Response to FCA DP23/4

Regulating cryptoassets – Phase 1: Stablecoins

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Sent to: FCA

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 the discussion paper published by the Financial Conduct Authority (**FCA**) on 6 November 2023 on its proposed approach to regulating fiat-backed stablecoins that may be used for payments (DP23/4).

1.2 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 the FCA.

1.3 Members shall also provide feedback on other papers published in the context of the UK government's proposals to regulate fiat-backed stablecoins, including:

(a) the Bank of England's discussion paper on the regulatory regime for systemic payment systems using stablecoins and related service providers; and

(b) the Prudential Regulation Authority's Dear CEO letter on innovations in use by deposit-takers of deposits, e-money and regulated stablecoins.

2. Executive Summary

Existing Regulations

Drawing on our responses to previous consultations, UK Finance and its **members support the broad proposal to build upon the existing regulatory/legislative regime for stablecoins used for payments**. Relevant sources are the Electronic Money Regulations 2011 (EMRs), the Payment Services Regulations 2017 (PSRs), and the FCA's Client Assets Sourcebook (CASS).

Furthermore, UK Finance and its members broadly support applying the principles of the CASS regime to payment stablecoins. However, we believe there is a need for further guidance in certain areas to reflect the novel characteristics of cryptoassets.

Cryptoasset custody services give rise to unique and complex considerations relative to traditional assets, due to the variety of crytoassets and forms of DLT (permissioned, permissionless etc) on the market. These features should be accommodated through a more principles-led approach to CASS to help ensure good customer and market outcomes.

Industry recognises that some work must be done to reflect the novel functionality and risks posed by stablecoins; in particular, the EMRs, PSRs and CASS must be amended to **fill in gaps in the existing regimes that do not yet cater for stabelcoin issuers and their service providers**. Stablecoin issuers and service providers perform functions that are often unique and separate from typical e-money and payment firms. Regulatory requirements for redeemability, safeguarding/custody (of the tokens, consumer funds and private keys) and firms providing wallet services would therefore need to be considered.

Security Tokens

We also note that for custody activity, the proposed approach is to afford the same regulatory treatment to security tokens as shall apply to stablecoins rather than that which applies to “specified investments” under the Financial Services and Markets Act 2000 (FSMA). This is at odds with the current regulatory treatment of security tokens and in HM Treasury (HMT) and the FCA’s wider proposals for cryptoasset regulation, where security tokens are subject to existing rules for specified investments. The proposed approach is at odds with the UK’s historical approach which has applied the same regulatory treatment to assets irrespective of whether they are in tokenised form. It is also at odds with the broad and well-regarded principle of technological neutrality.

The FCA’s justification for taking this approach is that security tokens and stablecoins share the same underlying technology and therefore present the same security risks. However, this approach ignores the fact that security tokens have more characteristics in common with traditional assets when compared to stablecoins or any other cryptoassets. Furthermore, the risk profile of a security token will vary depending on a number of factors including the nature of the ledger and network (for example, the majority of security tokens issued to date have been issued on private, permissioned ledgers and do not require investors or network participants to maintain private keys). UK Finance and its members believe that in line with existing custody practices, custodians should have the responsibility to assess their ability to safeguard and ‘control’ a security, in whichever form it is issued, and any specific risks arising from the means of issuance should be disclosed to investors by the issuer and considered by the custodian where relevant. **This could be achieved by ensuring security tokens are captured under existing CASS rules** and are not subject to any potential new custody regime for stablecoins.

We also note that the FCA’s current approach would contrast with the one taken by the EU’s MiCA, potentially putting the UK at a competitive disadvantage in relation to digital innovation.

Definitions

While there is currently no single, uniform definition of a stablecoin, and given the different types of stablecoins on the market, UK Finance and its members believe that there is significant regulatory and market benefit in creating a bespoke definition for a “single-currency payment stablecoin”. This also would include distinctions for stablecoins that are being used for wholesale purposes vs retail purposes. Further to this, **definitional clarity will help to outline the differences between e-money, tokenised deposits and stablecoins,** which will allow firms to prepare accordingly as they develop new forms of digital money for payments. UK Finance would be pleased to assist HM Treasury and the FCA in forming such a definition for regulated fiat-backed stablecoins.

Authorisations Regime

Members also expect and hope for an authorisations regime that avoids duplicative applications and reduces the burden on firms participating in stablecoin products and services, where feasible. Furthermore, as the UK moves through its previously described phased approach to cryptoasset regulation, members hope that beneficial authorisation routes are considered for previously regulated firms and those newly regulated firms who wish to acquire subsequent phases of cryptoasset authorisation.

Chapter 2: A new stablecoin regime

Q1. Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.

Yes – the proposed regime should differentiate between issuers of regulated stablecoins for wholesale and retail purposes.

Wholesale use cases do not attract the same risks as retail use cases. Wholesale use is designed for a specific and restricted group of users, such as financial institutions, market participants or large companies that have access to and comply with existing regulatory and supervisory frameworks, standards, and infrastructures.

Wholesale uses are also unlikely to achieve the same level of adoption, usage, or network effects as retail uses, given their more specialized purposes and functions.

<u>Financial institutions</u>

There are some clear use cases at the wholesale level for financial institutions to issue stablecoins. We've set out the following examples:

1. **Settlement** – stablecoins, particularly where programmable, could be used to replace/enhance the traditional "delivery versus payment" settlement system and enable transactions to settle instantaneously in a manner which could engender trust from both the buyer and the seller.
2. **Wholesale payments** – stablecoins could provide a way of managing wholesale payments in a quicker and easier way than some traditional settlement cycles, which can take several days. For example, stablecoins could provide efficient interoperability with future CBDC models in instances where clients might not be able to access CBDCs but instead access stablecoins as an on-chain payment solution. Stablecoins may also become an important means to settle the cash leg of security token transactions and accordingly contribute to developing the broader wholesale crypto ecosystem.

Where such business models are implemented, the risk profile would be significantly different to those risks faced by retail customers seeking to buy and sell stablecoins.

