

Regulation of Crypto-Finance Project

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Response to the Consultation Paper on the Proposed Regulatory Requirements for Virtual Asset Trading Platform Operators Licensed by the Securities and Futures Commission

The Securities and Futures Commission of Hong Kong

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I thank the Commission for this opportunity to submit these comments on its Consultation Paper. My chief focus in this short submission will be on issues related to prevention of market manipulation and abusive activities.

The Commission is right to identify market manipulation risks as an issue of concern in the context of VATP activities. However, it is important to note that virtual assets come with both novel market manipulation risks and with novel tools to mitigate the risks. This novelty causes uncertainty as to how market participants, like VATP's, should understand the scope of market manipulation and abusive practices (i.e., which market practices count as market abuse). Moreover, there is uncertainty as to which of the novel methods and tools may be appropriate to implement. On one hand, it is understandable that the Commission may want to leave a significant degree of flexibility to market participants, especially in methods and tools. Nevertheless, the uncertainty as to the interpretation of the concept of market manipulation and market abuse may have unduly chilling effects on desirable market activity.

I would thus like to suggest that the Commission considers augmenting the rules and guidelines from the Consultation Paper by additional guidance on what market activities specific to markets in virtual assets are more or less likely to be considered as market manipulation or abuse. In doing so, the Commission may want to consult my research on related questions in U.S. law and in EU law:

My '**Crypto-Asset Market Abuse Under EU MiCA**'¹ provides commentary for the new rules on market abuse in crypto-assets markets to be implemented as a part of the EU Markets in Crypto-Assets Regulation. What may be particularly interesting to the Commission is the question of the scope of market abuse prohibitions and how they will affect not only regulated trading platforms, but also decentralized finance (DeFi). This paper also considers how the rules on market abuse will apply to some of the key risks of market abuse in virtual assets, including: insider dealing, 'rug pulls', pump-and-dump and trash-and-cash schemes, wash trading, and 'oracle' manipulation.

The MiCA paper notes that there is a significant sphere of novel kinds of market activity in virtual assets, known as '**MEV extraction**'. The problem is that some methods of MEV extraction may appear to be analogous to known types of market manipulation (e.g., 'front-running'). However, as I argue in two further papers, it would not be advisable to jump to conclusions on this topic based on simplistic analogies with traditional finance. In '**MEV on Ethereum: A Policy Analysis**',² I look at the question of MEV extraction from a broader policy perspective. Whereas in '**Blockchain Transaction Ordering as Market Manipulation**'³ my co-authors and I analyze some of the MEV extraction strategies ('sandwiching' and 'oracle manipulation') under U.S. commodities and securities law.

¹ Available on SSRN: <https://ssrn.com/abstract=4375201>

² Available on SSRN: <https://ssrn.com/abstract=4332703>

³ Co-authored with Alex Sarch and Natasha Vasani; available on SSRN: <https://ssrn.com/abstract=4187752>