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The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

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A Closer Look at the Proposed UK Cryptoassets Regulatory Regime

In February 2023, the UK Treasury (HMT) published its consultation and call for evidence on the future financial services regulatory regime for cryptoassets (Consultation Paper). This is part of Phase 2 of HMT's effort to develop a regime to regulate the cryptoasset sector. Phase 1 involves the regulation of fiat-backed stablecoins, which will be covered by secondary legislation under the Financial Services and Markets Bill 2022-23 (FSM Bill) and will shortly be laid before the UK Parliament.

The current cryptoasset consultation will close on 30 April. We take a closer look at some of the key aspects of Phase 2.

The government has elected to place the regulation of cryptoassets within the framework of the existing Financial Services and Markets Act 2000 (FSMA) rather than create entirely new legislation. This is regarded as better aligned with the mantra of the 'same risk, same regulatory outcome' and is intended to create parity between crypto-based and traditional financial services. Security tokens are already captured under the FSMA framework, so there is logic in encompassing activities relating to wider crypto tokens within the same legislative framework.

Phased Approach

- The Consultation Paper sets out the government's phased approach to regulating cryptoassets, providing more detail on Phase 1, which was consulted on in April 2022 and will be legislated for in 2023. Phase 1 assigns oversight of fiat-backed stablecoins to the Payment Systems Regulator (PSR) rather than the Financial Conduct Authority (FCA). The PSR currently regulates payment systems such as Bacs (an interbank payment system) and CHAPS (the UK's real-time high-value sterling payment system). All other cryptoassets subject to proposed regulation, including other 'stablecoins' such as algorithmic or commodity-linked stablecoins, will be dealt with in Phase 2, and subject to FCA supervision.
- Stablecoins other than those which are fiat-backed will be subject to the same requirements as unbacked cryptoassets. They will be prevented from being presented and marketed as 'stable' or as 'payments instruments' or similar. These restrictions will be included in revised financial promotion rules.

Designated Activities Regime

- The proposed Designated Activities Regime (DAR) will be a new part to the FSMA, introduced by the FSM Bill, designed to provide a framework for regulating certain financial activities following the repeal of retained EU law. It will be used to regulate financial activities carried on by persons whose main business is not financial services and which will not be subject to authorisation. For example, the government is considering using this regime to restrict public offerings of cryptoassets that do not meet the definition of a security token and for admission to trading of a cryptoasset on a trading venue (see further below).

Definition of Cryptoassets

- In the FSM Bill a 'cryptoasset' is defined as a 'cryptographically secured digital representation of value or contractual rights [...] which may include [the use of] distributed ledger technology'. The definition is not tied to distributed ledger technology (DLT) as it is in some other contexts — notably, under the UK's Money Laundering Regulations 2017 (MLRs)) and the Financial Action Task Force's recommendations. A DLT-specific definition is also deployed in the EU Markets in Crypto-Assets (MiCA) Regulation.
- Given the breadth of the definition, apart from certain NFTs and utility tokens, it is difficult to conceive of cryptoassets that do not fall with it, as most will involve at least some representation of 'value'. However, as the legislative approach is designed to cover activities related to cryptoassets, rather than the cryptoassets themselves, not all tokenised use cases will fall within the regulatory perimeter. Certain use cases in the payment and settlement context will likely fall outside the rules, as there will be no regulated activities being carried out in relation to them. Equally, not all activities relating to in-scope NFTs will necessarily be captured. Note that the government acknowledges that it is the particular structure and characteristics of a token that determines whether it should be brought within the current regulatory perimeter, rather than any label such as 'NFT' or 'utility token' that may attach to it.

Territorial Scope

- The proposed regime would capture activities carried out 'in or to the UK'. This is an expansion of the general prohibition in section 19 FSMA, which regulates activities that are carried out simply 'in the UK', albeit noting that the notion of 'in the UK' has been construed broadly enough in certain contexts to include activities carried on outside the UK but targeting the UK market. The proposed regime will now explicitly capture activities carrying on from outside the UK and which are provided to UK persons. The consultation is silent on the extent to which the 'overseas person' exclusion will apply — an exclusion that permits non-UK persons to carry out certain regulated activities on a cross-border basis without requiring authorisation and which might otherwise be regarded as being carried out in the UK. It has hitherto been relied on by many non-UK broker-dealers conducting cross-border wholesale business.
- A 'reverse solicitation' carve-out is being considered, but there will be challenges defining its parameters so as to avoid misuse or regulatory arbitrage. For instance, it is unclear whether there will be a time limit to servicing clients who came in through reverse solicitation, and whether there will be limits to additional products or services that can be offered to such clients.