To distinguish wholesale use cases from retail use cases, it could be appropriate to adopt either the categorisation under:
1. the Markets in Financial Instruments Directive 2014/65/EU (MiFID) – categorising customers as "retail clients", "professional clients" and "eligible counterparties"; or
2. the Payment Services Regulations 2017 – categorising customers as "consumer" or "non-consumers".

Under MiFID, retail clients are clients that are not professional clients or eligible counterparties. Professional clients are clients always regarded as professionals, such as credit institutions, investment firms and large companies, and certain sophisticated clients that may elect to be treated as professionals on request. Eligible counterparties are, broadly speaking, larger financial institutions, insurers, pension funds and governments that operate in financial markets.

The actual tests for a professional clients and eligible counterparties are however fairly complex.

Under the PSRs, clients are divided in two categories: (1) consumers, micro-enterprises and small charities and (2) corporates. A consumer is defined an individual who is acting for purposes other than a trade, business of profession and a micro-enterprise and small charity is defined by certain (relatively low) financial thresholds.[1] A corporate, by contrast, is not a consumer, micro-enterprise or small charity.

Under both MiFID and the PSRs, additional protection is afforded to less sophisticated clients and greater flexibility is afforded to more sophisticated clients.

<u>Stablecoin issuers</u>

Where elements of the regime relate to the issuer, there needs to be a comparison of where there are differences between the wholesale /retail activity and its oversight. The issuer's role may be largely the same but could be regulated e.g. with less focus on consumer protection.

Issuers typically distribute directly to cryptoasset exchanges or other cryptoasset providers (e.g. an OTC provider). The cryptoasset exchange, in turn, distributes the stablecoins to consumers. There is not typically a direct relationship between the issuer of the stablecoin and the consumer. The stablecoin itself can also typically only be redeemed by the wholesale customer. This can provide a range of advantages, including, for example, reducing the overall number of redemptions needed and enabling stablecoins to be distributed to a wider range of customers.

A typical wholesale model for stablecoins thereby involves the issuer of a stablecoin issuing only to financial institutions or large corporate entities (often other cryptoasset businesses), rather than dealing with consumers directly. If regulated under the proposed regime, the issuer would be required to, among other things, carry out customer due diligence checks on and redeem stablecoins for consumers who hold such stablecoins; this would mean significant change to their current operating models, including the creation of mechanisms to deal with consumers which would create a significant additional disruption. Issusers of wholesale stablecoins are unlikely to already have consumer-related expertise within its business.

It might be preferable to consider whether an alternative regulatory arrangement could be created which would suit the current wholesale stablecoin model. For example, enabling issuers of stablecoins operating under a wholesale model to only make redemptions to their wholesale customers, provided those wholesale customers contractually agree to fulfil redemption requests for customers within the same timeframes and subject to the same requirements as the discussion paper.

<u>Other cryptoasset firms</u>

Should the FCA continue to build a regime for unbacked cryptoassets under phase 2, it is necessary to consider how wholesale and institutional investors will engage in the cryptoasset market. For example, some institutions may wish to leverage stablecoins as a hedge to mitigate risks in market downturn. A harmonised regime would enable industry participants to make the most of the benefits that stablecoins can bring to wholesale transactions, especially at a cross-border level.

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[1] A small charity should have an annual income less than £1m and a micro-enterprise should employ fewer than 10 persons and have an annual turnover or balance sheet of less than EUR 2m.

In addition, we would encourage HMT, the FCA and the BoE to consider the territorial scope of a wholesale regime separately to the proposed territorial scope of the retail regime. Consideration should be given to the following:

- Whether business to, as well as in, the UK should be subject to regulation in the first place;
- Use of the overseas person exclusion which already provides safeguards proportionate to the activity and UK client or counterparty in its use of "with or through" and a legitimate approach;
- Development of an equivalence regime for cryptoasset service providers who are regulated in another jurisdiction

The UK's open market approach is key to its international competitiveness and its position as a global financial market. The UK regulatory perimeter should be technologically neutral and the same risks should be subject to the same regulation.

Q2. Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?

Overall, we are supportive of the measures described to ensure that the value of the stablecoin backing assets is sufficient to meet redemption calls. This is an important element of maintaining confidence in the stablecoin ecosystem.

However, we note that when it comes to discrepancies between the backing assets and the pricing of the stablecoin, there may be high costs with regards to requiring firms to monitor and correct any discrepancy on a daily basis. We've considered this in further detail under question 4 below.

Q3. Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialise from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?

UK finance and its members broadly agree with the assessment, though feedback from our members suggests that at present the majority of the interesting use cases are arising in the wholesale payments ecosystem, rather than retail. Ensuring that the regulatory regime is fit for purpose for wholesale payments is of high importance to our members.

Consumer harm will need to be monitored once the new regime is in place. This will require robust regulation of the fiat-backed stablecoins, with a clear oversight regime to ensure that good practice is followed and that there is adequate coverage at all times to refund consumers.

In addition to the examples in the question:

- **Bridging the gap with unbacked cryptoasset market.** Another key benefit of stablecoins is the opportunity to bridge the gap between fiat currency held in traditional financial institutions and the wider unbacked cryptoasset market. Given the effectiveness of stablecoins when interacting with unbacked cryptoassets compared to fiat currency, the UK has a unique opportunity to pull value from the unbacked cryptoasset ecosystem into the UK economy.
- **Fostering further innovation.** We also expect that, as with a lot of new technologies, there will also be further innovation which can be fostered through the use of stablecoins. For example, where stablecoins are "programmable", this may create a huge range of

opportunities for innovation ranging from giving prizes with goods or services to enabling the sale of shares without the need for delayed settlement.

Chapter 3: Backing assets and redemption

Q4. Do you agree with our proposed approach to regulating stablecoin backing assets? In particular do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.

Overall, members agree with the approach to regulating stablecoin backing assets, however, there are some areas that members feel should be revisited.

Daily redemption requirement

When it comes to the shortfall discrepancy in the backing assets, the daily correction of this for stablecoins seem onerous – particularly given a stablecoin could be denominated in one currency but backed by assets in another. At short notice, we expect it would be onerous for a stablecoin (possibly even more so for an overseas stablecoin) to remain compliant with the FCA's regime to correct discrepancies on a day's notice. However, stablecoin issuers should ensure it is aware of discrepancies in the trading day and to log these for action.

