UK FINANCE

# UK Finance response to the HM Treasury consultation and call for evidence on the future financial services regulatory regime for cryptoassets

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**Sent to**: cryptoasset.consultation@hmtreasury.gov.uk

## 1 INTRODUCTION

1.1 UK Finance is the collective voice for the UK banking and finance industry. Representing more than 300 firms, we act to enhance competitiveness, support customers, and facilitate innovation. We welcome the opportunity to respond to HM Treasury's (HMT) consultation paper and call for evidence on the future financial services regulatory regime for cryptoassets. We have worked with Member groups from across our organisation, and have been kindly supported by Addleshaw Goddard in compiling this response.

1.2 We recognise and support the balance that HMT's proposals seek to maintain. We have highlighted some areas where we believe more consideration and detail is needed before the framework is finalised. In particular, we welcome HMT's confirmation that the Consultation and Call for Evidence on the future financial services regulatory regime for cryptoassets is intended to be an iterative process. There are a number of parts of the current Consultation where it is difficult for UK Finance and its members to provide detailed feedback pending clarification on some of the core overarching framework. We would welcome the future opportunity to engage with HMT on these more detailed issues as part of a second phase discussion or consultation process.

1.3 Given the breadth and diversity of our membership, there are differing views on certain key issues. We have sought to identify more broadly, what those multiple viewpoints are, and where this is relevant to specific issues raised by HMT.

## 2 EXECUTIVE SUMMARY

Here we have provided a brief executive summary highlighting some of the main themes that are made throughout our responses to the individual questions. There is a lot more detail and contextual narrative provided in our full responses in the main section.

2.1 **Need for legal certainty and regulatory clarity within the context of a proportional and balanced regulatory framework:** UK Finance and its members are keen to support the development of a regulatory framework for the use of cryptoassets in the UK financial services industry which provides certainty to firms and robust protection for consumers. This framework needs to be welcoming of innovation, support the attraction of capital and developer interest, and support the responsible use of new technologies in the UK financial services industry. There is a related risk that, if the regime is made too onerous, this will drive cryptoasset business and the entities that engage in it outside the purview of UK regulation and discourage existing authorised firms from taking the proper role they should play. UK Finance and its members are well placed to engage with HMT and the FCA to craft the right approach to take.

2.2 **Apply the principles of same activity, same risk, same regulation and technology neutrality in a proportional manner:** Members generally support the approach of regulating cryptoassets and specific activities relating to cryptoassets, not systems which may use cryptoassets. We consider that the mere tokenisation of a real-world asset should not de facto mean it needs to be regulated as a cryptoasset. Regulation should take into consideration the rights conferred by assets and the risks involved in the activities performed, as well as the size of those activities and their potential impact on the financial system

2.3 **Need for global coordination and agreed taxonomy**: Given the cross-border nature of most business models, it is important to agree terms and definitions on a global basis and also for regulators to agree on minimum standards to comply with given the difficulty of enforcing rules on entities operating cross border Industry also stands ready in the important task of engaging with other key jurisdictions to seek alignment where feasible.

2.4 **Territorial scope**: Though our members did not have homogenous views on the jurisdictional / territoriality elements of the consultation, there was a strong view that this is a critical element in the design of an effective and future-ready regime.

2.5 **Clarity needed on UK vision for holistic cryptoassets regulation and for scope delineation of different regimes:** Members felt it was important for the entire regime to be articulated and finalised before implementation of any part (while recognising that a phased implementation might well be necessary, particularly from a compliance and cost perspective). For example, Members questioned whether the focus on fiat-backed stablecoins in Phase 1 targets the areas of highest risk for the cryptoasset sector. It will be also important to delineate clearly what constitutes a cryptoasset subject to this new regime, what is the scope of RAO vs DAR as well as clarifying that any financial instruments using DLT technology should be subject to existing rules rather than this new regime.

## 3 THEMATIC COMMENTS

3.1 In addition to the specific responses to questions below, we have identified a number of core themes from members' feedback.

3.2 Definitional and Scoping Challenges

UK Finance and its members are broadly supportive of HMT's core design principles, namely "*same risk, same regulatory outcome*", "*proportionate and focused*", "*agile and flexible*" regulation. Members also understand the importance of having clear and consistent definitions for the proposed UK cryptoasset framework, as well as the approach taken by HMT of using a particularly wide definition of "cryptoasset", to allow for future technology developments and to avoid the need to amend the framework regularly in future.

However, the use of this broad definition of what a "cryptoasset" is, coupled with the proposed all-encompassing regulatory regime for cryptoassets may have adverse impacts on regulated firms, and unintended consequences for innovation in the UK financial services industry.

- Many UK financial services firms already use systems to manage assets or trade products in a dematerialised or digital form which have nothing to do with the emerging asset classes of cryptoassets. Members can see a risk that those systems could fall within scope of the broad definition of "cryptoassets" being used by HMT and therefore become subject to the new regulatory regime.

- Some members are involved in developing or using systems for financial services transactions which rely on cryptoasset settlement tokens (usually a payment stablecoin). The systems which use these types of cryptoassets act as a 'bridge' between digital assets and fiat currencies, and have the potential to increase transaction ease and efficiency as well as reducing costs for banks and their customers. The risk associated with the use of cryptoassets in these kinds of systems are different and, in our members' view, far more limited than the risks associated with (for example) unbacked cryptoassets being sold direct to consumers. Members focused on this aspect of the UK cryptoasset ecosystem are supportive of proportionate regulation of cryptoasset settlement tokens which reflect this more limited risk, rather than the entire transaction system being regulated. However, the current regulatory proposal does not sufficiently take account of the relevant risk levels of different types of cryptoasset activity. Further, the proposal to regulate fiat-backed stablecoins used for payment as a priority in Phase 1 does not reflect the risks which our members see as most critical.

- Members broadly agreed that same activity, same risk, same regulation principles should apply across the board. The majority agreed that technological neutrality also remains important. UK Finance members believe that it should be a core principle, that the mere tokenisation of an asset, the holding of a tokenised asset, or use by a financial services firm of a distributed ledger system which incorporates cryptoassets should not in and of itself impose additional regulatory obligations on financial services firms or require additional regulatory permissions.

- Some members have highlighted that cryptoassets can take many forms, including cryptoassets which are a direct digital representation of a real-world asset, such as a share or a bond, the trading of which is already subject to a separate regulatory regime in the UK. It is unclear how the proposed cryptoasset regulatory regime in the UK will interact with the Financial Services and Markets Act (FSMA)'s in respect of these kinds of "real-world" cryptoassets. Logically, it should not result in increased burdens under the general principle of same risk, same regulatory outcome. Applicable regulation to DLT representations of traditional assets should be the same that applies to the underlying type of asset (i.e. bond, share, etc.)

- In a similar way, while it is helpful to have HMT's policy statement that the proposed regulatory framework for cryptoassets is not intended to impose regulation on any underlying non-financial services activity which a cryptoasset might be used for, the definition and intended scope of "non-financial services activity" needs significant clarification. Tokenisation of assets has the potential to introduce significant efficiencies, including in back-office treasury, payment and capital allocation systems of financial services business and some members are exploring using underlying cryptoasset technology for these purposes. The technology should not be regulated as such.

- Finally, some members have asked for additional clarity on how existing (regulated) financial services business performed by UK-regulated firms (such as options or futures transactions where the relevant financial instrument is referable to cryptoassets as the underlying reference asset) will be affected by the proposals.

  We expand on these issues below.

Underlying all of these comments is a general concern that DLT technology can be used in many ways and for many purposes, all of which carry different levels of risk and that this is not fully reflected in the proposed regulatory framework. In addition, some members are concerned that the proposed framework does not yet fully acknowledge that the cryptoassets ecosystem and the technology that supports it has its own concepts which do not have direct analogies in the "real world". Accordingly, care needs to be taken to ensure that in applying the current FSMA regime, where concepts do not align, the framework should not assume that the

cryptoassets can be properly regulated using traditional finance or centralised finance concepts. The best current examples of this are in respect of cryptoasset custody, which we comment on further below.

UK Finance have noted the work being done by the Law Commission on how English and Welsh law should be adapted to accommodate digital assets, as noted in the Consultation. We agree it is important that the Law Commission's output is considered as part of designing the proposed framework. It remains critical that the UK has accurate, agreed and consistent legal tools to describe what is unique about cryptoassets so that HMT can design regulation that is, accordingly effective for its purpose.

