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Q&A-Better regulation of cryptos will address "legitimate" risk concerns, lead to increased adoption: Todd Cipperman, Cipperman Compliance Services



Better regulation to address "legitimate" risk concerns and protect investors, including anti-money laundering, valuation and custody, will allow more widespread adoption of cryptocurrencies, **Todd Cipperman, managing principal at Cipperman Compliance Services,** told the Reuters Global Markets Forum on Monday, June 7.

Improved regulation will also provide the crypto space benefits of improved securities trade settlement and smoother cross-currency transfer, he added.

Separately, Cipperman called blank check companies - which have been in vogue during the past year – "an unintended consequence of a creaky regulatory regime."

"The SPAC (special purpose acquisition company) movement should be a wake-up call to the SEC (U.S. Securities and Exchange Commission) that it's become too difficult to IPO (initial public offering) in a more traditional manner," Cipperman said.

Following are edited excerpts from the conversation:

Q: What's would you say needs to be done to bring cryptos into the mainstream?

A: In one word: regulation. What's holding back the wide acceptance of crypto is fear and scepticism. It is up to securities regulators to address some of the -- legitimate -- risk concerns so that average investors can feel safe.

Q: What actions should the SEC take to catalyse responsible development of the crypto space?

A: There are several and others that may develop over time. Some of the biggest issues raised revolve around anti-money laundering, valuation, liquidity, security, custody, and suitability. For example, let's take anti-money laundering. The financial regulators have implemented a well-accepted AML (anti-money laundering) regime when it comes to cash transactions. Now, the U.S. Treasury department is recommending similar reporting for crypto where a crypto exchange would have to report transactions in excess of $10,000. The point is that we don't need to throw up our hands and say crypto is too risky. We merely need to use some of our current tools and apply them a little differently.

Q: In terms of valuation and custody, what can be done to make improvements?

A: Valuation really puzzles me. The securities markets trade all sorts of securities that are not traded on exchanges, so-called Level 3 securities. Both the sell side and the buy side have developed excellent valuation processes to ensure that securities are marked to market. I don't see why crypto is any different. I am not suggesting that valuations don't have a subjective element. However, firms can develop valuation procedures. For example, several recently proposed bitcoin ETFs (exchange-traded funds) describe very specific valuation proxies and processes. We should not avoid crypto as an asset class only because the valuation process is less transparent than securities traded on an exchange.

On custody, the SEC last year allowed a five-year pilot program to allow special purpose broker-dealers to serve as crypto custodians. So, custody can be done. Some professionals argue that the distributed ledger is the best, most secure custodial platform.

Q: What do you see coming out of the five-year program? Is the difficult part about valuing crypto the fact that unlike debt and equities, there are no cash flows expected that can be discounted to come up with 'fair value' and the like?

A: The pilot program for custody says that these special purpose BDs (broker-dealers) will not violate the customer protection rule if it (i) ensures access to the digital asset securities and the capability to transfer them on the blockchain, (ii) does engage in any business other than serving as custodian and effecting transactions in digital asset securities; (iii) assesses whether the digital asset is a security subject to an effective registration statement or exemption; (iv) assesses the relevant distributed ledger technology; (v)

protects against theft or loss of private keys; (vi) adopts procedures in case of a disruption; and (vii) provides customers with disclosures and an agreement.

The SEC says that the five-year period will give the industry time to develop accepted practices and allow the SEC to gain experience in overseeing them. These seem like fairly easy conditions to meet. I expect that the SEC will see if any huge problem or scandal arises. If not, I would expect broader adoption.

Your question about discounted cash flows raises only one method of valuation and mostly for fixed income. Many assets -- e.g. natural resources, real estate, VC (venture capital) are valued-based on market inputs rather than discounted cash flows. There is an entire industry around valuing Level 3 assets. Discounted cash flow is only one input. Crypto, for example, often uses futures markets as a significant input for valuation.

Q: What is your view on the issues raised about listed companies using their treasury's funds to invest in crypto?

A: This may be more of a financial risk issue than a regulatory issue, although it certainly concerns me. Having said that, I think we are all focusing too much on investing in crypto as an asset class rather than thinking about crypto as a payment mechanism or fiat currency. For example, several industry players are investigating the use of crypto for securities settlement, which could eliminate T+2. I have also seen firms use crypto as the method to buy a fund so that transfer agency activities are less costly and more secure. Then, of course, there is the use of crypto as a global, cross-border payment mechanism that could someday displace credit cards -- which are really only an analogue version of cryptocurrency. Back to your question, though: I am concerned about public companies investing in crypto as I would if they were speculating in currency swings. I would rather the companies I invest in put their cash into their operations rather than speculating on currency swings.

Q: Changing tack to payment for order flow (PFOF): what meaningful changes, if any, could be seen on this front?

A: I am generally very sceptical of PFOF. I just think it's a huge conflict of interest. Somebody has to pay to process what are usually small retail transactions. If the retail investors pay "zero" commissions, they are paying somewhere. Unless, the venue can unequivocally show better execution, I think it's merely hiding the fees behind a marketing gimmick. I think the SEC should outlaw PFOF. Short of that, the SEC should mandate much more detailed and obvious disclosure and best execution compliance requirements.

Q: Do you see a meaningful return to a client-payment-for-brokerage model, given the popularity of Robinhood and its ilk?

A: Although I think it's bad for retail investors, I foresee a two-tier market. Institutional investors will demand to see a full accounting of brokerage practices. There was a case last year where a mutual fund manager misled a board about trade routing practices. I suspect that PFOF and zero commissions won't matter to a more sophisticated client. I fear that the Greek chorus of retail investors will demand zero commissions whether or not it's better for them based on the data. Retail investors often do not do what's in their best interest, unfortunately.

Q: What are your views on SPAC regulation amid accusations of promoter conflict of interest? How do you see the situation changing?

A: The SPAC movement should be a wake-up call to the SEC that it's become too difficult to IPO in a more traditional manner. Former Chairman (Jay) Clayton decried the closing of the capital markets because of onerous regulation and disclosure requirements for small companies. The SPAC is an unintended consequence of a creaky regulatory regime.

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