Location Requirement

- Whether firms will need a physical presence in the UK in order to be authorised and to be able to provide services will not be based on factors set out in legislation. Instead, it will depend on the opinion of the FCA as to the nature and scale of the firm's activities and the risks of harm the activities could cause. Such an assessment inevitably requires some judgement and could change over time. Firms seeking to operate in the UK and the EU may therefore be required to form subsidiaries in both jurisdictions and comply with both UK and EU regimes.
- The government has stated specifically that cryptoasset 'exchanges' that fall within the regulatory perimeter would likely need to operate through a UK subsidiary in order to provide trading services. This could filter out many overseas trading venues and require them to operate carefully on a 'reverse solicitation' basis if they intend to have some market presence in the UK. The government is considering an 'equivalence'-type solution where a UK presence would not be required if the local regulatory standards of the cryptoasset firm are deemed equivalent and a co-operation mechanism can be put in place between the authorities of the relevant jurisdictions. Query whether this would be a realistic solution, at least at the outset, given that other jurisdictions may be behind in regulating cryptoasset businesses.

Which 'Specified Activities' Will Be Captured?

- In broad terms, HMT proposes that issuance, payment activities, operating a trading venue, dealing, arranging, activities relating to lending and borrowing, custody and validation activities should be subject to FCA authorisation, although some of the activities will be deferred beyond Phase 2. The scope of these activities are largely based on existing regulated activities relating to 'specified investments' under the FSMA framework but will have to be tailored for crypto assets. It is also unclear the extent to which existing exclusions from authorisation will apply.
- The specified activities will have to be carried out 'by way of business' in order to fall within the perimeter.

Custody

- HMT acknowledges the varied ways in which cryptoasset custodians may hold cryptoassets and/or provide means of access to cryptoassets (through a wallet or cryptographic private key), including by cold storage (offline) or multi-signature hot wallets (online). Exchanges may provide custodian services alongside trading services, as is typical for 'centralised finance' (CeFi) cryptoasset exchanges. Alternatively, they may integrate directly with customers' wallets and avoid direct involvement in the flow of funds by executing transactions only through smart contracts, as is the case with decentralised finance (DeFi) exchanges.
- The Law Commission is currently exploring the possible adaptation of English law to accommodate digital assets and the differing custody arrangements that may be used. The outcome of the Law Commission's work will be taken into account by HMT in developing the regime to address custodial activities. Acknowledging the differences between custody of cryptoassets and custody in traditional financial services, 'safeguarding' activity will fall within the perimeter and will require authorisation even if it is not accompanied by 'administration' activity, which is required in the traditional financial services context. This is consistent with the scope of custody activities that are captured under the MLRs. Segregation of cryptoassets from the custodian's own assets will be required, as well as organisational requirements designed to minimise risks or loss or diminution of value. A bespoke resolution regime is also being considered, presumably to give priority to, and to maximise value, for clients whose cryptoassets are being held in custody.
- HMT's proposals are unexceptionable as far as they stand, but the devil will be in the detail of the legislation. Many custodial providers may cease to perform that role because capital and governance requirements, and the operational requirements to effect segregation, may be too costly or burdensome. Care will also have to be taken in defining 'safeguarding' in the cryptoasset context to avoid capturing ancillary service providers such as those offering retrieval services, for example, for lost and private keys.

Market Abuse

- Abusive behaviours such as 'pump and dump', 'wash trading' and 'spoofing' have been as commonplace in crypto markets as they are in traditional financial markets. Both the fragmented nature of cryptoasset markets and the lack of global harmonisation on market abuse rules make it difficult to introduce market abuse requirements that work. Absent harmonisation of international standards and co-operation mechanisms between regulators, it will not be possible to achieve regulatory outcomes that match those in financial markets. This concern is augmented by the fact that cryptoassets are primarily traded by retail (and therefore more vulnerable) customers. HMT has noted that they do not expect this new market abuse regime to be as effective, at least initially, as the regulations governing traditional securities markets.
- The onus will be placed on trading venues, rather than on issuers, to police, detect and monitor abusive behaviour. This reflects the inherent difficulty in some cases in identifying a single issuer of a cryptoasset and the absence of a main trading venue for a particular cryptoasset. Cryptoassets are typically traded on numerous crypto exchanges. The nature of the monitoring and reporting obligations of suspicious transactions executed on cryptoasset exchanges will likely mirror those that apply to existing traditional trading venues. The government is also consulting on whether all regulated cryptoasset firms should be required to publicly disclose inside information and maintain insider lists. This goes beyond the requirements that apply to firms under the existing market abuse regime.