Composition of stablecoin's backing assets

The FCA proposes that backing stablecoins are government treasury debt instruments that mature in one year or less or short-term cash deposits (which we assume also includes funds held at the Bank of England).

There appears to be a significant delta between the assets which can be held to back a stablecoin compared to, for example, the assets which can be held to back e-money. In particular, by contrast, e-money firms can invest in "secure and liquid" assets, which can include money market funds or longer-term government debt. As e-money appears to create a similar risk to stablecoins, it is difficult to understand why a similar risk would not be regulated in a similar way. Finally, for the same reasons, we would also query whether it might be permissible to enable stablecoin issuers to hold a comparable guarantee, equivalent to the safeguarding arrangements permitted for e-money / payment institution, rather than needing to hold backing assets.

Risk weighting alternative backing assets

An alternative approach could be using risk weightings for alternative assets in order to mitigate the higher risk resulting from the use of such assets. Adopting a more restrictive approach could undermine the attractiveness of the UK as a destination for digital innovation and stablecoin activity.

It could be useful for the FCA to consider whether flexibility for the risk weighting of backing assets could be permitted, especially for backing assets that are held at above 100% of the value of a stablecoin. Should flexibility be offered to issuers, the assets would still need to remain relatively low risk to minimise movement and mindful that if the shortfall is too big it could cause failure of the issuer in trying to top up any backing asset.

For example, if short term government debt is seen as sufficiently safe that £1 of stablecoin can be backed with £1 of government debt, perhaps the FCA could permit £1 of stablecoin to be backed with £1.20 of high-rated investment grade corporate debt with, of course, appropriate limitations and minimums on the types of assets held. This would be a similar approach which is being used under MiCA with the use of HQLA being permitted as backing assets.

This flexibility may bring additional benefits to firms and customers. For example, it could provide issuers with the ability to earn a higher yield, enable them to spread their risk over a wider range of assets and facilitate easier redemptions for customers. It should be noted that the perception of a stablecoin token as being a reliable asset is integral. Therefore, purchasers of the stablecoin token may be inclined to check how the backing assets are composed and weighted. In line with the new Consumer Duty, issuers would need to clearly articulate this information and it may be incumbent on the issuer to ensure the backing asset composition is not risky in order to attract users.

Q5. Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business-as-usual or firm failure scenarios if multiple currencies are used?

UK Finance and its members understand the focus on sterling-denominated stablecoins. However, we encourage the FCA to consider the most likely to be used use cases so the UK economy can best realise the potential of stablecoins.

There are existing business models that use stablecoins to transact from overseas currencies into a stablecoin that can then be off-ramped into sterling. Some firms have existing relationships with overseas banks from multiple jurisdictions that allow users in those jurisdictions to make purchases either straight from their local currency or via a stablecoin that would allow the overseas consumer to interact with the UK retail market. This type of transaction allows both overseas retailers and retailers based in the UK to interact with overseas customers with greater efficiency both in terms of transaction speed and cost.

For overseas stablecoins and stablecoins denominated in currencies other than sterling, members say there are business opportunities that would need overseas currencies to be incorporated into the regime. However, members note that stablecoins that are backed by overseas stablecoins or a basket of reference currencies may be subject to additional risks compared to those that are backed by a single currency and consequently may need to maintain larger liquidity/capital buffers to provide for the necessary level of price stability. Partial backing in another currency would introduce a level of additional complexity and potential volatility that could increase intraday deviations from par. There was also a suggestion to look at the Monetary Authority of Singapore's regime that allows all G10 currencies to be used to back stablecoins. This may facilitate more effective cross-jurisdictional supervision of stablecoin payment systems, however this would require an unprecedented level of regulatory coordination.

There may be a business case to allow limited backing in another currency that could be beneficial to allow for redemption facilitated by overseas government debt or cash where the domestic UK market is not open (for example during the UK's bank holidays).

The FCA may want to consider further use cases where it may be difficult to see a reason for having a dominant currency backed stablecoin. Payments made within gaming, e-sports, and Web 3 may be open to using stablecoins that are backed by different currencies. In the mentioned use cases in this paragraph, a basket of currencies backing the stablecoin for such payments could be useful. Furthermore, members suggested that small/micro corporates and charities may be more interested in interacting with different stablecoins than UK retail consumers.

Q6. Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?

UK Finance and its members agree that it would be beneficial for regulated stablecoin issuers to have the option to decide on whether to retain revenue derived from interest from backing assets of a stablecoin.

Issuers benefiting from such a model would avoid placing additional costs on consumers. With the current retail payments system in the UK (for example the FPS), consumers do not incur charges for making payments, as these costs are borne by PSPs. For regulated stablecoins for retail payments to be competitive, issuers need to raise funds through means other than solely charging consumers fees for payments.

As discussed above, e-money institutions are also able to invest consumer funds in secure and liquid low-risk assets that have been approved by the FCA (although we note that, according to recent case law,[2] these assets technically belong to the e-money institution rather than a customer). Nonetheless, drawing a parallel based on a similar risk, it seems appropriate that stablecoin issuers should be able to retain the revenue derived from interest and returns from the backing assets. Similarly, we also note that the equivalent rules in CASS do not prohibit firms from retaining interest on client assets, albeit subject to the agreement between them and the customer.

Q7. Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular:

i. Are there any practical, technological or legal obstacles to this approach?
ii. Are there any additional controls that need to be considered?
iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?

Overall, members agree with the approach of basing the safeguarding requirements on the CASS regime.

Where stablecoin backing assets are held by banks as deposits, one suggestion is the application of the ("Banking Exemption") for credit institutions, under CASS 7.10.16R. If it is the FCA's intention that asset backed stablecoins cannot be backed by money held under the banking exemption this would constitute a departure from the existing CASS rules. Where non-credit institution issuers hold cash as client money with credit institutions, existing acknowledgement letters should be issued to these credit institutions. The most important guiding principle for safeguarding stablecoin backing assets should be that the backing assets are held in a bankruptcy secure manner.

