UK FINANCE

HMT: UK regulatory approach to cryptoassets and stablecoins

UK Finance response

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UK Finance is the collective voice for the banking and finance industry.

Representing more than 250 firms across the industry, we act to enhance competitiveness, support customers and facilitate innovation.

We welcome Her Majesty's Treasury's consultation on the regulatory approach to cryptoassets and stablecoins. UK Finance members see huge potential for digitization to make transformative changes to the UK's financial markets, by delivering innovative products, increasing operational efficiencies and reducing risk. The UK is a world leader in financial technology and should capitalise on the opportunities presented by digitisation to shape the future financial landscape and position the UK as a global leader in digital finance.

There is a particular opportunity for the UK to be at the forefront of digitization in capital markets. To do this, the UK should send a strong signal to the market that it is committed to pursuing digitisation as a strategic objective for the UK's capital markets, to attract investment and innovation to the UK. Moreover, our members note their continued interest in the work of the Bank of England in their investigation of a Central Bank Digital Currency. Our members believe a wholesale CBDC could remove layers of inefficiencies, reduce the cost of transactions for corporates and financial institutions and unlock value end-to-end across the whole market.

This consultation is an important opportunity for the government to set out a clear approach to ensure that the UK is able to continue to lead and embrace innovative technology and practices that have the potential to deliver numerous benefits to UK consumers and businesses.

In light of this, we make the following overarching observations:

- Regulatory clarity – It is important that the regulatory approach is pragmatic and provides greater certainty to the market, to drive investment and foster innovation. This will be achieved by providing guidance on the interpretation of rules in a DLT context, and making changes early to market rules that cannot be applied. In order for firms to feel confident to invest, it is crucial the UK moves quickly to reduce uncertainty.
- Same activity, same risk, same regulation – We are supportive of the regulators continuing to assess their regulation of cryptoassets and stablecoins using the principle of 'same activity, same risk, same regulatory outcome'; adapting rules where necessary, to address any regulatory obstacles or challenges specific to crypto-asset development whilst ensuring financial stability and the same regulatory outcomes are achieved.

- International standardisation –The UK should capitalize on the opportunities around digitization of financial markets and should move early to attract investment and foster innovation. At the same time, UK Finance and its members are supportive of all activities being undertaken by the UK Government and regulatory authorities to ensure that consistent approaches can be agreed on in order to reduce the chance of regulatory and international arbitrage and support global co-ordination.
- Regulatory extension – Our members note that, for those use cases noted by the Government as out of scope of the existing regulatory perimeter, it is essential that a clear, strong and robust regulatory regime is provided in order to reduce regulatory arbitrage and provide confidence for financial firms to provide related services in an ecosystem that continues to protect users and consumers through consistent regulation and clear legal certainty.

As the government outline, we support the near-term priority to ensure the framework supports the safe use of stablecoins. We support the government's activities to actively monitor new and emerging risks as this market continues to mature in order to ensure that the regulatory landscape continues to work for the people and businesses who operate in it, alongside preventing economic crime as necessary. In light of this ongoing engagement, we encourage HMT to continue its work through the Cryptoassets Taskforce. Our members remain interested in the output of this group and consider that this body could be an ideal means for industry and government to work collaboratively to understand this space and ensure that the financial industry remains resilient and robust throughout ongoing innovation in this space.

1. Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

Classification of crypto-assets is an intellectually challenging task and there are many other institutions which have undertaken the classification of the application of Digital Ledger Technology to various use-cases within financial services. These include the AFME/GFMA classification, the work undertaken by the European Union under the Markets in Crypto Assets (MiCA) draft regulation, opinions from other regulatory bodies such as the Office of the Comptroller of the Currency (OCC) in the US. Notwithstanding the good work of the FCA already in their specification of the various types of crypto-assets and the UK's approach to their regulation, e-money tokens, security tokens, unregulated tokens (including utility tokens and exchange tokens). It is important that policymakers and industry use the same taxonomy for referring to crypto assets to provide clarity around the regulatory treatment and the AFME/GFMA classification is an important initiative in this regard, which we recommend the UK adopts within its own work.

A central pillar of the UK economy and its attractiveness for new businesses is the concept of legal certainty. Firms should be able to launch new products and services with certainty and without the fear of retrospective redefinition of their legal rights and obligations. Regulated entities already act with responsibility when considering the risks associated with a product or service and we believe the regulators should support the market usage of new technologies and financial instruments. In this light, the FCA's current guidance broadly outlines the ability for regulators to manage the use of e-money tokens and security tokens. The approach that regulators may take towards cryptoassets deemed outside the scope of existing regulation is potentially a point of unnecessary uncertainty for the market, however we appreciate the complexity of the current market and the difficulties associated with its immediate categorisation.