This feeds through into the comments from our members on the timing of implementation of the UK regime and particularly the proposal that this there should be a phased implementation. Some members feel strongly that the current proposed phased approach does not target the areas of highest risk first, and that the overly broad and prescriptive application of FSMA to cryptoasset activity and the regulatory approach in practice will stifle innovation and investment in the UK financial services industry in the short-to-medium term.

3.3 Financial Crime

There are questions in the Consultation which have direct implications for economic crime, and a number that have broader implications for financial crime and compliance, particularly as it affects the UK regulated sector. There is only a limited focus on these issues in the proposals and we believe that more detailed guidance is needed as part of the design and implementation of the proposed UK regulatory regime for cryptoassets.

At present, firms carrying out cryptoasset activity are required under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the 'MLR's) to be registered with the FCA and have appropriate due diligence and money laundering controls. There is no equivalent regulation which requires those firms to implement relevant **fraud controls or to implement controls to reduce and manage consumer harms**, particularly where a customer may be vulnerable.

Some UK Finance members have seen very high associations of fraud and/or significant losses of capital with crypto-related activities by their customers. One Member assessed that approximately one quarter of investment losses are related to crypto investments with another Member noting that the fraud rate for crypto transactions under the merchant category code 6051 (used for payment transfers to non-financial institutions providing cryptoasset services) is 12-13 times higher than when the merchant category code is not 6051. The current regulatory burden driven by financial crime related rules results in UK payment service providers (PSPs) primarily being held liable for fraud and economic crime risk experienced by consumers in relation to cryptoassets, which is entirely outside of the PSP's control. Against this background many firms have taken risk-based decisions to restrict or block payments related to cryptoassets for their customers in the UK. Some UK banks have also decided, again on a risk basis, not to offer banking services to cryptoasset-related businesses.

At the moment, these sorts of fraud, scams and "get rich quick" schemes are not being adequately addressed by UK financial service regulation, even given the Government's recent proposals to address fraud. Given the higher fraud risk associated with the types of cryptoassets that are promoted, sold to and traded by consumers, members consider that the proposed UK regulatory regime for cryptoassets should specifically address this risk. One option would be to extend UK consumer and fraud protection obligations to cryptoasset service providers in the same way as financial institutions. If HMT is not minded to address these issues as part of the current consultation, we suggest that urgent further work is done in the interim to assess how these economic and financial crime risks related to cryptoassets should be managed in the UK.

To assist HMT's consideration, UK Finance and its members have identified the following specific issues which they believe should be addressed as part of the approach to reducing and managing financial crime in this sector, by way of regulatory determination:

(a) At least an interim obligation on cryptoasset market participants in the UK regulatory regime to have systems, controls and processes in place to identify, manage, reduce and report financial crime which occurs and which they are reasonably aware of, including fraud;

(b) Agreed data standards and data collection which help UK regulated firms in screening and identifying payments to cryptoassets firms which are outside the scope of the proposed UK regulatory regime (and therefore to block payments to unregistered cryptoasset firms doing business in the UK). Particular guidance may be needed in respect of the impact of the proposed regulatory perimeter and any implementation of a reverse solicitation model to enable UK regulated firms to determine whether to process a payment to an unregistered cryptoasset firm outside the UK which is serving a UK customer. In the same way, it will be important that there is appropriate FCA supervision & enforcement against e-money firms providing wallets for / allowing transfers to unregistered crypto firms (whether UK or overseas).

(c) Data standards, data collection and guidance to assist UK regulated firms when risk assessing the processing of payments to cryptoasset service providers, including crypto exchanges. Most UK firms have very little insight into the relative risks of payments to crypto exchanges as there is no requirement on crypto firms to implement Confirmation of Payee (CoP) or use tactical solutions such as Mule Insights Tactical Solution (MITS) or data sharing via the Best Practice Standards (BPS). There are products available through third party vendors that help assess risk, but these are embryonic in nature. There is a need for a crypto specific versions of FCA warning lists (e.g. to include payee information, possibly shared via industry platforms / FCAS / other public-private partnerships).

(d) A fair allocation of responsibility for dealing with fraud and financial crime relating to cryptoassets between UK banking firms/PSPs on the one hand and cryptoasset firms on the other is required. We believe that firms bringing risk into the system should have a similar level of regulatory burden, taking account the nature and the size of the risk. It remains essential that the Payment Systems Regulator (PSR) establish clear mechanisms to ensure that all participants within the payment landscape are incentivised to develop effective fraud controls, inclusive of PISPs and currently unregulated firms such as crypto exchanges. In the same way, liability for fraud costs should be shared across the crypto ecosystem. The fact that the consultation does not cover how the proposed new regulation will interact with existing financial crime legislation raises material concerns around conflict or contradiction in the legislative landscape being proposed.

(e) A clear approach to liability and risk is needed, particularly involving transactions relating to consumers. In particular, the UK Financial Ombudsman has mandated reimbursement of UK consumers in transactions relating to cryptoassets on the basis that the relevant firm did not have a verbal conversation with a particular customer about the risks of engaging in unregulated cryptoasset activity. This is not a practical approach for FIs to take in the long term and particularly not where a UK consumer chooses to engage in cryptoasset activity with a business that should be, but is not registered under the proposed UK cryptoasset regime. In the interim period, the FCA may wish to consider a similar extension of the FOS regime for cryptoasset activity as was put in place for APP fraud (potential interim measure pending FSMA extension).

Overall, many UK Finance members are finding the current conditions for business challenging. We are hopeful though for further improvements as the two sides of industry are able to come together more effectively. Ultimately, fraud and scams are a challenge that affect all firms in the ecosystem. UK Finance is working with

our members, crypto-native firms, other trade associations, HMT and the regulators to help to identify where we can use our convening power to bring together the different sides of the industry. This helps by enable the sharing of best-practice and considering ways that firms from all sides can work together to support their shared customers.

We want to work with the government and regulators to strike the right balance. If the cryptoasset framework imposes too great a liability on firms currently authorised under the existing regime, they will be reluctant to support growth and participation. This in turn would be likely to result in cryptoasset focused firms electing not to establish in the UK which would not support the HMT objective of ethical and responsible innovation in the UK.

3.4 Payment Stablecoins

UK Finance members have already highlighted the potential importance of payment stablecoins for financial institutions and global business transactions. While there is no single definition, a payment stablecoin is a cryptoasset specifically designed as a means of payment or settlement which is expected to maintain a stable value and is backed by short-term, high quality liquid assets. Most payment stablecoins are likely to fall within the scope of the Phase 1 regulation of fiat-backed stablecoins used for payments, referred to in the consultation.

UK Finance supports the design of a regulatory framework which specifically addresses payment stablecoins and increases the UK's chance of becoming an important global player in this space. With the Bank of England exploring a UK central bank digital currency (CBDC), there is a great opportunity for the UK to build a comprehensive and proportionate regulatory framework for regulated digital settlement assets, of which payment stablecoins are one type.

However, some members have expressed a concern that the current proposed approach to regulation of payment stablecoins is not risk based, is administratively onerous and does not encourage innovation. We address this in more detail in response to the specific questions raised below.

3.5 Jurisdiction of any UK cryptoassets regime

As set out below, there is a divergence of views between UK Finance members on the appropriate jurisdictional scope for the proposed UK cryptoassets regime. Some members could see significant challenges relating to the implementation of any reverse solicitation exception, particularly in respect of retail business, and how this would work in practice. Some Members have contributed to other trade association and industry responses to this HMT consultation, which set out detailed concerns with regard to the HMT proposals on jurisdictional reach and the proposal to implement a materially different jurisdictional construct from that prevailing in the current regulatory environment). Members are not unanimous in supporting this view but are agreed that considerable further thought needs to be given to this aspect of the consultation. (See question 7 below.)