Consideration may need to be given to current business day vs calendar day conventions for stablecoins where managing asset backing may need to be 365 days a year in respect of topping

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[2] Baker and another v Financial Conduct Authority (Re Ipagoo LLP) [2022] EWCA Civ 302

up and to a lesser extent removing excess if non-domestic assets are used. Alternatively, or in conjunction a prudent buffer could be considered to allow for normal VAR on non-UK market days.

Members also believe that backing assets should be demonstrable to consumers. For consumer confidence in the stablecoin and to align with the principles of Consumer Duty, it would be practical for there to be clear disclosure of the backing assets. An independent audit of the backing assets would also be necessary. This could provide consumers and businesses the ability to make informed decisions about which stablecoins to use. This practice may also incentivise issuers to ensure a safe level of backing even if flexibility is granted to them on the types of backing assets issuers can use.

Q8. We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:

i. Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets?

ii. What are the benefits and risks of this model?

iii. Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?

Some members have suggested that a regulated issuer could partner with multiple independent custodians in order to reduce the risk that one of the custodians fail. Should the independent custodian be a credit institution, it would be imperative that the institution has a sufficiently high credit rating and therefore be trusted to fulfil this function. If stablecoin issuers diversify their consumer safeguarded funds across different independent institutions, this may reduce similar risks. It would be useful for the FCA to issue guidelines on how independent custodians are rated and supervised. The stablecoin model might require them to handle the custodianship in a different way and the custodian may need time to adapt its processes and procedures.

UK Finance and its members propose creating a regulatory regime which enables a stablecoin issuer to either safeguard backing assets itself or use a third-party custodian so that the optionality is available depending on the preferences and circumstances of the stablecoin issuer. Stablecoin issuers should not be mandated to appoint an independent custodian. Instead, whether an independent custodian is appointed should be the commercial choice of the issuer, subject to appropriate disclosure of the arrangements and risks to the stablecoin holders.

Should the role of the custodian include liability to ensure assets were backed at all times, this may not be viable. Traditional custodians act solely on the instruction of their client and would not manage the assets. It would be useful to obtain additional clarification of the FCA's view on the role it would expect an independent custodian to have.

The benefits of this model are that the assets are held by a well-capitalised expert institution directly on behalf of the underlying investors and in the event of the issuer's insolvency the assets remain protected.

The risk is that there may be limited take-up of issuance of stablecoins under this model, as it is unclear whether any custodians would be prepared to take on the risk with this model, without themselves also being the issuer of the coin and related return. We would welcome further guidance on how the custodian would hold backing assets ‘directly for customers’ as we would not expect the custodian to have a contractual relationship with the coin holder.

As previously mentioned, the most important guiding principle should be that the backing assets are held in a bankruptcy secure manner.

Q9. Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:

i. Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations whether this might this be difficult to deliver?

ii. Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate.

iii. Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.

iv. What costs associated with our proposed redemption policy do you anticipate?

<u>Obligations under financial crime (including AML) laws</u>

UK Finance and its members anticipate that the proposals may put stablecoin issuers (and their service providers) under undue pressure in the context of their existing financial crime (including AML) obligations. In contrast to the position under the EMRs (which does not impose an execution time requirement on redemptions), stablecoin issuers would be given only until the end of the following business day to perform the necessary financial crime checks (covering all of AML, fraud and sanctions), making information requests and resolving escalations.

UK Finance and its members are of the view that firms should be required to satisfy redemption requests in line with existing regulatory standards. To prevent fraud and financial crime, there may be a need to have parity by having flexibility on execution times in instances where a transaction has been flagged as a potential instance of financial crime or fraud. This would help ensure that firms can conduct adequate fraud and financial crime checks. We note that one day is typically not long enough to investigate serious breaches.

Separately, where large withdrawals are instructed after dealing times for government bonds, it may not be possible to pay all clients by the end of the next business day.

We acknowledge that firms should be able to return redemption amounts to customers by the end of the next UK business day, but this timeframe should start from the point when the issuer is satisfied with all AML/CTF checks based on the documents provided by the holder.

<u>Outsourcing Redemption</u>

Current FCA standard and requirements on outsourcing should be applied with existing governance and oversight rules. The location of the provider outside of the UK could complicate matters on insolvency if there were weaknesses in arrangements and legal status. An issuer may look to outsource the valuation of backing assets to a fund accounting type provider.

<u>Consumer interaction</u>

As noted previously, members flagged the fact that stablecoin issuers usually distribute their stablecoin tokens directly to a cryptoasset exchange at a wholesale level and thus may not currently have processes in place to directly interact and deal with an individual consumer directly. Should a stablecoin issuer's first interaction with a consumer be at the point of the consumer's redemption request, then it may need more time to fulfil redemption than one day if the consumer has not provided all the requested information. **Please also see our response to question 1 for an example proposal for how to tackle this issue.**

Furthermore, in line with the Consumer Duty and providing consumers with detailed information to ensure good outcomes, some members have noted that if an issuer or custodian were to clearly disclose a redemption period that is longer than by the end of the next business day in certain instances, for example the suspension of redemption raised for mass redemption requests, and users agreed to this, it is hard to see a regulatory reason to prevent such a model. This also factors in that an extended redemption period could reduce liquidation stress on the backing assets themselves. Other than the previously mentioned examples, there are not many instances that should enable any additional fees or processes that restricted redemptions.

Volatility

One day redemption may put stress on the backing assets, which would need to be liquidated rapidly in order to meet the deadline. In this instance, issuers may face disproportionate transaction costs that would be borne by themselves if required to sell backing assets to facilitate redemption. To mitigate this risk, one suggestion would be to allow issuers to hold a small number of backed coins on a proprietary basis to allow them to manage such redemption requests.

Gas fees

One final consideration raised by Members is how will the regime account for gas fees which are chargeable at redemption and whether these can be deducted directly from the amount being redeemed.

Custodians

From our understanding of the proposals in the discussion paper, the FCA seems to have envisaged a scenario where custodians could be involved in the redemption process. There should not be an obligation on the custodian to fulfil this function, apart from the transfer of assets and delivering them on time.