In light of this diversity of classifications, we recommend the following approach:

- The proposed approach to using the FCA's existing classification is pragmatic and will enable the UK regulators to continue to engage and regulate this nascent market in order to give comfort to firms engaging in these markets and to continue to protect consumers in their use of products and services based on crypto-assets – as well as potentially using these assets as tools for investments.
- There are further clarifications that the market, as it innovates and as particular propositions gain greater market adoptions, will require from regulators. We particularly note the publication of the GFMA classification as beneficial to the UK regulators to consider as further work is undertaken to specify particular use-cases by regulators; we particularly note the following definitions covered by the proposed regulatory approach:
    - Central Bank Digital Currencies (CBDC): Digital form of money that represents a liability of a central bank in a single fiat sovereign currency that may or may not pay interest.
    - Tokenised Commercial Bank Money: Digital form of money that represents single fiat currency and is issued by/structured as a claim on a bank, credit institution or other similarly highly regulated depository institution.
- We are supportive of the definition by HMT of single fiat stabletokens and an approach that is based on payments regulation and note its similarity to the GFMA definition of Tokenised Commercial Bank Money.

- We note that the definition of other asset-linked stabletokens may be enhanced as per below and consider that regulatory clarity on the precise FCA authorisation regime and requirements on backing assets will be of ongoing interest to the industry:
    - Tokens (crypto-assets) designed to minimize/eliminate price fluctuations relative or in reference to other asset(s), and which are not issued by a central bank, FMI, bank, credit institution or highly regulated depository institution. They may represent a claim on the issuing entity, if any, and/or the underlying assets.
- Particular definitions on the use of cryptoassets by the market may be necessary to support specific use-cases, and the industry concurs with HMT that the regulatory environment will need to retain the flexibility necessary to ensure that new applications and innovation is able to be reflected in the ongoing work of regulatory bodies.
- As noted by HMT, it goes without saying that the definition of stablecoins or cryptoassets must be regarded as fluid and no attempt should be made by the regulators or industry to definitively establish all the ways in which the market and consumers can put innovative technology to use within the context of exchanging financial value across all aspects of the financial apparatus. A 'stablecoin' may hold a 1:1 relationship with a given asset, and that underlying asset may be considered relatively stable or unstable: to a certain extent, all statements of stability must be regarded as relative to the marker against which such stability is to be judged.

2. Do you have views on the proposed new regulated category of 'stable tokens'?

UK Finance and its members are supportive of the proposed regulated category of 'stable-tokens' as a mechanism to help firms better understand their product's position vis-à-vis the regulatory environment and provide a technologically neutral response to market activities. As regulatory consideration of these categories continues, it will be useful for the market to understand with greater detail how this newly proposed category of 'stable tokens' is similar to, overlaps with and, in some cases, may capture existing products and services. UK Finance and its members look to continue to work with the UK regulators in order to better understand the specifics of how this category will be applied to the market.

It should be noted that the relevant activities being undertaken by the market, and the risks that they bring, may be distinct from the underlying technology, asset or business process that they use. Certain uses of particular assets may not require the same regulation, due to different activities being undertaken, and the flexibility of regulators and the market will be appreciated in order to firms to establish the optimal way for the market and regulators to manage the relevant risks to the wider market while ensuring that customers and consumers are appropriately protected. While the term of stablecoin may be useful for regulatory purposes, our members do note that there is a danger that its definition may unnecessarily become technologically bound to the products created by market and we invite caution from regulators in further creating new statements of monetary category.

3. Do you have views on the government's proposed objectives and principles for cryptoassets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

Broadly, the objectives and principles proposed by HMT align with industry expectations of their role in regulating cryptoassets and stablecoins. Inevitably the objective of promoting competition and innovation will cause perceived conflicts with financial stability and consumer protections – in this regard, we recommend that regulators consider their proportionality in intervening in these areas.

