

COMPETITION

# Considering the competition law implication of cryptocurrency and regulation one ought to say – Competition Commission start running!

7 December 2022 7 min read

The cryptocurrency sector is innovative and fast-moving. Cryptocurrency and crypt exchanges are attracting a lot of focus also as Crypto exchanges have achieved enormous success. But with success (and scale) comes [competition law](#) scrutiny, particularly in a sector where the economic fundamentals and emerging market data suggests that it may be trending towards concentration.[1]

In considering the *Intercontinental Exchange/Trayport*[2] merger the **UK Competition and Markets Authority** stated that:

*"Liquidity pools tend to be self-reinforcing; that is, the more people that trade on a single venue the greater the liquidity and the more people who will come to that venue to trade. These network effects are an important feature of the wholesale energy trading markets. As a result of network effects, the value of the services offered by trading venues increases with the number of market participants that use that venue. To some extent, this can make liquidity 'sticky' and it prevents traders from easily switching between venues and/or clearinghouses because doing so will risk losing access to the highest liquidity and, therefore, best prices available. [...]"*

*As OTC markets become more liquid the products concerned become more suitable for exchange-based trading. Accordingly, exchanges develop vanilla or copycat products and compete to become the first exchange on which liquidity gathers, including by offering fee holidays, discounts and rebates. Given the importance of network effects and the stickiness of liquidity once it has gathered on a venue, the time to market and first-mover advantage is an important competitive factor."*[3]

Similar observations have been made in the **European Commission's reviews** of potential concentrations among trading venues for traditional financial instruments.[4]

*"Financial market infrastructure platforms at all levels of the value chain are characterised by significant network effects. Market participants are naturally driven to the venues where other market participants are already active. As such market participants tend to concentrate their activities on a single venue to achieve synergies. Therefore, one of the intrinsic qualities of a platform, be it a trading venue, a clearing house, or a settlement venue stems from the number of other market participants that are concentrating their activities on that specific venue.*

*This is because, for instance, in the area of trading, the accumulation of customers implies that more people actually trading or at least showing their willingness to do so for a specific price results in a higher likelihood of one participant finding a suitable counterparty for a specific trade. This is typically referred to as the "liquidity" of a venue or the "depth" of the order book. Higher liquidity on a platform is typically associated with narrower and, therefore, better bid-ask spreads which increases the likelihood of execution.*

*These characteristics lead to two main consequences. First, there are significant first mover benefits in these markets, and second, once liquidity has built up on one large venue, this naturally attracts further liquidity. As a result, exchanges with less liquidity are more likely to suffer from wider bid-ask spreads and lower order book depth"*

## The cryptocurrency sector

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What is clear is that the cryptocurrency sector is facing a historic challenge.[5] We have noted the value of cryptocurrencies in freefall. Bitcoin is approximately 70% lower compared to its high in late 2021. Also, suddenly we have learned of the suspension of withdrawals and in the case of Celsius, a crypto lender filing for Chapter 11 bankruptcy in July 2022.

But are competition authorities thinking about the future regulation of the cryptocurrency sector? While the Competition Commission is finalising their report into Digital Markets, one would wonder to what extent the impact of cryptocurrency is on the radar in South Africa?

We know that competition can take many forms. While some markets can sustain a large number of firms operating and growing alongside one another, in other markets the competitive process inevitably results in the elimination of rivals. This is referred to as the 'winner-takes-all' scenario, where competition takes place 'for' the market; not 'within' it.[6] This is part is in line with what the Competition Commission is concerned about in relation to the digital marketplace.

What is important is to understand the role of network effects within the cryptocurrency sector.

It is critical to understand what type of competition to expect from crypto exchanges; specifically, whether the sector is characterized by network effects and how strong any such network effects are. Without doubt, liquidity is a core aspect to consider when thinking about competition between cryptocurrency sector participants. Some crypto users may very well deem larger exchanges as being more stable and secure.[7]

Crypto is no longer the hobbyist industry that it once was, where thousands of bitcoins are exchanged for a pizza.[8] What will the approach be in terms of South African competition law in future?

### The FSCA declares crypto assets as financial products

The Revised Small Merger Guideline is effective from 1 December 2022. These guidelines were specifically adopted as there are concerns that potentially anti-competitive acquisitions in digital or technology markets are escaping regulatory scrutiny due the acquisitions taking place at an early stage in the life of the target before they have generated sufficient turnover or accumulated capital and physical assets that would trigger mandatory merger notification as set by the turnover or asset thresholds.

What this means is that consolidation within the cryptocurrency exchange world in South Africa will not be able to go by unnoticed.

### The start of the original Bitcoin white paper stated[9] —

*"Commerce on the Internet has come to rely almost exclusively on financial institutions serving as trusted third parties to process electronic payments. While the system works well enough for most transactions, it still suffers from the inherent weaknesses of the trust based model. Completely non-reversible transactions are not really possible, since financial institutions cannot avoid mediating disputes. The cost of mediation increases transaction costs, limiting the minimum practical transaction size and cutting off the possibility for small casual transactions, and there is a broader cost in the loss of ability to make non reversible payments for non-reversible services.*

*With the possibility of reversal, the need for trust spreads. Merchants must be wary of their customers, hassling them for more information than they would otherwise need. A certain percentage of fraud is accepted as unavoidable. These costs and payment uncertainties can be avoided in person by using physical currency, but no mechanism exists to make payments over a communications channel without a trusted party.*

*What is needed is an electronic payment system based on cryptographic proof instead of trust, allowing any two willing parties to transact directly with each other without the need for a trusted third party. Transactions that are computationally impractical to reverse would protect sellers from fraud, and routine escrow mechanisms could easily be implemented to protect buyers".*

Let us then ask — Who is holding it all together and who will be watching?

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Footnotes

- [1] Waksman, Alexander, *Antitrust and Crypto Exchanges: Time to HODL* (November 8, 2022) (accessed 5 December 2022)
- [2] Intercontinental Exchange, Inc. v. Competition and Markets Authority Case Numbers: 1271-1272/4/12/16
- [3] CMA, Final Report, Completed acquisition by Intercontinental Exchange, Inc. of Trayport, 17 October 2016, paras. 2.59-2.60 and 7.37
- [4] Case M.7995 *Deutsche Börse / London Stock Exchange*, European Commission, decision of 29 March 2017, para. 56
- [5] *Ibid*
- [6] *Ibid*
- [7] NextAdvisor, *Want to Buy Crypto? Here's What to Look for In a Crypto Exchange*, 3 May 2022
- [8] Coindesk, *What Is Bitcoin Pizza Day?*, 22 April 2022
- [9] S. Nakamoto, *Bitcoin: A Peer-to-Peer Electronic Cash System*, p.1



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