Q10. What proof of identity, and ownership, requirements should a regulated stablecoin issuer be gathering before executing a redemption request?

UK Finance believes that the proof of identity and ownership requirements that are applicable should align with the customer due diligence requirements under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017/692.

Chapter 4: Other key expectations of stablecoin issuers

Q11. Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians. Please explain why.

In principle, UK Finance and its members agree that, should Consumer Duty apply across all forms of retail payments, then stablecoins used as a method of payment should also abide by the Consumer Duty principles.

However, the FCA must consider the role of exchanges in this distribution chain. Since cryptoasset exchanges that interact with stablecoins, at present, purely conduct a market making function. Distribution agreements may need to consider the cryptoasset exchange's role in facilitating payments and whether they would come into scope as a payment arranger. Cryptoasset exchanges, if included in the scope of the Consumer Duty, would therefore have to change and adapt their own interactions with consumers and clearly define their role within the stablecoin payments chain. It would therefore be useful for the FCA to include proportionate guidance as to the responsibilities of cryptoasset exchanges within the payment chain.

Q12. Do you consider that regulated stablecoins should remain as part of the category of 'restricted mass marketed investments' or should they be captured in a tailored category specifically for the purpose of cryptoasset financial promotions? Please explain why.

Given that the proposed regime does not intend for the consumer themselves to receive returns generated from backing assets, it seems inappropriate to consider regulated stablecoins that are used for retail payments as a mass market investment.

Following the application of the proposed custody requirements, systems and controls, and capital requirements under this discussion paper, firms issuing stablecoins will be regulated by the FCA in a way that would significantly reduce the risks arising from stablecoins when compared to other cryptoassets.

Additionally, stablecoins will have similar protections in place as e-money, and e-money has far fewer restrictions on its promotion despite posing a similar risk.

In this respect, considering the similarity in the products and similar risks, it might be preferable to apply the same financial promotions as apply to e-money.

Moreover, the Consumer Duty would also deliver additional robust requirements on communications to consumers.

Chapter 5: Custody Requirements

Q13. Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.

A mandated segregated wallet is unlikely to be viable and therefore do not see a need for individual client wallet structures be mandated.

Q14. Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.

Client disclosures should be a necessity, given the effects an illicit person(s) could have on the overall practice of maintaining an omnibus wallet structure. The existing general disclosure requirements in CASS 6 and 9 and COBS 16/16A could be broadly sufficient, and where necessary, possibly enhanced for specific risk of stablecoins and for unbacked cryptoassets.

Q15. Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?

UK Finance and its members are of the view that the stablecoin regulatory regime must give consumers confidence that, if they choose to use stablecoins for payments, their money is safe and they have the right protections.

Current business models for major cryptoasset platforms typically generate revenue through the scaling effects of combining different products and services. This also provides customers with efficiency accessing services through a single global interface. We would therefore support the recent recommendations made by IOSCO that ultimately, sufficient, reliable, and clear information should be made available to clients and any third parties on the rights to any client assets.[3]

Clients potentially could be interested to borrow and lend cryptoassets. We appreciate this is an early-stage conceptual use case and are eager to work with the FCA to consider such an opportunity in the future phase 2 approach to regulating cryptoassets.

Q16. Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.

We support the FCA's approach to minimise the risk of loss/diminution of clients' cryptoassets, and to consider both on and off chain transactions. We expect both cryptoasset firms and custodians will provide practical input on the proposals. We would be grateful for further clarification on whether on-chain records should include both private chains as well as public blockchains.

The following are suggested principles that should apply to the custody of cryptoassets in order to minimise the risk of loss or diminution of clients' cryptoassets:

<u>*Asset Segregation & Bankruptcy Remoteness*</u>

- Client assets should be segregated from firm/principal assets.
- Cryptoassets should be held in segregated wallets without co-mingling of proprietary firm assets and other client assets.
- Custody services should be distinct from other services.
- Rehypothecation should not be permitted.
- Client cryptoassets should not form part of the bankruptcy estate of the custodian.

<u>*Recordkeeping*</u>

[3] IOSCO, Policy Recommendations for Crypto and Digital Asset Markets: Consultation Report, page 36 (accessible here).

- The custodian should demonstrate adherence to regulatory requirements and best practices for client asset safety and recordkeeping.
- Cryptoassets should be clearly accounted for separately on books and records as belonging to the client, segregated from proprietary assets and assets of other clients.

Security & Technology Standards

- Security should be central to the design architecture and operations of technical infrastructure.
- The custodian should be the only entity with possession and control of the private key(s) of the assets being custodied.
- Private keys should be protected from generation through storage (e.g., via key shards via multiparty computation (MPC), in separate and independently secure locations).
- Technology architecture should be designed for resiliency and security with monitoring and controls against failures and compromise.

Risk Management Framework

- Identification and mitigation of risk across end-to end lifecycle.
- Policies and controls should be designed to mitigate identified risk and ensure adherence to risk appetite.
- The custodian should employ and develop expertise across the three lines of defense.
- The custodian should implement business continuity and disaster recovery plans.
- The custodian should implement strong internal governance practices, including enhanced third-party governance for service providers.
- The custodian should provide clear disclosures to investors and clients of the risks associated with cryptoassets.

Supervisory and Regulatory Oversight

- Cryptoasset custody offerings should be subject to regulatory approval and supervisory oversight.
- Regulatory approval should be required for custody products.
- There should be monitoring/supervision of the entity offering custody services.

Q17. Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?

UK Finance members generally agree that reconciliations are a key way to ensure books and records are accurate and correct any errors arising irrespective of traditional or crypto asset class. We would be grateful to engage with the FCA further to define real time reconciliations and assess its practicalities. The availability of this DLT information may facilitate transactional checks, but it is unclear whether this would be in addition to or instead of a periodic reconciliation. Key to this is finality of settlement. Clear rules should be in place to determine when the DLT is considered final, and the extent to which real time finalisation messaging can be used to complete the transaction. Positions can then be independently verified by end of day reconciliations.

