coinbase

To:
Financial Services Regulatory Authority
Abu Dhabi Global Market
ADGM Square
Al Maryah Island
PO Box 111999
Abu Dhabi, UAE

3 October 2024

Re: Proposed Regulatory Framework for the Issuance of Fiat-Referenced Tokens

Coinbase Global, Inc. (together with its subsidiaries, **Coinbase**) appreciates the opportunity to respond to the Proposed Regulatory Framework for the Issuance of Fiat-Referenced Tokens (the **Consultation Paper**) published by the Financial Services Regulatory Authority (the **FSRA**).

Coinbase started in 2012 with the idea that anyone, anywhere, should be able to send and receive Bitcoin easily and securely. Today, we are publicly listed in the United States and provide a trusted and easy-to-use platform that millions of verified users in over 100 countries rely on to access the crypto economy.

Although we are not an issuer of Fiat-Reference Tokens (**FRTs**), we believe that FRTs serve as digitally native settlement instruments in the broader digital asset economy and are essential to its operation. The FSRA's proposed framework is, therefore, a necessary step in ensuring the success of the digital asset economy in the Abu Dhabi Global Market (**ADGM**).

Coinbase appreciates the FSRA's thoughtful attention to this important topic, including the focus on harmonization with regulatory regimes globally. We look forward to continuing to work with you to advance the regulatory treatment of digital assets, including FRTs.

Yours sincerely,

Tom Duff Gordon
Vice President, International Policy
Coinbase

Introduction

Coinbase welcomes the opportunity to respond to the Consultation Paper. While FRTs are already widely used, an appropriate regulatory framework for issuers of FRTs (**Issuers**) will further encourage their adoption and accelerate the inevitable growth of the digital asset economy.

The FSRA was a pioneer in defining the regulatory perimeter for crypto-assets with its 2018 framework and has the opportunity to once again help lead the way with a dedicated regulatory framework that is appropriately tailored to the specific features of this novel technology. Not only is this the right approach to regulating FRTs, it would also create synergies within ADGM across traditional finance and its increasing digitization.

Notably, we support the FSRA's proposal to allow Issuers to distribute income on reserve assets to holders. We believe it is important for Issuers to have the ability to share interest on reserve assets with holders, particularly as banks move to do this same with the tokenization of deposits. Doing so will help promote a level playing field across like instruments in a multi-payment economy.

We also strongly support the FSRA for seeking to align its proposed framework for FRTs with those being established in other jurisdictions. Accommodating the cross-border nature of the digital assets through regulatory harmonization with other leading jurisdictions will make ADGM an attractive place for future investment in the digital asset economy.

Although we are not an Issuer, our comments are informed by our experience in digital asset markets and a conviction that appropriately regulated FRTs will help to bring digital assets and the promise of economic freedom to the mainstream. We have sought to provide specific responses to the questions posed by the FSRA.

Targeted responses

Question 1 – Do you agree with the FSRA's definition of a Fiat-Referenced Token and its treatment as an asset which is distinct from a Virtual Asset?

We agree with the distinction made by the FSRA between FRTs and other digital assets, including Virtual Assets. The primary objective of FRT regulation should be to ensure the 1:1 redemption of reserve assets held by the Issuer, which requires a different approach to regulation than other digital assets, where the primary objectives should focus on addressing asymmetries of information between issuers and holders or more generally on consumer protection.

Question 2 – Should the issuance of a Fiat-Referenced Token be a distinct Regulated Activity or fall within the scope of the Regulated Activity of Providing Money Services?

In our view, users and the digital asset ecosystem are better served by recognizing the issuance of FRTs as a distinct Regulated Activity. Although the FSRA correctly recognizes that FRTs and Stored Value share certain of the same regulatory objectives and users may think about them similarly, their roles in the broader economy are distinct. As the FSRA notes, Stored Value typically functions in a closed loop (i.e. permissioned) system that is not necessarily based on digital ledger technology and does not similarly feature the ability to self custody or transfer assets directly to another user.[1] Instead, consumers using a Stored Value card typically do so with a particular merchant, or set of merchants, in mind. In order to access the value of the Stored Value card as a means of exchange, the card must be redeemed. The Stored Value card itself is not typically transferred as a means of payment, rather its value is eliminated at the time of purchase, and the merchant who accepted it cannot now use that same Stored Value card to conduct additional transactions on its own.