## 4 RESPONSES TO QUESTIONS

**1 Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please specify why.**

As noted above, UK Finance and its members are broadly supportive of HMT's core design In principle, the expansion of the list of "specified investments" to include cryptoassets in Part III of the FSMA's Regulated Activities Order (RAO), is consistent with this approach. It will allow specific activities relating to cryptoassets to be defined as regulated activities and the implementation of tailored rules, which could be used to manage

some of the key thematic issues identified above. This in-principle support is subject to the following specific points of context/concern:

The proposed definition of cryptoassets used by HMT is incredibly broad. In particular the reference to "*digital representations of value or contractual rights that can be transferred, stored or traded electronically*" has the potential to bring within scope some assets used in a wide range of electronic systems used by financial services firms in the UK to manage assets and trade products in digital or dematerialised form which have no relationship to "cryptoassets" and are not supported by a DLT system. We understand the concern expressed by HMT that any definition should be technology neutral and should be broad enough to capture potential future changes in the technology currently underlying cryptoassets in order to mitigate against regulatory arbitrage. However, the proposal also contains a power to update the definition of cryptoasset by secondary legislation, which in our view should be sufficient to allow for responses to technological changes without the risk of arbitrage. A number of members consider that any definition of cryptoassets should remain referable to DLT systems or similar technology at the present time, whereas others are supportive of remaining technologically neutral.

UK Finance members do, however, broadly agree that it is important for there to be a clear and defined list of the types of crypto activities in scope of the UK regulatory regime, supported by a list of specific exclusions which, among other matters, will ensure that ongoing use of core electronic systems which may deploy assets of the type described above (i.e. which fall within the broad definition but are not "cryptoassets" as the term is commonly understood) and which is used by financial services firms in the UK to manage assets and trade products do not become regulated activities.

Similarly, the broad definition runs the risk that all cryptoassets (security tokens, exchange tokens, utility tokens, NFTs, stablecoins etc) have the potential to be captured by this regime if any specified activities are performed in relation to those cryptoassets.

As a result, specific exclusions will be needed, in our view in at least the following situations:

(a) cryptoassets which are used solely as a transaction technology to facilitate settlement of transactions (i.e. between participants of a payment system or in bilateral transactions) or as a record of ownership;

(b) any cryptoassets used for non-transactional/operational/back-office use by the financial services sector;

(c) any cryptoassets that are already within scope of the RAO as another type of specified investment, in which case they should be treated only as that other type of specified investment (on the basis of same risk, same regulatory outcome);

(d) any specified investment which is already within scope of the RAO but where the underlying reference is to a cryptoasset – for example, an option or future contract entered into by a party with relevant Part IV FCA permissions, but where the underlying is bitcoin;

(e) NFTs, providing they are non-fungible and are not used for financial services activities or otherwise as a financial instrument within scope of the RAO;

(f) clear exclusions and/or delineation of regulated activities which come within the scope of this regime for any cryptoassets which are subject to separate regulation as part of Phase 1 as fiat-backed stablecoins,;

(g) any UK central bank digital currency, as this will be subject to a separate regulatory regime when introduced in the UK. We have considered, however, the possibility that other countries may launch a CBDC which becomes available to UK persons, and can see a rationale for any firm offering those cryptoassets in the UK being subject to regulation;

(h) loyalty or reward programmes which may be provided by financial services firms (and indeed other firms e.g. airlines) using the same underlying technology as cryptoassets. Loyalty or reward programmes typically are contracted mechanisms that offer rewards to members/customers for their participation in the programme. This means the use of redeemable points or credits that are primarily obtained through participation in such programmes. The holder of such points/credits would not be able to transfer them to others without the issuer/offeror's permission; such points/credits are non-fractionable and do not have investment purposes as they are primarily used for the purchase of goods or services or other benefits in connection with a loyalty or reward programme. It is important that such loyalty or reward programmes are clearly excluded from any proposed legislation to the extent that the definition of financial services is broad enough to capture this sort of activity by financial services firms.

(i) Cryptoassets which are e-money tokens may also need to be carved out of this proposed framework for cryptoassets (as they are for financial promotions).

In respect of recommended exclusions (e) and (f), some members raised issues specifically relating to payment stablecoins, and note that based on the current proposals, there is a risk that firms which develop, use and promote payment stablecoins will be regulated (using slightly different definitions of what a "cryptoasset" is) under the MLRs, the new financial promotions regime relating to cryptoassets, and the new stablecoin regulatory regime. This is likely to make compliance for payment stablecoin firms complex and expensive, and difficult to navigate for those firms participating in stablecoin activities. Any unnecessary increase in compliance costs may likely result in higher costs being passed on to consumers. For payment stablecoins or 'digital settlement assets' that will be legislated for and then authorised as part of Phase 1, the proposals are not clear whether payment stablecoins will then be considered in scope of specified investments under the FSMA regime at the point of Phase 2, requiring potentially a further authorisation process. If this is the intention, some members consider it will cause extra burdens on those firms who would have to go through two authorisation processes at different phases during HM Treasury's formulation of the financial services regulatory regime for cryptoassets. Those members are of the view that this matter is confusing, and should clarity not be provided on this matter then it could become costly, disjointed, and impose an unfair burden on firms issuing payment stablecoins versus other types of firms participating in phase 2 cryptoassets (noting that trading activities relating to payment stablecoins would also fall within phase 2).

Some members have suggested it would be sensible to have a separate definition for "payment stablecoins" which would allow a more bespoke regulatory regime, reflecting the more limited risk associated with this type of cryptoasset which it is used as a settlement token versus when it is traded as a speculative investment.

Members are aware of proposals relating to the establishment of a cryptoasset taxonomy, which might address both the exceptions referred to above but also address the criteria for slotting different new or emerging cryptoassets into different buckets, carrying different regulatory consequences. This would be supported, subject to a sufficient level of global coordination to reach a broadly applicable taxonomy.

**2 Do you agree with HM Treasury's proposal to leave cryptoassets outside of the definition of a "financial instrument"? If not, then please specify why.**

In principle, most members agree with the proposal, for the reasons set out by HMT, although some did not agree with the description of cryptoassets as "a new asset class with unique features and risks". Given the broad uses for cryptoassets technology in the financial services sector it will be important to have tailored rules

which take account of the specific use or activity being undertaken, rather than the blanket approach of designating all cryptoassets being used in this sector as "financial instruments" with all the consequences that would entail. Some members noted that certain cryptoassets (e.g. security tokens) are already within scope of the definition of financial instruments (which leads to the need to exclude them from the proposed future UK cryptoasset regulatory regime as proposed above).

As noted, it remains important in our view that the mere digitisation or tokenisation of an asset should not change its regulatory status or treatment – rather it is the subsequent activity associated with the tokenisation that might lead to the asset coming within the UK regulatory perimeter, such as offering it for sale or as an investment.

**3 Do you see any potential challenges or issues with HM Treasury's intention to use the DAR to legislate for certain cryptoasset activities?**

We consider that more clarity is needed as to how HMT will use RAO and DAR together, ideally with confirmation of the cryptoasset related activities that would be regulated using the DAR framework in preference to the RAO. We can see that use of the DAR might be beneficial in relation to the offering of unbacked cryptoassets and/or for DeFi related activities, particularly where there may be actors seeking to profit from volatility in underlying unbacked cryptoasset markets or from DeFi platforms. Clarify of scope and clear delineation of the two regimes is needed.

**4 How can the administrative burdens of FSMA authorisation be mitigated for firms which are already MLR-registered and seeking to undertake regulated activities? Where is further clarity required, and what support should be available from UK authorities?**

Our understanding is that there are three broad categories of firms that will be affected by the proposals relating to FSMA authorisation:

(a) Firms that are undertaking cryptoasset activities which currently require them to be registered under the MLRs and will in future require them to be fully authorised under FSMA;

(b) Firms that are fully authorised under FSMA and will need to seek a variation of permission from the FCA to allow them to carry out or continue cryptoasset activities;

(c) Firms that are not yet registered under either FSMA or the MLRs who intend to carry out cryptoasset activities in future, and who may be part way through a MLR authorisation process at the time when the FSMA regime comes into force.

All three categories of firm will need to undertake a relevant authorisation process under the new proposed cryptoasset regime.

There are also firms that are fully authorised under FSMA to undertake activities such as entering into, arranging or advising on options, futures or other financial products where the underlying reference asset is a cryptoasset. Our understanding is that this type of firm will not need to seek a variation of its FSMA permissions to continue its existing activities.

For firms which require additional permissions, it is critical that there is a smooth and manageable authorisation process, recognising that the FCA has historically experienced significant capacity constraints when dealing with cryptoasset permission applications and it remains to be seen whether the remedial steps recently announced will deliver the intended efficiencies.