Where a sub-custodian is appointed to hold custody assets in DLT, we would appreciate clarity from the FCA whether real-time reconciliation would also be applied to the sub-custodian, and as part of due diligence of the sub-custodian whether the firm would need to assess the sub-custodian's capacity in undertaking reconciliations on a real-time basis to the DLT.

Q18. Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

Firms providing crypto custody should be permitted to use third parties. CASS adequately addresses any associated risks to holding client assets with third parties.

It is critical that the end to end custodianship is subject to the operational resilience requirements, with added requirements on due diligence of third party providers and separate identification of assets. We would expect this to be subject to an overarching agreement between the parties. We agree that the lead crypto-custody entity should remain responsible for the performance of the third parties it uses.

Q19. Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

Members would welcome further clarity on custodians providing "periodic statements to each of their clients of the assets they hold for that client", and whether these proposals would mirror existing requirements to provide such periodic statements as may be applied to, for example, Payment Services Providers. We believe that a statement of accounts that, for example, take the form of a monthly balance, would be beneficial. The detail of what exactly should be provided by a custodian to a client should be agreed with the custody community with input from clients.

Members note that SYSC and CASS in combination with the CAOO proposal and in conjunction with the SMR regime provide a sufficient framework. New entrants may need more guidance or supervision to ensure full compliance with regulatory expectations.

Q20. Should cryptoasset custodians undertaking multiple services (eg brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

UK Finance and members note that the separation of multiple services is not currently required for traditional assets. Existing rules such as the segregation of duties, management of conflicts of interest and ringfencing of assets (such as the segregation of client assets from proprietary assets) could be sufficient in addressing the risks that may arise from cryptoasset custodians who undertake multiple services. Therefore

Q21. Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:

i. Would these issues differ between institutional and retail clients?

ii. What would be the operational and cost impact?

iii. What are the benefits to clients of cryptoasset exchanges prefunding trades? Can these be achieved if there is legal separation of entities?

iv. Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?

v. Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?

vi. Are there alternative ways to ensure the same level of consumer protection?

The activities of holding assets and providing a trading venue, for traditional assets, are typically housed within the same entity. There are existing rules that mitigate the risks associated with an entity operating both exchange and custody services.

ii. There are additional cost implications for maintaining separate additional regulated entities. This includes capital, licensing fees as well as extensive governance and administration.

iii. Prefunding trades may reduce chances of trades failing. Some members note that this may still be achievable if there is a separation of entities.

iv. Existing rules that govern custody and ringfencing of assets should also be applicable to cryptoasset custodians, such as the segregation of client assets from proprietary assets. Some members note that having separate legal entities for such various services should not impact the way clients' accounts are managed and structured.

v. To note, the conflicts of interests stated are not new and exist within traditional custodians. The FCA's rules and principles are designed to manage such conflicts, and we are eager to work with the FCA to assess where these rules could work and apply to cryptoasset exchanges that also operate custody-like activities.

Q22. What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

By enabling custodians to take a more active role in redemption, such as fulfilling redemption obligations on behalf of a stablecoin issuer, could also result in increased efficiencies and improved customer experience.

In addition, if a custodian is appointed to support a regulated issuer, the custodian will need to keep the issuer informed of any stablecoins held by a customer.

Members believe this should not prevent custodians from agreeing with the issuer to provide it with other services independent of their custody offering such as acting as paying/transfer agent or administrator in connection with redemptions. We would expect that it is the issuer who should have regulatory responsibility for ensuring any redemptions comply with applicable regulatory requirements, with the custodian's paying/transfer agent and/or administrator role typically being limited to acting on instruction of the issuer.

Chapter 6: Organisational requirements

Q23. Do you agree that our existing high-level systems and controls requirements (in SYSC) should apply to the stablecoin sector? Are there any areas where more specific rules or guidance would be appropriate?

UK Finance and its members agree that the in principle that high level systems and controls requirements in SYSC should apply. UK Finance and its members are of the view that robust governance arrangements with clear lines of responsibility, effective risk management and internal control mechanisms will mitigate many of the risks that we have seen in the failures of cryptoasset firms. We and members echo the FCA's views that the proposals should make use of the benefits of distributed ledger technology and the data it can provide to firms.

However, members would be grateful for further guidance on exactly which requirements would be applied.

Q24. Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular:

i. Can you see how you might apply the operational resilience framework described to your existing business (eg considering your important business services and managing continuity)? Please set out any difficulties with doing this.

ii. What approach do you take when assessing third party-providers for your own internal risk management (such as responding to, testing and managing potential disruption)?

iii. Are there any minimum standards for cyber security that firms should be encouraged to adopt? Please explain why.

We agree with the proposal to apply operational resilience requirements to both regulated stablecoin issuers and custodians and believe it should be possible for both issuers and custodians to define their important business services and assess how they might apply the framework. This may require further engagement with the sector to clarify new terms and consider whether there are differences in relation to cryptoasset firms and technical providers that may require a separate section in SYSC 15A.

Further analysis is required on what an adequate level of operational resilience is required for DLT networks, and what the due diligence and oversight requirements are for custodians.

For private, permissioned networks, there should be an operating entity(ies) that is/are responsible and accountable for having the appropriate controls and governance. For open networks, 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.

Lastly, when applying operational resilience requirements to custody, it is essential that any operational resilience requirements aim to create a level playing field between financial institutions and new digital entrants.

Q25. Do you agree with our proposal to use our existing financial crime framework for regulated stablecoin issuers and custodians? Do you think we should consider any additional requirements? If so, please explain why.

We support an approach that will look at the existing financial crime framework and assess how well it fits the stablecoin/unbacked cryptoasset regulated issuer and custodian models. Without good adherence, we are likely to see more money laundering. You will be aware that several banks and building societies have conducted in depth risk assessments and felt it necessary to stop customers from making payments to cryptoasset firms.