In stark contrast, FRTs are intended to serve as a means of exchange that are not required to be redeemed with the Issuer to transfer value to another user – the asset itself is transferred. Unlike with Stored Value, a merchant who accepts FRTs can conduct additional transactions using that FTC as a means of exchange in an infinite cycle without ever needing to redeem the FRT. This is a very different intended purpose than Stored Value and requires a distinct regulatory approach. We urge the FSRA to recognize this distinction.

Question 3 – Do you agree that the proposed range of permitted Reserve Investments described in paragraph 14 is sufficiently broad?

We agree that an FRT backed exclusively by short duration high quality liquid assets (**HQLA**) and appropriately considered bank deposits minimizes the amount of financial risk, and consequently reduces the need for overcollateralization to ensure 1:1 redemption.

Although not addressed in question three, we believe that the Issuer should be permitted to hold investments in a different currency than the referenced fiat currency. While it is economically efficient for the Reserve Investments to be held in the same currency as the FRT itself, as this removes any FX or basis risk associated using other currencies, we do not believe there should be a prohibition on holding assets in another currency. It is a common practice at funds and other investment vehicles to create synthetic exposures to

[1] Consultation Paper at 7.

lower cost or enhance liquidity compared to holding an underlying, and we do not want to rule out that possibility here. This may be particularly true for fiat currencies where the derivatives/FX market is more liquid than the underlying government debt instrument.

Permitting Reserve Investments of a different currency – with corresponding use of appropriate hedging instruments – will make it easier for issuers to launch FRTs in smaller currencies. For example an Issuer could issue FRTs denominated in emerging market currencies fully backed with US Treasuries, using swaps to hedge foreign exchange risk. To the extent that an Issuer uses Reserve Investments denominated in different currencies, there should be a sufficiently mature foreign exchange market to manage the fiat peg, and any residual basis risk that cannot be accounted for in a hedging strategy should be appropriately accounted for in the Issuer's risk management strategy.

Question 4 – Do you agree with the FSRA's proposed approach to allocation limits?

We agree with the FSRA's efforts to avoid overly prescriptive requirements, including with respect to precise allocation limits given that reserve assets are HQLA.

We additionally urge the FSRA to proceed thoughtfully in determining the minimum amounts of commercial bank deposits it will approve, and any associated diversification requirements. Bank deposits are primarily used by Issuers to manage liquidity – through the mint and burn process that bridges the FRT to underlying fiat – but need not form a greater percentage of the reserves structure than what is required to manage the redemption process. Unlike HQLA, deposits introduce bank credit risk to the reserves, and like we saw with Silicon Valley Bank failure in the US, can introduce spillover risk. Banks also have discretion over whether to serve potential Issuers, and in some jurisdictions, given the early stage of development of the digital asset ecosystem, some Issuers may face challenges in securing those relationships.

Question 5 – Do you agree with the FSRA's proposed approach to periodic attestation and disclosure?

While we are not an Issuer ourselves, we are a public company subject to strict auditing requirements that give confidence to markets on the efficacy of our practices. Similarly, as a general principle, we think it is important that Reserve Assets are subject to periodic third party audits to ensure confidence in the Issuers' practices.

Question 6 – Do you agree that Issuers of Fiat-Referenced Tokens should be able to distribute earnings from Reserve Investments to holders?

We strongly support the FSRA's decision to allow Issuers to distribute earnings from the Reserve Assets to holders of FRTs. Many jurisdictions are unnecessarily banning or limiting this possibility out of deference to incumbent banking rules and practices. However, this is short-sighted and incompatible with a digitally-native financial system. As banks move towards tokenizing deposits, allowing Issuers of FRTs to pay interest to users on Reserve Assets is critical to ensuring a level playing field for payment instruments. Permitting Issuers to distribute earnings to the holders of their FRTs would also put beneficial competitive pressure on depository institutions to pay interest to their clients, which, particularly for retail clients, is often not done, or is done at rates well below market rates.

