender currencies, commodities, or crypto assets, and (iii) crypto-assets that are intended as means of payment and stabilize their value by referencing one fiat currency. MiCA wants to enhance transparency for crypto asset holders by requiring ESMA to establish a register of service providers and considers crypto asset services as financial services. The European Union is a supranational body with law-making power in its Member States. MiCA as a regulation (as opposed to a directive),<sup>26</sup> once adopted, will become applicable throughout the European

Union, taking precedence over any national rules. Thus, by implementing a harmonious regime, which becomes directly applicable in all Member States, fragmentation can be avoided.

Outside the European Union, small jurisdictions such as Switzerland and Liechtenstein are known for their crypto-friendly stance. Switzerland has been fast to act and seize the opportunity to attract crypto business with its regulators’ clear guidance and the amendment of existing laws, amending several civil, financial market, and securities laws, introducing electronic registers, and DLT Licenses.<sup>27</sup> A neighboring country, Liechtenstein, has passed a completely new law for digital assets and introduced a container model in 2020, paving the way for any right or asset to be tokenized.<sup>28</sup>

In other parts of the world, such as in Asia, the regulatory environment is maturing as well. Many jurisdictions, including Japan, South Korea, Singapore, and Hong Kong, have implemented cryptocurrency license requirements. While in Singapore, crypto companies and exchanges are regulated and can apply for licenses,<sup>29</sup> Hong Kong has proposed restrictions on crypto-asset trading.<sup>30</sup>

Even more drastic restrictions on digital asset providers and users seem to be more commonplace elsewhere in Asia and in parts of Africa. On 24 September 2021, for example, in its most aggressive crackdown yet, several Chinese authorities in conjunction issued a blanket ban on all crypto-related transactions and activities, including mining.<sup>31</sup> While

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**23** See EBA, Report on crypto assets with advice for the European Commission, (Jan. 9, 2019) <https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2545547/67493daa-85a8-4429-aa91-e9a5ed880684/EBA%20Report%20on%20crypto%20assets.pdf>.

**24** See European Commission COM(2020) 593 final, Proposal for a Regulation of the European Parliament and of the Council on Markets in Crypto-assets, and amending Directive (EU) 2019/1937, <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX-%3A52020PC0593>.

**25** See Dirk A. Zetsche & Jannik Woxholth, The DLT Sandbox Under the EU Pilot Regulation, (Oxford Business Law Blog, May 14, 2021), <https://www.law.ox.ac.uk/business-law-blog/blog/2021/05/dlt-sandbox-under-eu-pilot-regulation>.

**26** See European Union, Types of legislation, [https://europa.eu/european-union/law/legal-acts\\_en](https://europa.eu/european-union/law/legal-acts_en).

**27** See Federal Council Press Release, Federal Council brings DLT Act fully into force and issues ordinance, (Jun. 18, 2021), <https://www.sif.admin.ch/sif/en/home/documentation/press-releases/medienmitteilungen.msg-id-84035.html>.

**28** See Government of the Principality of Liechtenstein Press Release, Liechtenstein Parliament approves Blockchain Act unanimously, (Oct. 3, 2019), <https://www.regierung.li/en/press-releases/222958/?typ=content&nid=11164>. See The Token and Trusted Technology Service Provider Act (TVTg), <https://www.gesetze.li/konso/2019301000>.

**29** See Monetary Authority of Singapore (MAS) Payment Services Act (PSA), <https://www.mas.gov.sg/regulation/acts/payment-services-act>. See the 2021 amendments of the PSA, <https://sso.agc.gov.sg/Acts-Supp/1-2021/Published/20210301?DocDate=20210301>.

**30** See Mercedes Ruehl & Leo Lewis, Stakes Rise for Singapore’s Big Crypto Bet, (Financial Times, Sept. 30, 2021), <https://www.ft.com/content/1f948b38-2061-416d-951d-69415b879c17>.

**31** See Alun John, Samuel Shen & Tom Wilson, China’s top regulators ban crypto trading and mining, sending bitcoin tumbling (Reuters, Sept. 24, 2021), <https://www.reuters.com/world/china/china-central-bank-vows-crackdown-cryptocurrency-trading-2021-09-24/>.

crypto is prohibited, the adoption of the digital yuan is further encouraged.<sup>32</sup> Blockchains are not simply disregarded; instead, they form part of China's DLT infrastructure strategy.<sup>33</sup>