Q26. Do you agree with our proposal to apply our existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians? In particular:

i. Should we apply the current SMR and requirements to issuers and custodians of regulated stablecoins? Are there additional SMFs or requirements needed to capture the nature of regulated stablecoin business services?

ii. Should we create additional criteria to determine when the 'enhanced category' of the regime should apply to regulated stablecoin issuers and custodians?

iii. Should we apply the current certification functions and requirements to regulated stablecoin issuers and custodians? Are there any additional functions needed to capture the nature of regulated stablecoin issuers and custodians business services?

iv. Do you agree that we should apply the existing Conduct Rules to regulated stablecoin issuers and custodians?

UK Finance believes that existing frameworks, such as the Senior Managers and Certification Regime (**SM&CR**), would be appropriate in mitigating the risks posed to stablecoin tokens, by ensuring there is senior responsibility and oversight of the firm's procedures.

It may be useful for the FCA to liaise with the Bank regarding the enhanced category of the SM&CR, as this may cross over with the Bank's systemic threshold, thus creating unnecessary additional regulatory criteria that are already covered by the Bank's systemic stablecoin regime. It will also be necessary to make clear when the 'additional category' should apply.

Chapter 7: Conduct of business and consumer redress

Q27. Do you agree with our consideration to apply our Principles for Businesses and other high-level standards to regulated stablecoin issuers and custodians? Are there any particular areas you think we should apply detailed rules regarding information to (other than those for backing assets set out in Chapter 3)?

UK Finance and its members broadly agree that the principles for business should apply to stablecoin issuers and custodians. There is a need to ensure that the different and layered business models that exist in cryptoassets are carefully considered, to ensure they are correctly positioned. For example, we do not believe that a cryptoasset exchange is currently an entity that should currently be permitted to issue a regulated stablecoin. If it were to issue a regulated stablecoin, we agree that this ought to be through a separate entity.

Q28. Do you consider that we should design more specific conduct of business rules to regulated stablecoins issuers and custodians? In particular what approach should we take to applying rules on inducements and conflicts of interest management to regulated stablecoin issuers and custodians?

UK Finance and its members agree in principle that inducement and conflict of interest management rules should apply to stablecoin issuers and custodians.

Q29. Do you agree that the dispute resolution mechanisms provided in traditional financial services (ie the application of the DISP sourcebook and access to the Ombudsman Service) should be applied to the business of regulated stablecoin issuers and custodians? Have you identified any gaps or issues in relation to dispute resolution? Please explain.

UK Finance and its members believes that the existing dispute resolution mechanisms in payment services should be made available to other new payment systems in order to ensure parity across the retail payments market.

While our members appreciate the nuances of stablecoin token issuers, should there be a lack of access to the Ombudsman Service, consumers and merchants may be dissuaded from participating in this ecosystem and not realise the benefits it may bring.

Q30. Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.

One view is that, as long as there are adequate dispute resolution procedures and protections for consumers in instances of firm failure, not extending FSCS protection would be acceptable. As this market develops, and if the models become clearer and more defined, it may be that a custodian might for example come within the FSCS remit (noting the potential for this in an indirect pooling event). Nonetheless, at this stage, there are more important improvements that need to be introduced and adopted.

Chapter 8: Prudential Requirements

Q31. Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas:

i. Capital requirements and quality of capital

ii. Liquidity requirements and eligible liquid assets

iii. Group risk

iv. Concentration risk

v. Internal risk management

Under the FCA's Prudential sourcebook for MiFID Investment Firms (MIFIDPRU), MiFID investment firms must have at all times own funds that amount to at least the highest of the following:

- their fixed overheads requirements, generally this is at least one quarter of the fixed overheads of the preceding year;

- their permanent minimum capital requirement, which varies depending on the type of investment business carried out by a firm; or
- their “K-factor” requirement, which is a complex calculation based on the amount and type of investment business carried out by a firm.

Under the EMRs, the own funds requirement for issuing electronic money is calculated at least 2% of the average outstanding electronic money (although it must be at least EUR 350,000).

In light of the above, the FCA’s proposal for calculating capital requirements appears to be closer to the MiFID calculation method than the method under the EMRs.

We have the following concerns about the proposed prudential requirements:

- The method of calculating initial capital implemented under MiFID is complex and difficult to calculate – particularly when considering K-factor calculations.
- The method of calculating capital requirements under the EMRs is relatively straightforward.
- It is arguably easier to draw parallels between an e-money firm and a stablecoin issuer than it is between a stablecoin firm and a MiFID investment firm.

In light of the above, taking into account that e-money firms pose an equivalent risk to stablecoin issuers, it might be preferable to use the capital requirements calculations imposed on e-money firms rather than those imposed on MiFID investment firms.

On concentration risk, to mitigate the risk that backing assets and client monies are concentrated in only a handful of banks or other financial institutions, the FCA and PRA could consider implementing concentration or large exposure type limits, as also recently recommended by the BCBS[4]. The FCA could also consider additional requirements proposed by the BCBS, such as bankruptcy, remoteness of the deposits from any party that issues, manages or is involved in the stablecoin operation; and that the banks apply the Basel Framework (including the liquidity coverage ratio). This would to an extent help to diversify any flight risk on any one single banking entity, as well as ensure concentration risk is continually monitored.

Overall, we agree that the five areas of prudential risk listed above are relevant and ones that regulated entities have (in many cases) already adopted. Members see this as an opportunity to ensure that regulated stablecoin issuers and their custodians provide services that are based on strong financial and risk-based foundations. 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 from providing institutional-grade solutions that addresses identified risks of the crypto asset class.

Chapter 9: Managing stablecoin firm failure

Q32. Do you agree with applying the existing CASS rules on post-failure treatment of custody assets to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins, as well as CASS pooling events? If not, why not? Are there any alternative approaches that should be considered? If so, please explain.

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[4] See for example, BCBS, Supervisory framework for measuring and controlling large exposures, page 8 (accessible here); see also the Bank for International Settlements’ Executive Summary on this matter.

Given the focus on the CASS regime, we believe that it is sensible to apply its rules on the failure treatment of custody assets to regulated issuers and other firms that hold backing assets. The potential pseudo-anonymity of holders is something that issuers may need to consider, given the risks of not knowing the identity of the holder is or where its funds may have come from.