The industry view is that use of cryptoassets and stablecoins as a means of payment and exchange of value will play an increasingly important role in the future digital economy. Over five thousand crypto-assets globally have already emerged, designed to provide a digital form of exchange of value in a peer-to-peer system. It is imperative that the stability and benefit afforded to the UK's financial ecosystem of robust regulation is not threatened by uptake of systemically significant volume through unregulated parties. In addition to this, the importance of the UK's financial crime prevention measures to this growing ecosystem are considered to be essential for firms to ensure that all parties to transactions, including consumers, using these value exchange mechanisms are appropriately protected against the risk of unknowingly becoming complicit in criminal enterprises.

4. Do you agree with the approach outlined, in which the regulatory perimeter, objectives and principles are set by government and HMT, with detailed rules to follow set by the UK's independent regulators?

UK Finance and its members agree with the outline approach articulated by HMT and are supportive of the UK regulators being delegated authority to undertake specific regulation in areas where it's necessary. This proposal aligns with the overarching narrative of regulatory supervision of the financial markets, as more fully articulated in our response to HMT's Future Regulatory Framework review. We agree with proposals for setting overarching and activity-specific framework legislation and identifying public-policy matters to be taken into consideration in regulatory standards. Where these need to be updated from time to time, secondary legislation is an appropriate vehicle, but it must be subject to proper scrutiny. Given the fluid nature of the use of stable tokens and other technological or structural innovations, we expect regulators to work closely with industry in order to achieve practical outcomes that that deliver on regulator and industry objectives and focusing on areas where risks and opportunities are most urgent.

We also recognise the good work that the regulatory community has already undertaken since the Cryptoassets Taskforce's 2018 report clarifying the regulatory perimeter and policy expectations regarding cryptoassets more generally; reiterate the industry's desire to engage in this forum and its continued work; and particularly note the importance of expanding consideration of the Fifth Anti-Money Laundering Directive and ensuring that consumers are appropriately supported to reduce customer harm. It is also considered that crypto-asset service providers may need to be subject to operational resilience requirements and to transaction surveillance as defined in the EU Funds Transfer Regulation which should also apply to the transfer for crypto-assets when used for payment purposes; especially in the cross-border context.

While the delegation of specific rules to the UK's independent regulators is supported, it will be necessary to ensure that these regulators remain appropriately staffed and have the necessary expertise, to manage the authorisation flow and the supervisory requirements. A number of applications or functional differences between various cryptoassets may be identified, or claimed, by regulators and providers, and it is important that the regulators have the right capacity to assess accurately in specific cases the right regulatory approach. In this we reiterate our principle for same activity, same risk, same regulation and the use of existing regulation where possible and extending beyond this as necessary in order to cover identified gaps and deliver appropriately tailored approaches.

5. What are your views on the extent to which the UK's approach should align to those in other jurisdictions?

We are supportive of UK Regulators defining a pragmatic approach to the use of stablecoins and other crypto related technology and business process innovation within the UK in order to enable firms to gain comfort in their use and the creation of products and services reliant upon these

technologies and processes. There is an opportunity for the UK to be at the leading edge of digitization and there are benefits to moving early, ahead of other jurisdictions. While international consistency is important, the UK should ensure it adopts an approach that puts it in a strong competitive position to attract technology driven investment and new business to the UK.

In this regard, we support the UK regulators in their endeavours to align international approaches to the management of cryptoassets and stablecoins, and particularly management of internationally available cryptoassets and stablecoins. The European Commission's Market in Cryptoassets (MiCA) proposals and the publication of other regulatory material, such as the interpretive letter published by the Office of the Comptroller of the Currency (OCC) in the US (Interpretive Letter 1174) are important developments to monitor.

Further, there is the opportunity for the UK to lead in the assessment and regulatory standpoint on cryptoassets and stablecoins. International harmonisation is an important outcome and the UK has the opportunity to be an active contributor to these discussions as we create suitable regulatory best practice and standards. Given the wider political environment, it is considered that the regulators involved in the implementation of the government's policy could continue to assist UK firms already innovating in this space and support the UK's international agenda by creating clear principles for interoperability with other nation's regulatory regimes.

6. Do you agree with the government's assessment of risks and opportunities?

The risks outlined by the government align with previously identified risks, however, we consider that the government and regulators could consider in greater detail the impact of financial crime implications of increased use of cryptoassets and stablecoins. We have already noted the prescient assessment of the NRA 2020 and note that our members have also identified the use of cryptoassets being used by criminals to obfuscate proceeds of crime. Our members also consider that there is a risk to consumers of increased fraud in this area due to the innovative means by which firms are able to claim value of these tokens for consumers. It is unclear to which all consumers are sufficiently educated on how cryptoasset offerings are able to generate and retain value in all circumstances and this could increase the ability for fraudsters to target consumers.

