

lpa.

Defy. Deploy. Run.

Trade Surveillance for Crypto Assets

LPA CONSULTING WHITEPAPER

November 2023

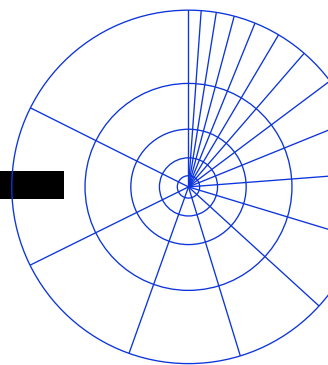


Table of Contents

1	Foundations of Crypto Assets	2
2	Navigating Regulatory Landscapes	3
3	Trade Surveillance Challenges and Solutions	4
4	Key Takeaways and Next Steps	6

1 Foundations of Crypto Assets

In the ever-evolving landscape of finance, crypto assets have emerged as a dynamic and intricate realm, marked by high diversity and complexity. Understanding these digital assets goes beyond mere transactions. It involves delving into the sophisticated infrastructure that underpins their existence.

Crypto assets encompass a broad spectrum, ranging from cryptocurrencies like Bitcoin and Ethereum to tokens representing real-world assets. This diversity is mirrored in the infrastructure supporting these assets. Similarly, there are various methods to gain exposure to crypto assets, broadly categorized into two approaches:

— Direct Exposure

Direct exposure to crypto assets involves owning the assets themselves, such as holding a crypto currency in a wallet. Many investors choose to directly engage with crypto assets through centralized exchanges such as Bison, Kraken, Binance or Coinbase. This avenue provides a user-friendly interface for trading, with custody options extending to the exchange itself or private wallets. Private wallet custody is further categorized into hot and cold storage methods. Hot storage keeps private keys connected to the internet for quick access, while cold storage keeps them completely offline for enhanced security. Trading typically occurs during predefined trading hours, with volatility-dependent interruptions possible.

For investors prioritizing anonymity, decentralized approaches provide a viable alternative. Transactions take place without the involvement of intermediaries or time constraints, and custody is usually overseen through private wallets. This decentralized methodology resonates with the fundamental philosophy of blockchain technology, emphasizing the empowerment of individuals with autonomous control over their assets.

— Indirect Exposure

Investors aiming for indirect exposure often explore diverse financial instruments like Exchange-Traded Notes (ETN), Funds (ETF), and Derivatives (ETD). These tools serve as a bridge for conventional investors to tap into the potential of crypto assets without the need for direct ownership. Custody arrangements in this domain commonly involve a depot bank, harmonizing traditional financial practices with the dynamic crypto landscape. Like other instruments in this category, trading typically takes place at regulated trading venues. However, with certain instruments, over-the-counter (OTC) transactions are possible as well.

As crypto assets continue to redefine the financial landscape, navigating this complex terrain requires a holistic understanding of both the assets themselves

and the intricate systems supporting their trade. Whether opting for direct exposure through centralized or decentralized means, or embracing indirect exposure through traditional financial instruments, compliance functions must remain vigilant to the unique characteristics that define the world of crypto assets.

2 Navigating Regulatory Landscapes

The smooth functioning and the public confidence in financial markets are the prerequisites for economic growth and wealth. Market abuse, which comprises market manipulation and insider trading, harms the functioning and confidence in financial markets. In order to uphold the integrity of those markets, regulators around the world have adopted laws to detect and punish market manipulation and insider trading. In the European Union (EU), the Market Abuse Regulation (MAR, Regulation (EU) No 596/2014) requires firms arranging or executing transactions in financial instruments to establish and maintain systems and procedures to detect suspicious orders and transactions. In case of a reasonable suspicion, the competent authority must be notified.

