July 16, 2021

James P. Sheesley, Assistant Executive Secretary
Attn: Comments-RIN 3064-ZA25
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

RE: Request for Information and Comment on Digital Assets (RIN 3064-ZA25)
(Via Electronic Submission: info@vegaxholdings.com)

Dear Mr. Sheesley:

Thank you for the opportunity to provide comments on the current and potential use cases of digital assets. We appreciate the Federal Deposit Insurance Corporation's willingness to gather information and solicit comments from the industry and other stakeholders.

Our company, VegaX Holdings, is a leader in digital asset management. Our team has years of experience in both traditional and decentralized finance.

We hope our insights can help the FDIC create a sound regulatory framework that allows responsible innovation in the field of digital assets to flourish.

Request for Information and Comment on Digital Assets (RIN 3064-ZA25)

Introduction

The digital asset market has seen tremendous growth in the last few years. Digital assets have already disrupted traditional financial services and have the potential to play a key role in the future growth of the sector. Our active involvement in the digital asset market has enabled us to develop a fine understanding of the space. We are a group focused on providing both new and experienced unique investment opportunities in the digital assets space.

The comments in this discussion paper are aimed at exploring the current and potential use cases of digital assets, the nature and scope of the activities, and the challenges and uncertainties that the industry faces.

Novel and Unique Considerations Related to Digital Assets

In this section, we explore the current and potential use cases related to digital assets that are being considered by different institutions. These use cases are in addition to the ones already mentioned in the ‘Request for Information and Comment on Digital Assets’ document shared by the FDIC.

Additional/Alternative sub-categories or categories that IDIs are engaged in exploring

The different categories of digital assets that are being explored are:

Utility Tokens

Digital assets that serve a specific purpose are known as utility tokens. For a digital asset to be considered a utility token, it must be designed with the intention of being used to pay for the right to access a good or service. The primary use of utility tokens by companies is to raise interest in their products and create additional value for users in their network.

Institutions engage in issuing utility tokens while taking the following benefits into consideration:

- Engaging directly with their customer base
- Creating a customized economic model for rights to access a service
- Enhancing their ability to quantify the value of the right being sold

Hybrid Tokens

Hybrid tokens are customised digital assets which share the characteristics of different categories. Most common combinations of hybrid digital assets are seen across technology solutions and asset based categories along with their functionality as a utility token.

Examples of hybrid tokens:

- **Asset + Utility -** A digital asset that represents both a share of company ownership and the right to receive the first product.
- **Technology (Payment) + Utility -** Paying for transaction fees on the network and the right to receive dividends.

Activities IDIs are considering or currently engaging in - Nature and scope of the activity

As a service offering, it is the use of digital assets for the purpose of staking and their functionality as a stablecoin that seem to be the prominent activities that most institutions are focusing on.

Specific products or services IDIs are offering or planning to offer to consumers are:

Staking as a service

Institutions act as a third party service provider that enables investors to stake their digital assets. They act as a service platform which takes care of the technical aspects involved in the process of staking digital assets. Such providers charge a fee for their services that is usually a percentage of the stake rewards earned by the investors.

Stablecoins as a service

Stablecoins are a relatively new asset class of digital assets. These are backed by real world assets which are stable in nature. Such assets combine the stability of a real world asset like fiat currency with the efficiency of blockchain technology. Paxos is a service provider that enables institutions to incorporate stablecoin functionality into their operations and service offerings.

The extent to which IDIs are considering engaging in activities for other purposes - such as to facilitate internal operations

Banks and financial institutions are increasingly integrating digital assets and blockchain technology into their internal operations. It is believed that such integrations would allow them to improve upon their service offerings, enabling them to be more efficient in their operations and offer a better customer experience. Utilizing a blockchain based infrastructure offers better security, transparency, trust, programmability, and flexibility as well as significantly lower costs at scale. The two main areas experiencing early adoption are payments and clearance and settlement.

Extent and scope of activities IDIs are engaging in that are custodial in nature

An increase in interest from both retail and institutional investors has led to a rise in the demand for custody options. The market is continuing to evolve and with that, we have seen the emergence of different types of custody options being offered. Moreover, many new providers have also entered the growing market.

Similar to traditional markets, custodians provide customers with financial services such as safekeeping, trade settlement, exchange, clearing and corporate action execution. However, it should be noted that safekeeping is the area where most emphasis is being placed on at the moment. Harnessing their market expertise, custodians offer customers a better option to minimise the risk of fraud, theft and/or loss of digital assets.

Custodians safeguard digital assets by securely maintaining customers' private keys. To do this, they offer different offline and online storage options. Hot storage is an online storage option where customers can access their assets via a digital private key. Offline storage options include cold storage, multi-signature wallets, and smart contract wallets.

The extent of activities related to digital assets that have balance sheet impacts

Institutions are increasingly looking to add digital assets to their balance sheets. This is being done in order to maximize returns on cash that is not being used in the day-to-day operation of the company. In addition to offering potential returns in the future by increasing in value, digital assets also allow institutions to stake their holdings and earn yield on their investment. This is seen as a major benefit as opposed to holding cash which currently does not have as attractive yield options. Furthermore, institutions are adopting an acquire and hold strategy when it comes to digital assets with the aim of using them as a form of payment in the future.