For firms which are moving from the MLR-only regime to a full FSMA permission regime, it would be helpful for the FCA to produce a specific list of **additional** documents, processes or policies which are expected to be required, against those which the FCA required as part of the MLR-authorisation process, rather than requiring firms to produce documents as if this was an entirely new, first-time application. Similarly, the FCA should recognise where its approach to certain issues (such as the "fit and proper" test) in the context of the MLR-only application for cryptoasset firms was equivalent to the approach that would be taken for a FSMA-authorisation application, such that those issues may not need to be the subject of a full and complete review as if this was a first-time application under FSMA.

The FCA should allow a realistic period of time for firms to prepare and file their application under FSMA, and a temporary permission regime which allows cryptoasset firms to continue business for a period pending the determination of their applications.

It would be helpful for the FCA to adopt a similar temporary permission regime for firms that are fully authorised under FSMA and need to seek a variation of permission from the FCA for cryptoasset activities, to allow them to carry out or continue cryptoasset activities.

However, any temporary permissions regime needs to be accompanied by clear guidance from the FCA as to the regulatory status of such firms. This will ensure that PSPs, in particular, are not put under an additional administrative burden.

With regards to payment stablecoins specifically, our members are of the view that much can be done to mitigate the administrative burdens for firms. At present, should the MLRs not be amended to exclude payment stablecoins then it seems firms would need to go through both a VASP registration as well as an e-money licence (should payment stablecoins fall under e-money as suggested in the payment systems review and call for evidence). At present the industry is concerned that two intensive applications would have to be conducted. If the two separate frameworks for stablecoins and the broader cryptoasset regime are retained, at the very least aligning the required applications would be incredibly beneficial, and would reduce expensive compliance burdens on firms.

**5 Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.**

Please see comments above. UK Finance members consider that more detail is needed from HMT on the precise scope and definitions of the regulatory framework for fiat-backed stablecoins which are used for payment. It is also not clear if those stablecoins which are already regulated under the existing UK payment services/e-money framework will be subject to the new proposed Phase 1 stablecoin regime in addition, and how these two regimes will operate in practice for covered cryptoassets.

**6 Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.**

For our members, their concerns on this question follow on from their considerations with regard to authorisations. There is a fear that, due to phase 2 regulation being developed separately and coming later in the period, firms who operate wider crypto services as well as offering access to payment stablecoins will face difficulties in getting the payment stablecoin side of their business to be approved by regulators without the whole of their wider crypto offerings and business also being assessed by the FCA. In this event, the business would then seemingly need to repeat a substantial part of its application for authorisation as part of Phase 2. It would be very beneficial to have clarity from HM Treasury on this matter. At present the potential for firms operating in the payment stablecoin space having to go through numerous authorisation processes is a concern and would require disproportionate investment for firms' compliance departments.

Most members queried the need to prioritise the regulation of fiat-backed stablecoins used for payment, when compared to the real and present issues being experienced by consumers in the UK related to unbacked cryptoassets (particularly in relation to theft, fraud and financial crime). They would favour prioritising regulation which maximised the opportunity for the FCA to enforce against the unregulated cryptoasset providers who pose the greatest financial crime risk in the UK. Some members commented on the practical risks of the phased approach, including the risk of legislative precent for phase 2 being set by phase 1 (which is not subject to consultation), as well as the approach of phasing by product not activity, despite the underlying framework being activity based.

On balance, members tended to prefer a single regulatory regime covering both fiat backed stablecoins used for payment and other cryptoassets, implemented at a single point in time, with significant interim measures to manage financial crime risk pending implementation.

Some members could also not identify a good reason for not including advising and managing as activities to be addressed during phase 2, as these form a natural part of the range of activities of full service firms and should, in the view of those members, be dealt with at the same time as arranging and dealing.

Another concern expressed is a situation where a payment stablecoin is purchased on an exchange and is then left or held on this exchange, instead of being transferred to a wallet to be used for a transaction. This runs the risk of being classified as an exchange token that is not in use. More clarity is needed on what will be treated as a fiat-backed stablecoin which is used for payment and therefore subject to regulation in Phase 1.

Some members considered the better option would be to establish a clear vision for the activities that should be regulated and how with phase in implementations and transitional periods from a compliance implementation perspective.

**7 Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.**

There were two distinct views expressed by our members on this question. Some members agreed with the conclusion set out in the consultation that activities relating to cryptoassets are most often not confined to a specific jurisdiction and may be made available to UK persons from organisations with multiple jurisdictional touchpoints, none of which are the UK. Subject to the comments above about the types of cryptoasset activities which should fall within the UK regulatory perimeter, those members are broadly supportive of the proposal to capture cryptoasset activities provided **in or to** the United Kingdom. The capturing of cryptoasset activity provided by overseas firms to UK persons (natural or legal) would resolve the current position under the MLR regime where a cryptoasset firm can have a very significant UK client base and can target new UK customers with advertising, while still not "carrying on business in the UK" to the extent that it is required to comply with the MLRs.

We note that the proposed broad definition is likely to capture a very large number of overseas cryptoasset firms with UK clients and consideration should be given to specific guidance for those firms as to how to comply with the final UK cryptoasset regulatory regime, in light of that historic UK client base. In particular, if the overseas firm takes the position that it did not target or solicit UK clients and its UK customers accessed a particular cryptoasset service entirely at their own initiative, will it be required to terminate all of its UK customer business, if it chooses not to register?

In a similar way, some thought needs to be given to the extent to which an overseas cryptoasset business needs, or can practically speaking be required to have employees, resources or a presence in the UK in order to be able to register under the cryptoasset regulatory regime. While we recognise that the FCA has typically expected regulated firms to have a material presence in the UK, consistent with the fact of a firm being

regulated here, that may not be the appropriate position to take with this particular set of activities, given the global nature of the business and the capacity of technology to support extensive operations and a global presence with relatively limited physical and human resources. UK Finance and its members can see a material risk that, if the UK territorial scope rules, authorisation process and subsequent compliance burden is seen as overly onerous, overseas cryptoassets firms will simply ignore the UK regime and continue to provide services to UK customers from jurisdictions where there is a lower set of standards and limited enforcement risk. As such, there is a potential benefit to the UK in making the authorisation process for cryptoassets activities specifically accessible for overseas firms.

Other members disagreed with the blanket approach of imposing authorisation requirements on non-UK cryptoasset service providers when they deal with persons located in the UK, noting that this approach is inconsistent with the territorial scope for other regulated activities in the UK.

Members believe this would substantially limit the ability of UK wholesale market participants to engage and deal with non-UK cryptoasset services providers and would damage one of the key strengths of the UK financial services more generally, namely its relative open approach to market access. A number of members referred to the response made by AFME to the HMT Consultation on this point. These members would prefer to apply the same principles as apply under the current regime to determining who should be within jurisdictional reach and look at the concept of identifying where a particular activity is being carried on by way of business and note that only where a person is carrying on an activity by way of business in the UK should that person be regulated within the regime. These members also note how the Overseas Person Exemption (OPE) currently operates and support developing the concepts of reverse solicitation in order to assist overseas firms to navigate doing business with UK persons.

We note that HMT is considering an equivalence regime for cryptoasset firms and is supportive of this in principle. However, much more detail is needed to understand how this might work in practice, particularly where a cryptoasset firm has been approved under a potentially equivalent regime prior to the relevant phased part of the UK regime coming into force. As noted above, it is important that the UK regulatory regime for cryptoassets is not seen as unnecessarily strict or rigid in comparison to other equivalent regimes and that firms which have gone through an extensive approval process in other countries are not required entirely to repeat that process in the UK, where the UK accepts the relevant cryptoasset regulatory regime is broadly equivalent.

Similarly, in respect of a possible reverse solicitation exemption, it is unclear how this concept (which exists in the wholesale markets) will be expanded to capture cryptoasset retail activities i. Members also noted that whilst a reverse solicitation regime would be helpful, it should not be the main driver for the setting of the UK's territorial scope as capturing all cryptoasset activities in or to the UK.

Those members have expressed concerns that regulated firms in the UK (or elsewhere) may provide cryptoasset activities for firms that are not registered in the UK or are unregistered in their jurisdiction or registered in a jurisdiction that does not conform to equivalent UK standards. The consultation is unclear how the FCA intends to prevent extraterritorial firms from trading in the UK, particularly if there is a reverse solicitation or overseas person exemption.