Q33. Do you agree with our thinking on how the CASS rules can be adapted for returning regulated stablecoin backing assets in the event of a firm failure or solvent wind-down? If not, why not? Do you foresee the need for additional protections to ensure prompt return of backing assets to consumers or otherwise reduce harm in firm failure (eg strengthening wind-down arrangements, a bespoke resolution regime)? If so, please explain.

The underlying arrangements within the stablecoin make this a more complex situation than ought to be the case. We believe that this should be a trigger for firms to consider how they might develop a model that retains holder identity information, even if different details were used for trading purposes.

Based on the current arrangements, we do anticipate that there will need to be additional protections to ensure that consumers receive a prompt return of backing assets, as well as the need for firms to strengthen their wind-down initiatives.

Q34. Do you agree with the proposed overall approach for post-failure trading? If not, is there anything else that should be considered to make the approach more effective? If so, please explain. Are there any arrangements that could avoid distribution of backing assets in the event an issuer fails and enters insolvency proceedings?

This is a complex issue which we agree needs further consideration to ensure there is effective protection for consumers during an insolvency process.

Q35. What challenges arise when stablecoins are returned to consumers, particularly with respect to their entitlements? Do you foresee the need for additional protections to facilitate the prompt return of regulated stablecoins to consumers or otherwise reduce harm in firm failure (eg introducing distribution rules within CASS for cryptoassets, strengthening wind-down arrangements, or a bespoke resolution regime)? If so, please explain.

Earlier data suggests that the regulated issuer or custodian might not have sufficient detail to know how to return stablecoins back to the holder. We think that clear procedures will need to be agreed to ensure the prompt return of regulated stablecoins to consumers /reduce harm in firm failure. This will potentially require further engagement with firms either via a new consultation or through direct engagement. In any case, an appropriate regulatory regime will be needed and, with clarity on what firms are expected to have in place to support a potential future wind-down.

Chapter 10: Regulating payments using stablecoins

Q36. Do you agree that this approach to integrating PSR safeguarding requirements and custody requirements will secure an adequate degree of protection for users of stablecoin payment services?

UK Finance and its members are of the view that principles in the EMRs/PSRs regarding safeguarding and custody requirements will secure the right protections for users of stablecoin payment services. This follows the principle of same activity, same risk, same regulation.

Q37. Do you agree that the custody requirements set out in chapter 5 should apply to custody services which may be provided by payment arrangers as part of pure stablecoin payment services?

UK Finance also refers to the views stated in Questions 13 to 22 in this draft consultation response.

Q38. Are there additional risks or opportunities, not considered above, of different stablecoin payment models that our regulation of payment arrangers should seek to tackle or harness?

We have concluded that there may be, but that at this early stage in the regulation of different stablecoin models, the current proposals cover key risks/opportunities. The current proposals can be reviewed and built on as the market (and participants' understanding of the different types of risk) develops.

Chapter 11: Overseas stablecoins used for payment in the UK

Q39. What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?

There are additional risks that could arise from permitting overseas stablecoins to be used for payments in the UK, such as the issuers not having sufficient standards in relation to the backing of assets, which could in turn put consumer funds at risk.

However, UK Finance and its members recognise there would be some benefit of including overseas stablecoins within the scope of the FCA's proposed regime. Members have noted that the Monetary Authority of Singapore allows for overseas stablecoins to be incorporated into its regime, although limited to stablecoins that are denominated in a currency of the G10 member states.

As noted above in our answer to question 2, the UK's traditional open market approach is key to its international competitiveness and its position as a global financial market. The UK regulatory perimeter should be technologically neutral and that the same risk should be subject to the same regulation.

We would encourage consideration of use of the overseas person exclusion which, in its application of the "with or through" approach and the legitimate approach, already provides safeguards proportionate to the activity and UK client or counterparty.

Consideration could also be given to an equivalence regime, particularly given the regulatory regimes already developed in the EU.

<u>Wholesale markets</u>

In relation to the wholesale market, it is important to allow for the continued use of overseas stablecoins.

Financial institutions have the potential to use overseas stablecoins for settlement purposes, for tokenised securities, and it is therefore important that the UK continues to allow for their use in order to ensure it can remain at the forefront of digital asset innovation, including in relation to securities tokenisation.

Q40. What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins? Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?

UK Finance and its members are of the view that more clarity is needed on payment arrangers in the context of overseas stablecoins. Members note that the involvement of a private entity in an equivalence regime is an entirely new concept for UK regulation. As noted previously, we are of the view that regulation should be technologically neutral and query whether it is appropriate to develop a new regime for cryptoassets. We share the view of "same risk, same regulation".

<u>Competition concerns</u>

There are also concerns relating to competition, conflicts of interests and whether it is appropriate to share confidential information with a private entity. As the payment arranger would need an appropriate level of knowledge and expertise to authorise overseas stablecoins issuers, it is to be expected that the payments arranger will have their own stablecoin-related business set up in the UK. Our members have concerns that the payments arranger may have to obtain detailed information on an overseas stablecoin issuer's arrangements and business.

Conversely, should there be limitations as to what information a payments arranger can obtain, the payment arranger may not have full visibility to make robust risk assessments that would otherwise be expected of them. In this instance, UK Finance and its members have concerns that the payment arranger may be given an inappropriate degree of discretion whilst exercising what is effectively a regulatory function. We would therefore encourage the FCA to set out its expectations for how payment arrangers can demonstrate that it has, in good faith, assessed an overseas stablecoin to be compliant.

UK Finance and members suggest that there should be parity in the information that each payments arranger is required to request from an overseas stablecoin issuer. If the minimum level of information that ought to be requested from an overseas stablecoin issuer is not defined, payment arrangers may be incentivised to ask for a reduced amount of information in order to attract issuers to engage their services and cut on costs.

<u>Failure of an overseas issuer</u>

Subject to this, we would argue that if payment arrangers have undertaken all reasonable due diligence to assess an overseas stablecoin's compliance, then it should not be held liable or responsible if an overseas stablecoin fails to meet the FCA standards after approval.

We would encourage the FCA to consider all these issues further, and provide more details on the form, function and role that payment arrangers would be expected to have in the UK.