Where do IDIs see the greatest demand for digital asset services - What are the demand drivers?

As the digital asset market continues to grow, the importance of safekeeping services by reliable providers like IDIs will become vital. It is the service as a custodian where IDIs see the greatest demand. This is because of the following demand drivers:

- **Increased security and reduced risks** - Due to the nature of digital assets, they are seen as more vulnerable to risks than traditional assets. Security is given the utmost importance by customers as it safeguards their assets from potential theft and other novel risks related to digital assets.

- **Safer alternative in comparison to exchanges -** Exchanges have a higher possibility of being hacked or facing other loss making events. Moreover, exchanges are also susceptible to facing regulatory issues.

- **Operational efficiency** - Custodians can leverage technology and their regulatory expertise to provide customers with a better experience. This further enhances market participation as the customers feel more comfortable transacting in the market.

Risk and Compliance Management For Digital Assets

Elaborate on how the custody of digital assets differ from that of traditional assets

The custody of digital assets is similar in many ways to that of traditional assets. However, there are a few vital differences which require novel approaches. Here are some ways in which the custody of digital assets differs from traditional assets:

- **Security of private keys is vital** - Unlike for traditional assets, custodians safeguard digital assets simply by holding the private key on behalf of the asset holder. Through safe key management, custodians cryptographically secure the assets and take measures to ensure that the customer's private key cannot be accessed by any other party. Moreover, since the transactions executed using Distributed Ledger Technology (DLT) are mostly irreversible, it becomes even more important for custodians to limit access to private keys.

- **Recovery of lost assets is almost impossible** - since the digital asset in most cases is not a representation of an actual asset, the recovery of any lost asset is almost impossible. It is only in the case of a security token that recovery is possible as in such cases, a new digital asset can be issued while the actual asset remains secure.

- **Different storage options** - In digital asset custodianship, third party providers can offer both offline and online storage options to the customers.

Unique risks and challenges for digital asset custodians

While the industry has been growing steadily over the past few years, it has not been without its challenges. Being a niche industry that is constantly evolving, dealing with digital assets poses unique risks and challenges, some of which are as follows:

- Finding a balance between usability and safety of digital assets
- Concerns related to volatility of digital assets
- As the value of assets under custody increases, hackers become more likely to target them
- The more activity there is in managing digital assets in terms of volume of transactions, the more susceptible they become to being compromised
- Efficient and cost effective use of insurance options
- Misuse of anonymity function in blockchain technology for illicit transactions
- Unpredictability of regulatory decisions

It has been observed that digital asset use cases such as asset based activities including investments, margin lending, and liability based activities like deposit services, and reservices align more easily with the existing risk and compliance framework as compared to others. In contrast, novel use of digital assets in market making and decentralized finance would require the development of completely new risk and compliance management frameworks.

What actions should be considered to overcome the complexities?

We have seen that in the current scenario, investors both retail and institutional, are increasingly open to exploring different opportunities in emerging markets and technology. In order to boost the rate of adoption of what is quickly becoming a revolutionary asset class, it is important to provide consumers with clarity and reforms that safeguard their interests.

At present, the industry faces many challenges in the form of uncertainty. This adds to the risks and could potentially cause investors to question whether to explore a potentially life-changing opportunity. Below are some actions that can be considered to overcome the complexities and boost adoption:

- **Classification of digital assets** - As there is no universally accepted approach to digital assets, their classification is uncertain. Is it a security, commodity, currency, or other? It is important to classify the asset into one umbrella as this will bring more clarity when it comes to the regulatory approach to follow and the regulations to be mindful of.

- **Establishing a regulatory foundation -** Establishment of a regulatory foundation followed by the at-scale participation of key members of the regulated financial ecosystem around the world.

Are there any use cases that align more easily with the existing risk and compliance framework as compared to others?

Asset-based activities such as investments and margin lending, as well as liability-based activities such as deposit services and re-services align more easily with the existing risk and compliance framework than others.

This is primarily because such activities have been in practise for a long time in traditional financial systems. As a result, there is an existing risk and compliance framework that can be applied. This framework may not be up to date with some of the more advanced technology solutions, some of which are still being developed or are undergoing upgrades and innovations.

Are there any use cases that would require the development of completely new risk and compliance management frameworks?

Market-making and decentralized financing would require the development of completely new risk and compliance management frameworks. Decentralized processes are substantially different from centralized processes undertaken by traditional financial institutions, thus new risk and compliance management frameworks will be required to effectively regulate them. Considering that there is no involvement of a centralized authority in transactions, the risk should be viewed differently when assessing decentralized finance.

Conclusion

The digital asset industry is constantly evolving and appears to have reached the mainstream population. In order for the next step to be taken, the industry as a whole must demonstrate more certainty. While the issues related to security and regulatory compliance of digital assets are likely to remain prevalent for years to come, it is important to start addressing these problems. Swift actions for the implementation of a regulatory framework in the digital asset landscape is the need of the hour. This is where a trusted body like The Federal Deposit Insurance Corporation (FDIC) can play a vital role in maintaining stability and public confidence in this new asset class.

Thank You,
The VegaX Team
1115 Broadway,
New York, NY 10010
www.VegaXHoldings.com
info@vegaxholdings.com