For payment stablecoins, members are of the view that there should be similar accreditation and standards that overseas firms must meet before entering the UK market. It may be useful, to have a territorial regime for overseas firms who are offering their products or services in the payment stablecoins space to have an established minimum viable standard they must meet initially, before fully committing to entering the UK market.

These members are also seeking clarity on what HM Treasury would consider as reverse solicitation in the context of payment stablecoins and what would trigger the need for a domestic licence.

**8 Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?**

UK Finance and its members agree that the list covers the main relevant activities. We refer to the discussion above about the importance of ensuring that the definitions of the relevant cryptoasset activities will only comprise cryptoassets that are not covered by other categories of specified investments and will not comprise cryptoassets (or classes of cryptoassets) which have been excluded from the UK regulatory perimeter, or where an activity is being undertaken with only a tangential connection to a cryptoasset (for example, use of a third party payment system where the mechanism of payment for a fiat based transaction is the transfer of a cryptoasset). We re-iterate the point that care needs to be taken not to assume that a cryptoasset activity which has the same characteristics of a "real world" financial activity will be carried out or take place in exactly the way provided for in the existing UK financial services regulatory regime, (e.g. cryptoasset custody and real world asset custody may perform the same high-level function but be implemented in substantially different ways).

**9 Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?**

As noted above, a number of members queried the prioritisation of fiat backed stablecoins for regulation in Phase 1, although they were open to the phasing of **implementation** for regulation of cryptoasset activities generally. Members consider it is likely too soon to set regulatory rules on evolving areas like mining and validation.

Some members also felt that the proposed phased approach **to preparing and drafting** the various regulatory regimes for cryptoasset activities could have a material impact on existing cryptoasset projects, discourage innovation and effectively stop any investment or trialling of cryptoasset technologies pending the outcome of the entire UK cryptoasset regime. As a result, some members would favour a single preparation and drafting phase for the UK regulatory regime, with phased implementation for different types of cryptoasset activities along the lines of the current proposal. This would provide certainty to affected parties and allow for longer term planning and investment by affected firms in the UK fintech sector.

We reiterate the material risk that UK Finance members identified of leaving unbacked cryptoassets for phase 2 regulation, which leaves financial firms entirely responsible for managing risks in the interim, including to consumers. As noted above, we recommend implementing additional obligations on the crypto sector to help support any phased approach to implementation.

**10 Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?**

We refer to our response below at question 19. While this is specifically in the context of trading venues, the points raised are generally applicable.

**11 Are there any commodity-linked tokens which you consider would not be in scope of existing regulatory frameworks?**

No response.

**12 Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?**

We broadly agree with HM Treasury's proposal that algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets, on the assumption that a "crypto-backed token" is intended here to mean an asset-referenced token with a value determined in relation to other unbacked cryptoassets.

Members have noted that it may remain important for some closed/private ledger structures to be able to use algorithmic stablecoins as a form of cash on ledger/settlement token, pending the broader adoption of CBDCs, making the exceptions from regulation discussed above equally important in the context of these types of cryptoassets.

The way both algorithmic stablecoins and crypto-backed stablecoins work should not be defined as the same as those assets that HM Treasury consider unbacked cryptoassets. The regulation should not encompass both given the different risks they present. A regulatory scope that covers the assets in question would also likely be too broad to be workable.

**13 Is the proposed treatment of NFTs and utility tokens clear? If not,please explain where further guidance would be helpful.**

UK Finance has prepared a report on NFTs, covering: (1) a general taxonomy and description of the market, (2) NFT use cases, opportunities and risks, and (3) the legal and regulatory principles for tokens which is available here. We look forward to engaging further with HMT and the regulators on the contents of this report more broadly.

Members are broadly supportive of the activities based approach outlined, while highlighting that only NFTs (or other cryptoassets) which are being used for financial services should fall within the scope of financial services regulation unless – as a result of the particular structure and characteristics of the NFT or utility token – it constitutes a specified investment and the activities carried on in relation to the token constitute regulated activities that fall within the existing perimeter.

However, the statement relating to any "use" of an NFT in the context of financial services may be too broad. It is entirely possible that the role of an NFT in a particular structure could be marginal and could simply reflect the fact that an otherwise unregulated asset has been digitised or tokenised.

## General comments relating to Chapter 5, Regulatory Outcomes for Cryptoasset Issuance and Disclosures

While we support the high-level regulatory outcomes outlined, we have some concerns as to whether, particularly for unbacked cryptoassets, the extensive mechanics which underpin real world rules relating to admission of securities to a trading venue can be easily translated into the crypto-ecosystem. Seeking admission to a trading venue in the non-crypto world is an easily identified process, with the issuer and venue operator operating within a legally and operationally well-defined space, accepting into its processes assets which have, depending on the venue, a broadly similar and identified set of characteristics. The venue can, together with the issuer, do the required due diligence. The property rights and interests which the asset has are (more or less) understood by the market and the entitlements of the owner likewise. There are generally a variety of extrinsic non-digitised elements that support the asset.

Many of these characteristics do not apply to material subsets of cryptoassets. For example, for many crypto assets, the price of the asset is a product purely of supply and demand and does not depend upon any underlying "real world" value. This makes these assets volatile, as evidenced by recent events, as well as being substantially affected by perceptions of the integrity of a market or the robustness of a particular crypto exchange platform.

These differences, among others, mean that it will be difficult to capture the complexity of the many different types of crypto assets using a simple overlaying of frameworks and structures which deal with "real economy" assets. We also note that quite a few tokens are issued which are non-transferrable or for which there is no organised market. These represent another category of cryptoasset which may throw up challenges for regulators, when trying to embed them within the framework. The complexities of categorisation are discussed in the FCA's own paper (PS19/22) which usefully describes some of the classes of token and, indirectly, highlights some of the issues.

Against this background, we support the principal of grounding proposed regulation of cryptoasset issuance and disclosures on the framework described in HMT's Policy Note on Admissions to Trading and Public Offer Regime, in that that describes an overarching framework with considerable rule making discretion delegated to FCA.

We do, however, think that there will be material challenges to ensure that the regime works in practice and does not simply drive activities offshore, if an inflexible approach is adopted which treats the cryptoasset issuance and offer process as analogous to an offer of securities in the real world.

**14 Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?**

While at the highest level, we agree with these trigger points, we do stress the challenges of defining what will constitute a UK cryptoasset trading venue or making a public offer from a jurisdictional perspective. The freedom of jurisdictional choice and the effectively jurisdiction agnostic manner in which many on-line operators can work and consumers access their systems means that the risk of regulatory arbitrage is material. The concept of "offer to the public" which is well understood in the real world is also much harder as well to define, for trigger point purposes, in a way which will either not be too prohibitive or too broad brush. We consider that this area should be considered in greater detail, with relevant inputs from experts in cryptoassets and practitioners in those markets to come up with workable and proportionate solutions.

**15 Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?**

While we see the attractiveness of making trading venues the effective gatekeepers for issuance and offering of cryptoassets, the challenges of writing rules for e.g. the contents of an offering document or prospectus which provide the levels of comfort to which investors in real world assets have become accustomed will be significant and the due diligence challenges similarly onerous. The issues of liability will also be complex

(although we concur with proposals set out in the Policy Note on Admissions to Trading and Public Offer Regime referred to above). We also think that some degree of hierarchy may be appropriate, and consideration of target markets. We would also express concerns with simply treating venues with the same rule sets as are applied to MTFs. We agree that many of the operational rules and trading rules applied to platforms under MiFID derived rules should sensibly be applied but some may be disproportionate and or irrelevant.

Members are also of the view that there may be merit in putting the documentary onus more heavily on the issuer, which would then allow reliance more widely by other participants in the ecosystem looking at the same asset, rather than requiring duplicative investigations by multiple venues.

We consider the proposition that venues should be required to reject the admission of cryptoassets they consider could result in investor detriment, to bea potentially, a high bar to require judgements, which platform operators should not be required to make. This should be dealt with by appropriate warnings and disclosures (and by the ability of the related cryptoasset) otherwise to satisfy the venue's requirements for admission to trading.

**16 Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?**

These options appear appropriate.

**17 Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?**

Provided this regime can be appropriately flexed, addressing the idiosyncratic properties of different categories of cryptoasset, the concept of "necessary information" appears to be a good basis to proceed from and the categories of information are relevant and appropriate.