As per the National Risk Assessment of money laundering and terrorist financing 2020 (NRA 2020),[1] the nature of cryptoasset transactions is global and regulatory misalignment remains a key risk. The recent changes to the Financial Action Task Force (FATF) Travel Rule remain unevenly implemented, leading to differential transparency requirements across the globe. As with anti-money laundering (AML) / counter-terrorist financing (CTF) regulation across all sectors/delivery channels, this lack of international alignment leads to criminal assets being diverted to less transparent jurisdictions and later making their way back through another channel (for instance, if a cryptoasset transaction is converted to fiat currency in a jurisdiction with less stringent requirements; and proceeds are subsequently reintroduced to the UK via correspondent banking). It is important that the regulatory approach is able to ensure that these international requirements are able to reduce the chances of regulatory arbitrage. Our members consider that the further consideration of necessary economic crime requirements could be connected to the review of the AML regulatory review expected later in 2021. This review will allow an opportunity to consider the lower level details (risk and opportunities) and implications of utilising AML regulation to regulate cryptoassets and stablecoins and will need to consider such elements as the availability of consumer kiosks and ATMs to access cryptoasset

[1] https://www.gov.uk/government/publications/national-risk-assessment-of-money-laundering-and-terrorist-financing-2020

and stablecoin markets, as well as features of cryptoassets or stablecoins designed to enhance the anonymous nature of some transactions.

Additionally, our members wish to highlight the risk of banking disintermediation in the increased use of cryptoassets. We have already noted the importance of the existing regulatory, legal and supervisory activities that established financial institutions are subject to and that give a great deal of resilience, stability and consumer protection. Should payment and investment volumes shift from existing channels to unregulated mechanisms, there are significant risks to both financial stability, monetary policy and consumer harm. Again, we reiterate our concern that all firms in the UK undertaking the same activity, at the same risk, should be subject to the same regulation. It is important that the regulatory approach reduces the opportunity for regulatory arbitrage between different mechanisms of making payments or financial investments.

We also consider that the regulators should also consider to what extent tokens or stablecoin assets may be eligible for banks to include as High Quality Liquid Assets (HQLA) for the purposes of their Liquidity Coverage Ratio (LCR). We recommend that the PRA may need to consider this in greater detail in order to ensure that firms are not unduly disincentivised from holding such assets in future and how the PRA's intra-day liquidity regime may treat transfers in and out of token based payment systems.

We note that the government view of the potential opportunities is somewhat limited to the use of these tokens for the purposes of retail and cross-border payments. Our members have consistently noted that the benefits of speed, greater transparency and enaction of smart contracts based on digital structures of value may find better realisation of potential benefits within wholesale use cases. The research done by the FCA is helpful to highlight the potential benefit to consumers of the adoption of cryptoassets; however, the majority of payments made by consumers are made to businesses – and businesses and financial institutions themselves are often heavily reliant on existing payment systems in the conduct of their operations.

7. Do you have views on the proposed initial scope of UK cryptoasset regulation as summarised above?

UK Finance is supportive of the approach proposed by the government to ensure that tokens which could reliably be used for retail or wholesale transactions are subject to appropriate regulation. The appointment of the FCA to oversee an authorisation regime, suitably supported by the ongoing roles of the Bank of England and the PSR within their respective remits.

However, this needs to genuinely enable a level playing field and ensure alignment with a principle approach of same activity, same risk, same regulation and apply to all users of cryptoassets alike. We note that paragraph 2.7 of FCA's policy statement on cryptoassets states that "Where an FCA authorised firm carries on unregulated activity (for example, in relation to an unregulated cryptoasset), while that activity may not require a permission in itself, it is possible in certain circumstances that some FCA rules, like the Principles for Business (PRIN) and the individual conduct rules under the Senior Managers and Certification Regime (SMCR), may apply to that unregulated activity. Unregulated activities may also be relevant in assessing whether the firm continues to comply with the Threshold Conditions for authorisation." Such a stance appears to defeat the implementation of this principle and we consider that activities which, when conducted by a regulated firm, would be considered to be caught under regulation should, similarly, be subject to similar regulation when undertaken by firms who are not already regulated entities. Similarly, if we consider stablecoin payments as a regulated activity, we would then expect that all authorised providers will be subject to the same requirements regardless of size and other businesses/activity. Fundamentally, we expect to see the UK independent regulators oversight of cryptoasset providers to at least match the standards (and, where appropriate, levels of fines) of regulation in established financial processes.