— Indirect crypto asset investments frequently fall under MAR coverage

Financial instruments as defined by the Markets in Financial Instruments Directive II (MiFID II, Directive 2014/65/EU) are in scope of the MAR when they are admitted to trading on a trading venue, i.e. a regulated market, Multilateral Trading Facility (MTF), or Organised Trading Facility (OTF), or when the price or value depends on the price of a financial instrument that is admitted to trading on a trading venue. That means that indirect investments in crypto assets via financial instruments like warrants, structured retail products, exchange-traded derivatives, or OTC derivatives that are admitted to trading on an MTF or OTF are already in scope of the MAR. Therefore, firms that arrange or execute transactions in crypto-linked financial instruments must monitor these transactions via their trade surveillance system like any other security or derivative.

— MiCAR extends MAR requirements to direct crypto asset investments

Since direct investments in crypto assets are not in scope of MiFID II and the MAR, the EU has adopted the Markets in Crypto-Assets Regulation (MiCAR, Regulation (EU) 2023/1114). MiCAR transfers the MiFID II and MAR requirements for financial instruments to crypto assets. Crypto assets as defined by MiCAR are a digital representation of a value or of a right that is able to be transferred and stored electronically using distributed ledger technology or similar technology. Furthermore, MiCAR introduces regulatory requirements on the authorisation of crypto asset service providers, where crypto asset services include:

- providing custody and administration of crypto assets on behalf of clients,

- operation of a trading platform for crypto assets,
- exchange of crypto assets for funds,
- exchange of crypto assets for other crypto assets,
- execution of orders for crypto assets on behalf of clients,
- placing of crypto assets,
- reception and transmission of orders for crypto assets on behalf of clients,
- providing advice on crypto assets,
- providing portfolio management on crypto assets, and
- providing transfer services for crypto assets on behalf of clients.

Analogue to the MAR, MiCAR Title VI puts in place prohibitions and requirements on the prevention of market abuse like insider dealing, unlawful disclosure of inside information, and market manipulation. These requirements apply to crypto assets that are admitted to trading or in respect of which a request for admission to trading has been made. MiCAR obliges any person professionally arranging or executing transactions in crypto assets to have in place effective arrangements, systems and procedures to prevent and detect market abuse. That means that crypto asset service providers that arrange or execute transactions in crypto assets must implement a trade surveillance system and processes in the same way as firms that arrange or execute transactions in traditional financial instruments.

For firms that already offer crypto asset services, MiCAR applies from 30 December 2024. Firms that plan to introduce crypto asset services or are currently introducing crypto asset services should consider the new regulatory requirements as part of their implementation project.

3 Trade Surveillance Challenges and Solutions

To maintain market integrity through systematic trade surveillance, a deep comprehension of crypto assets and their underlying infrastructure is imperative. Crypto asset trading diverges significantly from traditional financial instruments, thereby impacting surveillance practices.

Crypto asset trades often transpire on decentralized exchanges, eliminating the need for intermediaries. The pseudonymous nature of blockchain transactions introduces an anonymity layer, posing a surveillance challenge. However, many centralized crypto exchanges incorporate a Central Limit Order Book (CLOB) at their core, serving as the hub for matching buy and sell orders. Vigilantly

monitoring and deciphering activities within this order book is pivotal for understanding market dynamics and uncovering potential irregularities.

Moreover, the diverse range of order types in crypto trading, encompassing market orders, limit orders, and beyond, demands nuanced comprehension. Each order type exerts distinct influences on the market, necessitating a keen eye for effective surveillance.

Additionally, crypto asset markets, being relatively new, exhibit higher volatility and lower liquidity compared to traditional financial markets. This introduces surveillance challenges that require careful consideration and adaptation to the evolving nature of the crypto landscape.

To comprehensively evaluate the impact of the emergence of crypto trading on trade surveillance setups, it proves advantageous to categorize market participants into two distinct groups.

— **Established market participants need to extend their surveillance setups**

Established market participants, including major banks and asset managers, typically have existing trade surveillance infrastructure to meet their obligations under MAR. Nevertheless, the introduction of crypto-linked instruments or the expansion of services to encompass crypto asset offerings, such as trading these instruments on behalf of clients or operating a crypto trading platform, brings about additional considerations for trade surveillance.

The offering of crypto-linked instruments, such as ETNs, ETFs or ETDs, falls within the MAR framework and necessitates immediate action for monitoring. On the other hand, providing additional crypto asset services falls under the scope of MiCAR.