**18 Do you consider that the intended reform of the prospectus regime in the Public Offers and Admission to Trading Regime would be sufficient and capable of accommodating public offers of cryptoassets?**

We think the proposed reforms to the Public Offers and Admission to Trading Regime set out in the December 2022 Policy Note to be necessary, but are unlikely to be sufficient in themselves. The manner in which the FCA will exercise the detailed powers to be delegated to it with regard to cryptoasset trading venues requires further analysis.

**19 Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?**

As a general observation, we broadly support using existing RAO activities covering the operation of trading venues as the basis for regulating crypto asset trading venues as it is: i..e made broadly consistent with the general principle of same activity, same risk, same regulation.

However, we would note material areas where current crypto trading facilities, which might fall within the definition of crypto trading venues under a new regime, differ materially from current regulated trading platforms. We take the view that this, of necessity, should mean that the regime will need to be considerably flexed and be proportionate, if it is not to risk straightjacketing this area of activity and/or effectively pushing it off-shore and outside the scope of regulation. There are a number of factors which distinguish crypto trading venues from conventional venues and which will need to be taken into account in designing the regime including:

(a) recognising the distributed nature of the internet, and that the legal location of a venue is a matter of choice and that a particular jurisdiction may provide a safe-harbour but remain completely accessible to users;

(b) that the various categories of cryptoasset that may be traded have many differing sets of characteristics and price drivers and that data relating to the particular crypto asset may not be objectively verifiable;

(c) that the price/value of particular cryptoassets may be driven by e.g. how the asset is established, a consensus mechanism whose operation is not transparent, or other factors which lack the ability to be easily and objectively observed;

(d) that frequently, in the cryptoasset space, access to trading venues is not intermediated and individuals who would be classified as "retail customers" often have direct access to trading;

(e) trading venues currently and frequently issue their own tokens which will give rise to obvious potentials for conflicts;

(f) crypto trading venues frequently represent only one component of a vertically integrated business model.

Against this background, members would suggest the following observations be considered:

(a) comments made in the context of the recent failure of FTX support the conclusions of the consultation that key elements of conventional and well-established disciplines, not confined to financial firms, were lacking. A regulatory framework which mandates robust control frameworks, which support BAU operational and financial rigour, operational resilience and the sound processes for the identification and management of conflicts will be important.

(b) the degree to which consumer protection and governance requirements can be built into the regime will be challenging. The lack of financial services firm intermediation will mean that there will be trading carried out on regulated exchanges by individuals and non-consumer third parties who are not, themselves, regulated as part of the UK framework for cryptoassets. Other than, perhaps contractually as a condition of access to trading, those non-consumer third parties will not be subject to standards which oblige them to behave as a professional would be expected to behave with regard to (e.g. market conduct).

**20 Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?**

We make the following specific observations

(a) Authorisation: the process for authorisation and level of management, financial and operational infrastructure that a cryptoasset trading venue will need to demonstrate will need to be nuanced. Currently, crypto trading venues are established with ease. The protocols and programming used appears easily available from a variety of sources and "setting up shop" is straight forward, as can be seen from the large number and types of crypto trading venue easily accessible with only a limited amount of on-line effort. A challenge will be to identify how much incremental "substance" the regime will require in order to both meet regulatory objectives but also not be such a deterrent that operators will seek to establish outside the framework of UK regulation and rely upon the global nature of the web for trading. The process for authorisation would ideally also be streamlined and made efficient,

and members are aware of challenges in this area (not least in the length of time that FCA have publicly acknowledged has been taken to process applications for authorisation within existing regulatory frameworks (e.g. SMCR)). It may also be appropriate to consider gradation to the levels of infrastructure and controls that a venue will be required to have, depending on, for example, the underlying nature of the tokens to be transacted, the participants proposed to be eligible to trade and the extent to which the venue also provides ancillary services, e.g. custody of private keys and settlement and on and off ramping to allow exchange into fiat.

(b) Prudential requirements: UK Finance members are broadly in favour of the proportionate imposition of prudential requirements in the context of a UK cryptoassets trading regime. The nature of the financial and operational risks needs carefully to be considered as does the extent to which trading venues also provide custody and clearance and settlement services as well as trading. The nature of trading should also be considered, with many transactions being effectively transacted on a bilateral basis and with venues not having a principal role, even when being providers of collateral or margin. Prudential rules will accordingly require a fair degree of nuance specific to the cryptoassets being traded and the variety of services provided:

(c) Consumer protection and governance: we agree with general requirements for venue trading and access rules to be fair, open and transparent. We also agree with the appropriateness of robust requirements for the identification and management of conflicts, including the suggestion for independent legal entities to be established if internal conflicts are irreconcilable. However, on the basis that government does not extend consumer protection and fraud obligations to the crypto sector we are recommending additional work in the interim to address this vulnerability.

(d) Date reporting: the data reporting requirements will need considerable focus in order to achieve meaningful outputs and may require designing in a way which moves elements away from reporting derived from e.g. MiFID and EMIR requirements. The processes of price formation, counterparty identification, trade and transaction data and identification of e.g. the distinguishing marks that might assist the identification of potential market abuse or other abusive practices and the nature of any build-ups of exposures are significant less developed in the crypto asset space than in conventional financial markets, with certain characteristics (e.g. the mechanisms for determining the price or value of certain categories of unbacked cryptoassets, and the prevalence of anonymity (notwithstanding AML/KYC requirements)). In other regards, by their very nature, certain assets supported by DLT have embedded within them certain data values which would normally need to be extrinsically reported. There is also an assumption that there will be for example; . an order book, or clear ability to identify large positions and holder information and wallet information – analogues of the non-crypto financial markets but which may well not apply in this space. The regime will need to be flexible enough to encompass these different operating models.

**21 Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?**

As a general observation, members generally support HM Treasury's approach of using MiFID derived rules as the basis for the regulatory framework to be applied to cryptoasset intermediation activities.

However, as with trading and custody and other conventional financial services related activities, there are certain unique and evolving characteristics of activities in the cryptoasset space which will necessitate some considerable flexing of design necessary in order to ensure that certain issues are addressed and a framework is created which is proportionate. And delivers the sought for regulatory outcomes without stifling innovation or resulting in the UK being perceived as an "hostile" regulatory environment where it is too hard to do business.

There are some key issues of which account needs to be taken. Importantly, it needs to be recognised that the cryptoasset world has developed away from regulation and, largely, away from institutions. This sector has predominantly grown off-the-back of unmediated individual participation and the development of products and services that facilitate bi-lateral and peer-to-peer dealing. The role of intermediaries is nascent, and they do not perform the familiar roles which, for example, were traditionally performed by intermediaries in the equities space where the only access an individual might have to a trading venue; or, to effect a transaction, was through an intermediary who acted as 'gatekeeper. With an expectation that they are expected to understand the market in ways its client did not. In the cryptoasset space, there is not the same degree of reliance on intermediaries for access or information.

This is particularly true in the DeFi space, where the collaborative nature of activity, separated from individual legal entities with governance and activities driven by collectively developed and owned protocols cannot easily be made to fit conceptually; or, practically, into the regulatory regimes designed for current financial services markets.

There is accordingly a legitimate concern that there is a risk imposing a regime (a) designed for a tangible asset based environment, where roles and responsibilities are understood, where the retail consumer does not have either access or expertise and (b) treating cryptoassets as analogous to financial instruments, onto an environment based on different concepts, where assets do not necessarily have any, let alone all the characteristics of the financial investments for which the regime was designed. And where intermediation is not a necessary part of the ecosystem and where roles and responsibilities do not 'map', will not achieve desired outcomes. It may result in businesses considering becoming regulated intermediaries declining to do so within the UK's framework, and offshoring and individuals still being able to access their services. Both of these results are quite possible and would result in a failure to achieve the higher regulatory outcomes that are sought.

To address this concern and to reflect the "individualistic" focus of how the crypto-ecosystem has developed, it may be more appropriate to make the relationship of intermediary less one of a 'fiduciary' and more one of 'agency' but within an overall framework intended to ensure honesty, fairness of outcomes and appropriate conduct.

The regime should be flexible to recognise the different categories of cryptoasset in relation to which services are provided and the concomitant differences in e.g. what intermediaries can reasonably be expected to do.

We would also suggest that there should be a clear hierarchy of customers, with different degrees of duty owed, reflecting the MiFID customer hierarchy and that customers with appropriate expertise, which may be self-certified, will not be owed e.g. duties around best transactional outcomes or best price (which are concepts better fitted to traditional exchanges where there is visible depth of liquidity and transparency of price formation).

