Dear Mr Davies,

RE: Investment products referencing crypto assets

Thank you for your Parliamentary questions relating to the Financial Conduct Authority’s (FCA) consultation paper on a potential prohibition of investment products that reference certain crypto assets, that you submitted on 16 October 2019, and for your letter of 15 October 2019 requesting that I meet with the CEO of CoinShares to discuss their concerns about this work.

Consumer complaints

We can confirm that we have not received any complaints in relation to the sale and distribution of crypto-referenced exchange traded notes (ETNs). We define complaints as any expression of dissatisfaction about the manner in which we have carried out, or failed to carry out, our ‘relevant’ functions. Complaints about a regulated firm, undertaking a regulated activity, would be made directly to the firm and not the FCA. This could then be referred to the Financial Ombudsman Service.

Consultation responses

You asked how many consultation responses the FCA received opposing the proposals in CP19/22. We have received 535 responses to the Consultation Paper. We will be publishing our policy statement (PS) and final rules in Q1 2020. We will provide full feedback on consultation responses and a list of non-confidential responses as part of our PS.

FCA’s Sandbox Program

You asked how many companies in the FCA’s Sandbox program are affected by the proposals in CP19/22.

The FCA Innovation hub encourages and supports innovation in financial markets in the interest of consumers to ultimately promote effective competition. The Regulatory Sandbox assists FCA authorised and unauthorised firms to develop testing activities of innovative business models with the FCA’s oversight. These small-scale, live tests generate valuable insights for both firms and regulators in terms of how certain new business models interact with the FCA’s regulatory framework and how consumers react to these new business models.

To date we have not facilitated the issuance of investment products that reference crypto-assets: targeted at retail clients through Sandbox and so our proposed ban would not affect the program.
Cost-Benefit Analysis (CBA)

You asked questions about:

a) our evidential basis for the statement in CP19/22 that crypto-referenced ETNs present risks to investors that are similar to crypto-referenced contracts for difference (CFDs),

b) our evidential basis for the statement in CP19/22 that we have seen poor outcomes from the limited products currently available on EU trading venues, in relation to ETNs that reference cryptoassets,

c) the reason why our CBA did not include the benefits of crypto-referenced ETNs and;

d) the evidential basis is for the statement that the majority of investors in Exchange Traded Notes which reference cryptoassets were likely to suffer a loss over the long-term.

Through our CBA in CP19/22, we have observed that retail clients investing in crypto-referenced derivatives and ETNs, are unable to value their investments due to unobservable pricing methodology for the underlying assets and due to the extreme volatility of price movements. This, in addition to widespread market abuse, financial crime and operational risk in the cryptoassets market could result in sudden and large losses for retail consumers investing in regulated products referring certain cryptoassets. The CBA was consulted on as part of the CP (see Question 4 on page 27) and we will consider any comments on the evidence base in the CBA when considering how to respond to the CP.

We have observed poor client outcomes for retail investors purchasing ETNs, with client losses between £5.7m and £24.2m. In the second half of 2018, for example, the ETNs saw higher losses per account compared to CFDs, with loss-making accounts averaging £6,000 loss per client in some months. We also observed a higher number of loss making accounts with 84 per cent to 91 per cent of retail accounts losing money between August and December 2018, when compared with CFD accounts.

Some clients saw profits in ETNs over the period we examined in our CBA, totaling £116m between November 2017 and February 2018. However, we considered the significant variance in client outcomes was consistent with the policy analysis and principled argument. That is, the value of these products in the short run is highly unpredictable and prone to extreme volatility due to the nature of the underlying assets.

Having further examined the distribution of outcomes in the ETN products, we saw disproportionate outcomes amongst the top 10 retail clients each month by firm, indicating a high concentration of profits among a small group of consumers. We did not consider that profits in ETNs represent a reliable indicator of likely future returns (for example, in the second half of 2018 most retail clients experienced losses in the same ETNs). We also observed the number of individual retail accounts making a profit to be relatively small, with a much greater number incurring losses over time per account.

Finally, in the CBA we found that the potential for consumer harm from sudden and significant losses across a large proportion of retail clients outweighs the possible effect of a smaller group of clients missing out on future profits as a result of volatility in a time-limited period.

Following your letter and your meeting with the Economic Secretary to the Treasury, I would be happy to meet with your constituent and my office will be in touch in due course.

Yours sincerely,

Andrew Bailey
Chief Executive