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## 03

### LOOKING TO THE FUTURE

As major jurisdictions refine their approach to digital assets, several international standard-setting bodies are working to harmonize regulation globally. Although their guidelines and recommendations are soft law, they play a key role in shaping the regulatory blockchain landscape. Among these are the Financial Action Task Force (“FATF”), the International Organization of Securities Commission (“IOSCO”), the Financial Stability Board (“FSB”), the Basel Committee on Banking Supervision (“BCBS”), and the Organization for Economic Cooperation and Development (“OECD”). In October 2021, for example, FATF updated its guidance for virtual asset service providers (“VASP”).<sup>34</sup> In November 2021, the IOSCO in its report sets out recommendations on sustainability-related practices, policies, procedures, and disclosures in asset management.<sup>35</sup>

There will inevitably remain differences among regulatory approaches around the world, opportunities for arbitrage, and jurisdictions that fail to meet global standards for regulatory protections. However, global financial regulation need not be perfect to be reasonably effective. So-called traditional finance is already highly digital and highly mobile. Ultimately, financial activity depends on trust.<sup>36</sup> Regulation can serve as a trust-building and -enhancing exercise, which leads activity to migrate to jurisdictions with strong protections against illicit activity, market manipulation, and fraud.

Minimizing risk and protecting users, while still realizing the benefits from new financial technologies, is a balancing act. Regulation must protect important public interests without unnecessarily stifling innovation. It is not an inconsequential undertaking; its effects will be felt both directly by those subject to the rules, and indirectly by investors and other market actors. Moreover, firms will change their behavior strategically in anticipation of, or in response to, regulatory mandates, which will produce second-order consequences. That is why continued research, education, and fruitful discussions between industry and regulators are imperative. Only in achieving a good balance between regulation and innovation, while continuously monitoring and evaluating the path chosen, and adapting it when and if necessary, can jurisdictions remain competitive and collaborative in the global economy.

To achieve these goals, regulators must continue to follow a deliberate process:

- (i) Assess whether existing rules, such as the classification of regulated securities transactions, can effectively encompass digital assets. Doing so may require formal clarification of how general terms will be applied in this context, and/or prioritization of enforcement against actors in clear violation of regulatory mandates.
- (ii) Consider proportionality and use tools such as sandboxes and safe harbors to address unintended consequences of applying requirements to nascent firms and activities.<sup>37</sup>

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<sup>32</sup> See Jamie Crawley, China's CBDC has been used for \$9.7B of Transactions (CoinDesk, Nov. 3, 2021), <https://www.coindesk.com/business/2021/11/03/chinas-cbdc-has-been-used-for-97b-of-transactions/>.

<sup>33</sup> See Jane Wu, Blockchain as an Infrastructure: A Deep Dive Into China's DLT Strategy, (Cointelegraph, Jun. 23, 2020), <https://cointelegraph.com/news/blockchain-as-an-infrastructure-a-deep-dive-into-chinas-dlt-strategy>.

<sup>34</sup> See FATF's Updated Guidance for a Risk-Based Approach to Virtual Assets and Virtual Asset Service Providers, <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html>.

<sup>35</sup> See The Board of the IOSCO, Recommendations on Sustainability-Related Practices, Policies, Procedures and Disclosure in Asset Management Final Report FR08/21 (Nov., 2021), <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD688.pdf>.

<sup>36</sup> See Kevin Werbach, Regulating Cryptocurrency Markets: First, Do Something (Medium, May 15, 2021), <https://kwerb.medium.com/regulating-cryptocurrency-markets-first-do-something-cc84a3424fa4>. See also Kevin Werbach, *The Blockchain and the New Architecture of Trust* (MIT Press, 2018).

<sup>37</sup> See, e.g., World Economic Forum and Wharton Blockchain and Digital Asset Project, Decentralized Finance: (DeFi) Policy-Maker Toolkit (Jun. 8, 2021), <https://www.weforum.org/whitepapers/decentralized-finance-defi-policy-maker-toolkit>.

(iii) Consider whether the technologies of digital assets and blockchains either eliminate the need for traditional requirements or make application of those requirements more problematic. Where possible, identify the solution that meets the policy goal in the manner most appropriate for the technical and market context.

(iv) Where needed, adopt new specialized rules for digital assets.

(v) Coordinate both informally and formally with other regulatory agencies and jurisdictions.

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To stay relevant, regulatory practices themselves should also be brought into the new digital era. Novel methods of so-called “RegTech” that harness the power of blockchains could further be explored and used. In cases such as money laundering, for example, flagging of suspicious wallets and transactions if any risks have been identified could happen automatically. Ongoing conversations between regulators and industry participants will be important for shaping such tools. The digital asset space is not only a challenge: it also represents an opportunity for governments if they seize this moment proactively to modernize and streamline regulatory processes. ■



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