**22 Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?**

We make the following specific comments

(a) Regulatory Trigger Point: This may require nuance and depend upon the nature of the intermediary relationship. In particular, there is a need to consider the role of possible introducers.

(b) Basis for the regime: we agree that the MiFID framework provides a sound basis for regulating the intermediary regime, but, as referred to above, emphasize the need for considerable flexibility to reflect the differing nature of crypto-related services. We also consider that it would be worth considering a

degree of differentiation of regulatory burdens when comparing e.g. an execution only service provided to a self-certified experienced crypto investor, professional investor, or market counterparty, compared with an advised service to a novice investor.

(c) Location requirements: Given the ease of establishment of crypto-service related business and the accessibility of services across the internet globally and cross border, this may require careful consideration. We refer to our prior comments on jurisdictional scope, possible reverse solicitation exceptions and the Overseas Person Exemption above.

(d) Consumer protection and governance requirements: We refer to general comments above and the current highly retail nature of much crypto investment. We also note the challenges that any intermediary may have, in the context of investments and an ecosystem which is fundamentally different in many ways from existing "non-crypto" securities and the non-crypto ecosystem in satisfying obligations couched in terms familiar to non-crypto financial services providers and regulators as the analogy may not hold up. For example, it will be very hard to define what constitutes "the best possible result" for a client when executing a transaction in circumstances where many of the metrics by which such matters are evaluated in the non-crypto environment either do not exist or are not easily and objectively measurable. We also note the challenges that the government's phased implementation proposal poses for non-stablecoins. We have suggested reframing the draft list of financial crime recommendations (as per para 2.7) as specific additional work in the interim.

(e) There are a number of specific issues that will have to be considered, including any imposition of an obligation or duty to act in a client or customer's best interest, as well as the product suitability assessment, affordability, other overarching duties etc.

(f) Data reporting: The same data collection and reporting considerations and challenges referred to above in the comments on financial crime, apply equally here

**23 Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?**

UK Finance has already commented, in its December 2022 paper on the Future regulation of Unbacked cryptoassets in the UK[1], on issues related to custody where, in the context of those cryptoassets, the only recognised use case was the safeguarding of private keys. There is also in that paper a useful critique of how CASS rules might be applied but also where, in the context particularly of defi and blockchain cryptoassets, some of the details of the CASS regime would simply not be applicable.

While most members supported the principle that cryptoasset custody should be regulated on par with traditional custody and the proposed approach of using existing regulatory frameworks for traditional finance custodians as a basis for the UK cryptoasset custody framework, many members consider this approach needs to be applied with nuance.

Some members noted genuine conceptual challenges in the area of what constitutes "custody" in the cryptoasset ecosystem and that a simple adoption of Article 40 RAO with amendments and variations will not have the conceptual breadth to encompass all the variety of cryptoassets. In particular, where a cryptoasset has no real-world counterpart and only exists on a digital ledger, custodians cannot directly custody the asset. Instead, they control the relevant private keys for the asset.

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[1] https://www.ukfinance.org.uk/system/files/2022-12/UKF%20Crypto%20Report%202022.pdf

It is likely that specific definitions of what constitutes "custody" in relation to cryptoasset activities will need to be put in place, taking account of the fact many cryptoassets and particularly defi products, exist outside relevant concepts of custody at least as far as safekeeping goes (although protection of keys is important). The role that is performed by some core cryptoasset operators sometimes appears to combine activities of a CSD, a custody bank and a corporate actions administrator (as well as a provider of finance) so more specific definitions may be needed.

One area where we believe further consideration is needed is in relation to the extent of custodial liability which was a key issue that arose during the legislative consideration of the EU's Markets in Crypto Asset Regulation (MiCA). We strongly believe that custodians should not be liable for events outside of their control, for example where losses are caused by network hacks, errors in the protocol underlying the cryptoassets, or other similar events. We therefore welcome HM Treasury outlining its proposal to take '*a proportionate approach which may not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control'*, as outlined in paragraph 8.5 of the consultation.

Simply because a custodian provides custody services for cryptoassets at the request of its clients, a custodian should not become the guarantor of the cryptoassets, its protocols, its issuers, or the distributed ledger. We would therefore welcome further detail on the intended approach in this regard, especially in light of the stated outcome in paragraph 8.7 that '*custodians should establish clear processes for redress in the event that cryptoassets held in custody are lost'*. It is important to recognise that overly broad liability for custodians risks driving consumers towards unregulated solutions or self-custody, ultimately putting them at greater risk of loss, and reducing the ability for authorities to monitor and mitigate financial crime.

**24 Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?**

The requirements of the custody regime should be appropriate to the nature of the cryptoasset being custodied. However, we agree that there should be a base line set of requirements, with appropriate flexibility regarding prudential capital, asset segregation (including keys), operational resilience and governance. Cyber security protections should be emphasised and we agree that any outsourcing arrangements should be the subject of appropriate scrutiny and documentation, though we would like to specifically state that we do not believe that the provision of custody constitutes outsourcing.

The complexity inherent in the variations of cryptoassets, and the different applications of DLT (permissioned, permissionless etc), means delivery of custody services has more unique considerations than for traditional assets. This needs to be accommodated through a more principles-led approach to the application of the CASS rules to help ensure pragmatic outcomes.

There is also a need to clarify when a custodian is required to treat the relevant cryptoassets as being held in custody for its clients.

It may be overly simplistic to state that once a private key has been delivered to a wallet that the custodian provides to its client that the cryptoasset is now being held for by the custodian for the client. It is important to note that this does not permit the custodian to perform screening, including anti-money laundering and sanctions screening, over the cryptoasset or other verification steps prior to extending the custody service over that cryptoasset.

Given the unique characteristics of cryptoassets, custodians should be protected while meeting regulatory obligations with respect to such screening and verification steps. Custodians should be permitted to take steps to ensure they can accept the relevant cryptoasset into custody for the client, a relevant example would be in relation to 'airdrops': custodians should not be deemed to custody, or be liable for, unsupported cryptoassets

or transfers into wallets without their (or their client's) consent. Even though custodians may not have the connectivity to the protocol for an unsupported cryptoasset, such a protocol may allow ledger supported cryptoassets into the public wallet maintained by the custodian for one of its custody clients without the custodian's permission. Requiring the custodian to build connectivity to a potentially unsafe or malicious protocol or otherwise be liable for a potentially unsafe or malicious cryptoasset may expose custodians to unacceptable risk, as the custodian will not have properly vetted the protocol or cryptoasset. Further to this, if the custody services were dependent on the custodian first reflecting the cryptoasset on the books and records then this would help custodians control what cryptoassets they will hold for their clients. This would also complement the Law Commission's proposal of emphasising 'control' over this asset class rather that 'possession' as being a key determinative factor.

In relation to hot/cold storage, we believe it is important for the market to determine, as it continues to evolve, the right technical solution to be implemented in different use cases and scenarios. It is recommended to not impose prescriptive requirements, but instead to encourage custodians to determine how to best safeguard their assets under custody. The choice of hot/cold wallets are technology/cyber risk choices which should be within the purview of custodians to manage, subject to the existing supervisory review of the custodian otherwise, custodians may not be able to take advantage of the most recent technological innovations, to the detriment of client safety, innovation, and competitiveness.

In addition to preventing qualified custodians from providing custody services, thereby driving consumers to unqualified custodial relationships, placing custodied assets on balance sheet may call into question the ownership title of the cryptoassets, which unquestionably should belong to the custody client. Should the FCA be concerned with operational or fiduciary risks associated with crypto asset custody, we would support that these continue to be assessed through the Pillar 2 framework in line with the current approach to risks associated with custody.

In relation to the future development of prudential rules by the FCA, we believe UK policy-makers should take an off-balance sheet approach to the custody of cryptoassets as set out in the Basel Committee's standards on the prudential treatment for banks' exposures to cryptoassets. It is essential that any capital and liquidity requirements associated with cryptoasset custody do not make custody unfeasible at scale for banks and prevent qualified institutions such as custodians from supplying institutional-grade solutions that addresses identified risks of this novel asset class. We therefore believe that in keeping with the '*same, activity, same risk, same regulatory outcome'* principle, custodied cryptoassets shouldn't be treated as on-balance sheet and should be accounted for the same way other assets are treated.