Allowing Issuers to pass through some portion of the interest and returns enhances the viability of FRT arrangements, particularly in higher rate environments like markets are experiencing today. Permitting interest payments to holders allows them to further participate in the economic benefits of the arrangements, and lessen the need for them to redeem FRTs for alternative stores of value during idle periods of use. This therefore has the added benefit of contributing to enhanced stability of the FRT arrangement itself.

Overall, we believe that permitting interest payments on regulated FRTs will promote innovation within the payments sector, facilitate a mixed payment ecosystem, and generate good outcomes for consumers.

Question 7 – Do you agree with the FSRA's proposed approach to redemption requests?

We are generally supportive of efforts by the FSRA to ensure that FRTs are redeemable on a 1:1 basis. The FSRA notes that certain reasonable conditions may be imposed on the redemption of FRTs, if disclosed in the White Paper. It is not clear from the Consultation Paper whether limits on redemption size would be considered a reasonable condition–even though such a condition is common for other types of money, such as commercial bank deposits. For example, it is common practice for banks to set daily limits on the amount of cash that can be withdrawn from deposit accounts (i.e. changing deposits for fiat) whether from an ATM or at a branch. In addition, where a deposit account holder intends to withdraw a large amount of cash, this generally requires prior notice with most banks, and even low value transactions may be delayed so that the bank can apply appropriate financial crime checks. These financial crime checks may extend beyond the T+2 proposed by the FSRA in the Consultation Paper.

On this basis, we propose that holders have the right to redeem at par at any time, but that the conditions for redemption, including timelines, thresholds and periods are at the Issuer's discretion and clearly disclosed to holders. At the very least, we would encourage the FSRA to provide additional guidance on what conditions it would deem reasonable, so that Issuers and other parties may offer feedback.

Question 8 – Do you consider the minimum Capital Requirement to be suitable for the activity of Fiat-Referenced Token issuance, or should a variable capital requirement be imposed?

In our view, an Issuer that limits Reserve Assets to HQLA avoids the risk from credit intermediation and poses minimal financial risk such that a lower level of net assets is required. In such a scenario, capital requirements should focus predominantly on operational risk. As we have discussed in other regulatory consultations,[2] Coinbase has done an extensive analysis of the capital requirements for FRTs, which support the adoption of a minimum rather than variable capital requirement:

> "We have undertaken a rigorous quantitative analysis to assess what levels of financial resources, including a capital buffer, the issuer of a fiat-backed stablecoin should maintain. The purpose of the exercise was to better understand and quantify the risks associated with stablecoins as it relates to our activities.
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> The initial results of this analysis indicated that, if the stablecoin's reserves are composed entirely of highly safe, liquid assets – such as highly rated sovereign debt securities maturing in less than 90 days, and deposits at regulated financial institutions – then the stablecoin's exposure to financial risks can be minimal. Our initial estimates depended significantly on assumptions regarding the accounting treatment of reserve assets – i.e., approximately 20 basis points under held to maturity (HTM) assumptions, and 36 basis points under available for sale (AFS) assumptions. Given this composition of assets, a minimal capital buffer would be sufficient to fully protect stablecoin holders against all categories of financial risk, including credit risk and market risk.
>
> The stablecoin's remaining risk exposures are operational in nature. In our exercise of estimating operational risks we considered a bottom-up, scenario-based methodology that proceeded as follows. First, we identified all of the potential categories of operational risk events. This included, for example, activities related

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[2] See Coinbase Response on 2/6/24 to the UK FCA paper titled "DP23/4: Regulating Crypto Assets Phase 1: Stablecoins": https://assets.ctfassets.net/c5bd0wqjc7v0/6BCKUrXEHMxlhGZkJy55j3/78c6e6134879862f94ac92f5afa2b91f/Coinbase_-_Feb_2024_Response_to_FCA_Stablecoin_Consultation.pdf

to minting, reserve reconciliation, illicit financial transactions, theft, loss, misuse of assets, cyber incursions, and data breaches.