We consider that the FCA, and other UK independent regulator, needs to be fully resourced to assess and manage risks in this space, and work with peers (for instance in the US) to consider innovative approaches to the regulation of risks in the DeFi/privacy space in particular.

8. Do you agree that this approach best balances the government's stated objectives and principles?

UK Finance agrees that, with the proviso of the above comments, the approach proposed by the government will be able, pending appropriate actions by the FCA, PSR and the Bank of England, to accomplish the government's stated objectives and principles.

9. Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

Yes, and we have no further comment.

10. Do you agree that the government should primarily use existing payments regulations as the basis of the requirements for a new stable token regime, applying enhanced requirements where appropriate on the basis of mitigating relevant risks? What other existing legislation and specific requirements should also be considered?

Broadly, this approach is supported by members of UK Finance. However, there are considerations that should be factored in when making this recommendation, outlined below:

- The Electronic Money Regulations 2011 and Payments Services Regulations 2017 primarily speak to consumer and retail payment use-cases. It may be necessary for additional considerations to be made for wholesale use cases.
- Due to the innovative manner in which payment services may be offered to consumers through a stablecoin authorisation regime, our members consider that additional requirements for these tokens be maintained for those firms which do not meet the requirements of an e-money scheme.
- The industry is minded to avoid regulatory arbitrage between potentially competing schemes. We expect that, for retail product offerings, the FCA will carefully consider the development of an authorisation process that clearly differentiates to the industry under what circumstances a firm is better to opt for a stablecoin authorised offering than compared to an e-money licence; and this should be considered in light of what the industry is able to achieve through enrolment in the other payment scheme opportunities such as a Payment Initiation Service Provider or a money service bureau. The FCA should ensure that the opportunity for regulatory arbitrage is minimised.
- We have already outlined the potential disconnect between a retail stablecoin scheme and a wholesale authorisation regime in question seven and we note again the points that were made above:
    - The user requirements for payments made in retail and wholesale environments are very distinct from one another – for a retail environment, principles such as consumer protection and ease of use are of prime importance while in the wholesale

environment settlement finality and corporate access considerations are of greater importance.

- The ability for firms to use relatively unstable cryptoassets as a medium of exchange between parties on an atomic settlement basis should not be overlooked.
- Appropriate distinction between the relative interests of various regulators will not be achieved should the government's approach offer no distinction between a retail and a wholesale use case.

11. Do you agree with the high-level requirements outlined? Do you consider that any additional requirements are needed?

Our members wish to note that it will be important for any future authorisation regime to consider the financial crime requirements that may arise from the use of cryptoassets and stablecoins. However, as with all of the high-level requirements that the government has outlined, our members consider that the government and regulators should adopt proportionality in the application of these high-level principles on a nascent market. As we noted earlier in question three; the industry view is that use of cryptoassets and stablecoins remains at relatively low volume and, in regards to the principle of 'same risk, same regulatory outcome', we would be concerned that excessive regulatory scrutiny of these markets does not inhibit their natural growth. Historically, new payment methods have grown from relatively humble beginnings and become increasingly more functional and capable as time progresses rather than immediately delivering the scale, resilience and financial crime mitigation that other payment products enjoy through their historical development and scale across the industry.

12. Do you have views on whether single-fiat tokens should be required to meet the requirements of e-money under the EMRs, with possible adaptation and additional requirements where needed?

UK Finance notes that it will be important for the government and regulators to clearly establish how the proposed stablecoin regime will interact and differentiate from the existing regulatory routes for firms to create payment services, particularly the EMRs as noted as its base. There is consensus that, to avoid regulatory arbitrage, the requirements of a stablecoin regime should at least equal, if not exceed, the requirements of the EMRs. We particularly note that the additional risk associated with the introduction of new technologies and untested business practices may justify increased regulatory supervision of these areas.

13. Do you have views on whether exclusions to the authorisation regime are needed in relation to the stable tokens regime, in light of the government's objectives? If so, which activities do you think should be excluded?

Market participants rely on a variety of existing exemptions. We therefore recommend that the UK authorities conduct a comprehensive review of all such exemptions to ensure that the current drafting does not unduly inhibit the use of cryptoassets where appropriate in the context of the policy objective. These include the exemptions under Part 2 of Schedule 1 to the Payment Services Regulations 2017 ("PSR") where certain activities are designated as not constituting payment services.