In relation to operational resilience, we believe further analysis is needed on what an adequate level of operational resilience is required for DLT networks, who is/are responsible for maintaining it, and what the due diligence and oversight requirements are for custodians.

We would draw a distinction between the resilience of public and private ledgers, and responsibility for that resilience. For private, permissioned networks, there should be an operating entity(ies) that is/are responsible and accountable for having proper controls and governance. For open networks (e.g. Ethereum), we note there is no such entity. In line with the importance of adopting a technology neutral approach, we support regulation that appropriately regulates both, while still encouraging responsible innovation. Furthermore, it is important that public blockchains and protocols should not be misconstrued as a service provider to custodians, as custodians have no control over, or any ability to influence, such blockchains and protocols. For public blockchains and protocols, custodians should not be responsible for losses caused by public blockchains and protocols beyond their reasonable control. The choice to connect with such public blockchains and protocols is determined by the act of custodying the relevant cryptoassets on behalf of the customer, and regulations that would prevent the custody of such cryptoassets by financial institutions would drive such cryptoassets from the regulated ecosystem to unregulated custodians.

In keeping with the core design principle of 'same activity, same risk, same regulatory outcome', the adoption by a financial institution of a blockchain or DLT based internal books and records system should not be subject to additional regulation. The adoption and operation of such a system would have been subject to existing regulations governing internal books and records, while the existing supervision and oversight of the financial institution will ensure that such system does not pose added risks when compared to a traditional books and records system. Book Entry Tokens are not cryptoassets; rather, Book Entry Tokens are the book entries of the financial institution, representing a record of, in the case of cash, the deposit liability of the financial institution has to its customers, and in the case of securities and non-cash assets, such assets the financial institution holds in custody for the benefit of its customers. Book Entry Tokens cannot leave the internal systems of the financial institution, posing no additional risk than book entries in existing, (non DLT) electronic books and records systems in use today.

**25 Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?**

UK Finance and its members broadly agree with the description and categorisation of the challenges of applying a market abuse regime to qualifying cryptoassets. One additional challenge we would highlight is the practical difficulty of identifying market abuse from market data and reported data by cryptoasset market participants given the relatively new market, the lack of historic data and the extreme volatility and interconnectedness of some cryptoasset markets. While this does not affect, in our view, the need for a market abuse regime, it does underline some of the practical difficulties for market participants in identifying and making appropriate reports where required to do so.

**26 Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?**

Yes, in principle.

**27 Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?**

Yes in principle. The higher incidence of fraud and fraudulent use of cryptoassets, including exploitation of coding errors and wallet takeover may need to be considered where such activities have indicators of market abuse as well the underlying criminal activity of theft, conspiracy, deceit or fraud.

**28 Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?**

In principle, yes – although members note the significant practical issues for such domestic UK regulation to overcome the borderless nature of the cryptoassets market. International collaboration will be critical to make these market controls operate equitably across jurisdictions and so as not to disadvantage UK firms.

**29 What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?**

No response

**30 Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?**

In principle yes, but some more detail is required to understand how this would operate in practice. Presumably it would be an SMCR type obligation on the firm and the relevant individuals. Guidance will also be needed on what specific types of information held by a regulated firm in respect of any cryptoasset would constitute inside information to a level of reasonable specificity. This would need to reflect the particular features of cryptoassets and the types of information that may (or may not) be available to the user.

**31 Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?**

Yes, our members agree with HMT's assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities.

HMT will also need to consider the extent to which the Consumer Credit Act 1974 may need to be amended to ensure retail borrowers are adequately protected.

**32 What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?**

There should be core requirements for firms, including:

(a) a need to be authorised;

(b) minimum prudential requirements that firms must meet;

(c) reporting requirements for firms in relation to their financial position, complaints and loans they have arranged; and

(d) disclosure requirements aimed at ensuring investors have all of the information they need to be able to make informed investment decisions.

**33 Do you agree with the idea of drawing on requirements from different traditional lending regimes for regulating cryptoasset lending? If so, then which regimes do you think would be most appropriate and, if not, then which alternative approach would you prefer to see?**

Yes. We agree with government's proposed approach of applying and adapting existing RAO activities, while making suitable modifications to accommodate unique cryptoasset features. We anticipate that HMT will need to draw on regimes such as:

- operating an electronic system in relation to lending
- dealing with investments
- entering into a regulated credit agreement as lender

**34 Do you agree with the option we are considering for providing more transparency on risk present in collateralised lending transactions?**

We agree that there is a benefit to including rules that would require enhanced transparency as to the risk involved with cryptoasset lending transactions.

**35 Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?**

Yes, we are of the view that regulatory treatment should differ depending on whether arrangements involve title transfer or not. This is because the regime needs to be tailored depending on the risks at play which will differ depending on whether title of the asset is transferred.

**36 Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?**

UK Finance members broadly agree that there are significant challenges for the UK in regulating DeFi organisations at the present time, due to the rapidly evolving nature of the sector and the underlying need for international consistency and standards. To the extent that HMT is seeking to define a set of DeFi-specific activities (such as establishing or operating a protocol) as a regulated activity requiring authorisation, this raises significant practical issues around ability of the UK to enforce against any person or entity undertaking such activity from outside the UK. Members favour waiting for the Law Commission report on the legal status of Decentralised Autonomous Organisation before any decisions on regulatory framework are taken.

**37 How can the size of the "UK market" for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?**

No response

**38 Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?**

In principle, the overall approach suggested by HMT seems reasonable. Members are concerned as to how easy it will be to implement this approach in practice, without the risk of simply offshoring significant DeFi activity outside the UK, with no engagement from the providers with the UK regulatory perimeter, but where UK customers will still engage with such activities and may then seek compensation from UK regulated firms when investments or activities lead to losses. As noted above, there is a material risk that using TradFi structures for regulation of DeFi activities will not work in practice, given the material distinction and differences which exist in terms of the process and technology used. Some members are of the view that the UK should leverage existing rules as much as possible, including applying concepts of unincorporated associations (where the relevant protocol fits within scope under English law) and/or developing the law to accommodate DeFi platforms as a relevant legal entity, as well as applying the same regulatory principles and expectations to the activity conducted on the DeFi platform, including taking into consideration on and off ramp entities

**39 What indicators should be used to measure and verify "decentralisation" (e.g. the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?**

No response

**40 Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?**

No response

**41** **What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?**

No response

**42** **What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?**

No response

**43** **Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.**

UK Finance and its members are broadly in favour of regulating the activities of cryptoasset investment advice and portfolio management, noting that this would assist with managing the risk of consumer harm and aligns with the principle of "same risk, same regulatory outcome". Having specialist and regulated advisory firms is preferrable and in line with traditional financial market ecosystems.

**44** **Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?**

Members do not see a material case at this point for regulating mining and validation, beyond those noted. They note some of the changes which are already taking place within the large publicly accessible systems such as Ethereum and note that proof of work is not typically used as a consensus mechanism in private networks involving financial services users.

**45** **Should staking (excluding "layer 1 staking") be considered alongside cryptoasset lending as an activity to be regulated in phase 2?**

Yes, our view is that staking should be considered alongside cryptoasset lending as an activity to be regulated in phase 2. However, there are different concepts of staking which carry different risks and impacts, so consideration should be given to the rights conferred and the risks involved and adequate disclosure should be provided.

That's because staking carries risk of detriment. For example, staking often requires a lockup or "vesting" period, where crypto can not be transferred for a certain period of time. This can be a drawback, as customers will not ' be able to trade staked tokens during this period even if prices shift. It is i important they understand this.

**46** **What do you think the mot appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?**

One regulatory hook is regulating staking as service providers.

Our members are of the view that it will be difficult to regulate validators themselves to the extent that they are retail consumers.

**47** **When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?**

No response

**48 What reliable indicators are useful and / or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and / or associated emission metrics, or other disclosures)?**

No response

**49 What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?**

No response

**50 How interoperable would such indicators be with other recognised sustainability disclosure standards?**

No response

**51 At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?**

No response

**52 Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?**

No response

If you have any questions relating to this response, please contact Rhiannon Butterfield; *Principal, Payments UK Finance* (Rhiannon.butterfield@ukfinance.org.uk) and/or Duncan McEwen, *Manager, Payments UK Finance* ( (duncan.mcewen@ukfinance.org.uk)