Then, for each category, we estimated the probability of an operational risk event occurring and the magnitude of financial losses that would be realized if it does. In the final phase of the analysis we calibrated and extrapolated the probability/loss distribution curves to ascertain the amount of capital necessary for sufficient certainty that all reasonably foreseeable losses are adequately addressed, with an additional margin for error.

As with any analysis of this nature, the results are sensitive to a wide range of factors, including expert judgments and assumptions regarding such matters as the likelihood of events that may range from 'vanishingly improbable' to 'not in a million years.' While the crypto asset industry does not have a long history with which to calibrate results, many aspects of operational risk can be extrapolated from the traditional financial system. Based on these assumptions, our estimates supported an operational risk capital buffer of between 39 and 76 basis points.

Hence our initial findings indicate that a capital buffer of a well-structured and properly regulated stablecoin on the order of one percent of the total amount of stablecoins outstanding should be sufficient to protect against financial and operational risks for an issuer that maintains a reasonably effective risk management program."

Question 9 – Would the restriction on conducting other Regulated Activities place an undue restriction upon certain Fiat-Referenced Token business models?

We do not believe that prohibiting the Issuer legal entity from engaging in other Regulated Activities would place an undue restriction on FRT business models, provided, as the FSRA notes, that other entities in the Issuer's corporate group are able to engage in these Regulated Activities. In our view, this permission should extend to a parent or a subsidiary of the Issuer (not just sister entities), provided that appropriate governance and other arrangements are put in place to limit any attendant conflicts of interest or wrong-way risk.

There are important efficiency and innovation benefits to be derived by combining multiple functions within a corporate group, although we understand the FSRA's concern of combining these functions with FRT issuance in a single entity. Permitting other Regulated Activities to be conducted by the other companies in the Issuer's corporate group maintains the protection of Reserve Assets, including in insolvency, without unduly restricting the overall business models that a corporate group can pursue.

Question 10 – Are there any additional disclosures which should be mandated for inclusion in a White Paper?

Disclosures should focus on any risk that an FRT may not be redeemable on a 1:1 basis and the FSRA should allow an Issuer to tailor disclosures to the risks presented by its business. As mentioned previously, where an Issuer uses only HQLA as backing assets, this risk is greatly reduced which should, in turn, limit the information that the Issuer needs to disclose. Disclosures that are not pertinent may be confusing to FRT holders and may make it harder for FRT holders to discern which information is important to understanding the risks posed by a given FRT. Likewise, where an Issuer's business presents unique risks, due to its choice of backing assets or otherwise, those risks should be disclosed to holders. Moreover, holders' rights and the Issuer's obligations should be clearly disclosed to FRT holders.

Question 11 – Do you consider annual stress testing to be adequate or are there additional stress testing safeguards which the FSRA should consider including?

Coinbase is not an Issuer; accordingly, we have limited thoughts to add on the potential implementation of stress testing. However, as with other risk mitigation requirements, an Issuer that only has HQLA as Reserve Assets may not need to rely as extensively on stress testing to assess its resilience, given the relatively simple nature of that business. Moreover any stress testing should be focused on meeting 1:1 redemption and not maintaining a strict peg. Stress testing should not include separate consideration of management events such as a capital raise, which, in the context of a well structured FRT, is not a relevant course of action.

Question 12 – Do you agree with the FSRA's approach to addressing AML and other risks in relation to Fiat-Referenced Tokens?

We agree with the FSRA that it would generally be reasonable to take the same approach to AML, IT, monitoring and other risks with FRTs that the FSRA takes with other crypto-assets.

Question 13 – Do you have any further comments on the Fiat-Referenced Token regulatory framework and associated draft legislative amendments?

No. Coinbase appreciates the FSRA's continued efforts in improving the regulatory environment for the digital asset ecosystem and the leading role the FSRA plays in advancing uniformity across jurisdictions. We look forward to continuing to work with the FSRA to develop the digital asset sector of ADGM.