Issuance and Prospectus Requirements

- As with traditional securities offerings, restrictions will be placed on public offerings of a cryptoasset and the admission of a cryptoasset to a cryptoasset trading venue without a prospectus. The DAR (described above) will be used as a basis to develop rules governing prospectus requirements, because the existing Prospectus Regulation (part of retained EU law) will be replaced under the FSM Bill.
- There will be exemptions from the prospectus requirement for offerings to 'qualified investors' (broadly, non-retail), offers of a small size or offers to fewer than 150 investors. A further possibility of making an offer through crowdfunding or similar platforms will also be recognised as an exempt offering, but the onus will be a platform to diligence the offering and ensure proper disclosure.
- Where a cryptoasset with no issuer is to be admitted to a trading venue, the venue would have the responsibilities of an issuer, including preparation of a disclosure document.

Trading Venues

- Proposals to regulate cryptoasset exchanges draw from existing regulations governing securities trading venues and would need to be tailored to the particular characteristics and risks of cryptoasset trading activity, such as cybersecurity, conflicts of interest and non-discriminatory access.
- As discussed above, cryptoasset exchanges that are subject to UK regulation will likely have to establish in the UK since they play a critical role in the cryptoasset value chain. This is likely to mean that many overseas cryptoasset exchanges will have to tread carefully, accepting UK-based clients only on a reverse solicitation basis or barring UK-based clients from accessing services altogether. The other key distinction with traditional trading venues is that cryptoasset exchanges may offer other

services, such as custody services, staking (depending on the relevant protocol and cryptoasset) and cryptoasset lending. This introduces other risks in addition to the operational risks associated with operating a trading venue, such as counterparty risks and market risks, depending on the range of activities of the cryptoasset exchange.

- Cryptoasset exchanges also do not lend themselves easily to the separation of trading and settlement functionalities as they are often part of a combined offering. There may be, therefore, difficult conflicts of interests issues for many cryptoasset exchanges.

Marketing Restrictions: Financial Promotions

- The Consultation Paper confirms the government's intention to bring 'qualifying cryptoassets' within the scope of the UK's financial promotions regulatory regime in 2023. That regime requires financial promotions to be made by authorised persons or, alternatively, approved by an authorised person, unless an exemption is available. Exemptions will generally not benefit retail-oriented cryptoasset firms and most firms are not presently authorised. It is impractical for cryptoasset firms to have marketing materials and communications approved by an authorised person given the lack of relevant expertise and willingness on the part of non-crypto firms to perform those functions. In recognition of this issue, the government will allow cryptoasset firms that are registered under the MLRs to issue financial promotions. The FCA will be empowered to issue rules governing such communications. Amongst other things, these rules will require in-scope marketing materials to be clear, fair and not misleading.

Comparing the UK and EU Approaches

- The UK approach has many similarities to the EU's MiCA. Like the proposed UK regime, MiCA will regulate stablecoins (but including non-fiat backed stablecoins such as asset-referenced tokens), exchange tokens with an identifiable issuer, and utility tokens, as well as activities covering custody, operating as a trading venue, issuance and intermediation services. (Note that advice and portfolio management are not included in the current phase of the UK legislative approach). When the next phase of the UK's legislative agenda is completed, it will more closely align with MiCA.
- MiCA provides for a clear route to authorisation for firms that are already regulated under existing EU legislation. However, the Consultation Paper does not provide any route for firms that are currently authorised or registered for anti-money laundering purposes in the UK. HMT has stated that it wishes to avoid multiple authorisation pathways and that this will be kept under review.
- For more detail on MiCA, see our 23 November 2022 client alert, 'EU's Proposed Legislation Regulating Cryptoassets, MiCA, Heralds New Era of Regulatory Scrutiny'.

Other Areas of Development

- HMT recognises that the legislative proposal is not comprehensive in its coverage of the cryptoasset space. There are calls for evidence in relation to DeFi, other cryptoassets activities and sustainability concerns. The government is considering whether cryptoasset investment advice and portfolio management, and to a lesser extent mining and staking, ought to be regulated activities, and seeks views on this. In light of ongoing efforts to regulate sustainability disclosures generally, the government welcomes evidence on the utility of environmental information for cryptoassets being made publicly available.

Conclusion

- A robust and coherent regulatory regime is a welcome step, both clarifying the government's intentions for regulation of the industry and giving confidence to cryptoasset users and firms navigating their legal and regulatory risks. It remains to be seen whether the UK proposals have struck a proper balance between fostering innovation, on the one hand, and creating a robust and clear framework for cryptoasset businesses establishing themselves in the UK, on the other.
- The consultation closes on 30 April 2023.