As a result of both decisions, existing trade surveillance setups must be expanded. This involves a meticulous review of the current market abuse risk assessment, with a specific focus on scenarios relevant to crypto asset surveillance. Recognizing the unique characteristics of the crypto asset class requires tailored risk assessments, addressing scenarios like inter-trading venues or cross-product manipulation, considering potential variations in prices and liquidity across different trading platforms.

Moreover, incorporating essential data for monitoring crypto assets may demand additional system integrations into the surveillance landscape. Subsequently, decisions need to be made regarding system-level alert rules and configurations. The parameterization phase is crucial, acknowledging that parameters optimal for other asset classes may not align with the specific needs of crypto asset surveillance, driven, for example, by the inherent high volatility in many crypto

assets. The challenge of lower data availability within the firm further emphasizes the importance of expert estimates and thorough market data analysis.

– **New market entrants offering crypto asset services need to establish a new surveillance setup from scratch**

In contrast, emerging market participants exclusively dedicated to offering crypto asset services as outlined in chapter 2, face the imperative task of building a surveillance infrastructure from scratch. This group encounters substantial challenges, notwithstanding assertions from leading trade surveillance solution providers about their capability to monitor crypto assets. The pivotal decision in this scenario revolves around selecting the right software, with distinctions in rule functionality, flexibility, and workflows persisting. This choice holds paramount significance for these firms as they navigate the dynamic regulatory landscape.

4 Key Takeaways and Next Steps

As the financial landscape undergoes a transformative shift with the integration of crypto assets, the importance of robust trade surveillance practices cannot be overstated. In anticipation of the entry into application of Title VI of MiCAR from December 30, 2024, the crypto industry stands at a critical juncture. While the enforcement deadline may seem distant, the journey toward effective trade surveillance demands an early start.

Early identification and assessment of risks, especially those specific to the crypto-asset class, lay the foundation for a comprehensive surveillance framework. This proactive approach enables firms to navigate challenges seamlessly and uphold market integrity.

The landscape of crypto assets is dynamic, and the data required for effective surveillance may be dispersed across various systems. Commencing the process of sourcing and integrating this data early ensures that surveillance systems are well-equipped to monitor the complexities of the crypto market. Delays in this phase could result in gaps in surveillance coverage.

The dynamic regulatory landscape, particularly with the upcoming implementation of MiCAR, underscores the importance of a proactive approach to compliance readiness. Companies that proactively align their trade surveillance practices with MiCAR requirements stand in a favorable position to promptly adapt to regulatory shifts, reducing the risk of non-compliance.

To facilitate this readiness, comprehensive training for compliance staff is essential. Established players with existing surveillance setups will need targeted education on the intricacies of crypto assets and their trading. Meanwhile, new

market entrants should focus on building a foundational understanding of compliance monitoring principles in general.

In conclusion, the journey toward effective trade surveillance on crypto assets is a forward-looking endeavour. Those who embark on this journey with foresight and diligence will not only ensure compliance but also position themselves as leaders in navigating the evolving landscape of crypto asset trade surveillance.

– **Authors**



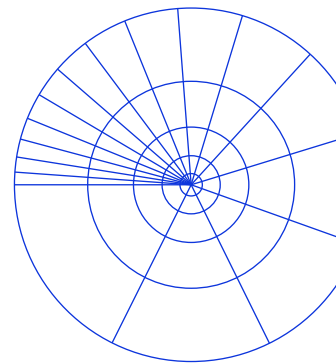
Daniel Wolff
Senior Manager

+49 69 971485-440
daniel.wolff@l-p-a.com



Philipp Faulstich, CFA
Manager

+49 69 971485-416
philipp.faulstich@l-p-a.com



Founded in 1999 by Stefan Lucht and Roland Probst to offer solutions as the finance industry evolved, LPA was built on the needs of its clients. Today the company has over 400 employees in 12 cities worldwide, delivering cutting-edge consulting through its specialist teams, and technology through software products.

Defy the processes of the past. Deploy innovation in a way that suits you. Run to the forefront of global innovation.

For more information, please visit www.l-p-a.com.