Such exemptions may be relied upon by wholesale market participants including, without limitation, custodians and prime brokers who routinely rely on the exemption for payment transactions related to securities asset servicing such as dividends, share sales or unit redemptions. In this context the UK authorities can provide such business with the opportunity to evolve their product offerings by

ensuring the asset servicing exemption contemplates both payments with cryptoassets and asset servicing activities relating to cryptoassets.

14. What are your views on the appropriate classification and treatment of (unbacked) tokens that seek to maintain a stable value through the use of algorithms?

The EMRs specifically handle cases where firms offer payment services digitally representing the UK's fiat currency. For instances where stablecoins are stabilised through the use of algorithms, it appears that these processes best resemble the management of fiat currencies, without the backing of assets that most central banks arrange to support the integrity of these currencies. It appears that, in these circumstances where these firms do not lay claim to any underlying asset or claim, that the application of the EMRs may not be most appropriate. Further, their use does not appear to align closely with current regulation for securities or other assets as there is a lack of legal obligation or tangible asset underlying a particular token. These tokens, then, seek to attain stability purely through market demand and the level to which a market values them in relation to other assets. In light of this fact that, the operation of these tokens in market could seem more similar to the issuance of a fiat currency by a central bank and/or modern nation state – the difference being that, in the event of institutional insolvency, there may be no underlying asset to fall back on.

Regardless of their seeming lack of stability, the market may be able to find effective use of these tokens. It may be unwise for the government, at this stage, to definitively make judgement on where best these exchange tokens sit and rely upon the appropriate management of systemic and payment systems risks by the Bank of England and the PSR to assess, at a later stage, the optimal process for regulation in the future. It is important that a suitable supervisory scheme is adopted for these tokens in order to ensure that the implementation of such tokens does not threaten financial stability or increase the risk of consumer harms.

15. Do you agree Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens?

Yes, UK Finance and its members agree that Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens, under the proviso that these token arrangements must reach the threshold of becoming systemically important to the UK, and potentially global, financial ecosystem. We caution with our earlier point that appropriate time should be given to these systems in order to allow for their systemic importance, or lack thereof, to become apparent – it may not be appropriate in all cases for the Bank of England to capture potentially systemic stable token systems at launch. The industry view is that use of cryptoassets and stablecoins remains at relatively low volume and, in regards to the principle of 'same risk, same regulatory outcome', we will look to the Bank of England to understand how appropriate protections and controls for systemic stable token payment systems may be introduced as their usage increases.

16. Do you have views on potentially extending Bank of England regulation of wider service providers in the stable token chain, where systemic?

UK Finance are in support of the extension of the Bank of England's regulation of wider service providers in the stable token chain, where systemic. To align with the principle 'same risk, same regulatory outcome' set out by the Treasury, we expect that current and future regulations would apply to new tech companies providing services to support stablecoins, in the same way that they apply to financial services firms to ensure a level playing field. Moreover, any new rules for service providers should be consistent with comparable rules in existing financial services legislation.

It is presumed that the Bank will work closely with the FCA as authorising body of stable token systems in order to reduce regulatory overlap and ensure that there is a coherent and cohesive understanding of the risks to the market posed by these structures. Similarly, and in relation to the questions following, we presume that the activities undertaken by the Bank of England, the PSR and the FCA will be appropriately co-ordinated, particularly in the early years of any implementation of stable token regulatory influence, under the existing Memorandums of Understanding between these parties.

17. Do you agree that Part 5 of FSBRA 2013 should apply to payment systems facilitating the transfer of new types of stable tokens?

Yes, UK Finance and its members agree that Part 5 of FSBRA 2013 should apply to systems that facilitate the transfer of new types of stable tokens, under the clarification that the activities of these systems are functionally similar to existing payment systems. We note our previous points regarding the need for the principle of 'same risk, same regulatory outcome' to also apply in light of the PSR's responsibilities to all parties that undertake payments services utilising new technologies or business principles based on stable tokens.

18. Do you have views on location and legal entity requirements?

At this time, UK Finance does not have any specific views on location and legal entity requirements. We offer the government's consideration of the following principles which may help industry, regulators and government to assess the optimal path forward to achieving the protection of financial firms, businesses and consumers within the UK through strong and effective regulation.

- Geographic location or legal entity requirements should not prevent the UK market from accessing and enabling products and services that rely upon extra-national stablecoin or cryptoasset structures, even when (such as Bitcoin) these cryptoassets may have no recourse to a legal entity or specific geographical location.
- The UK regulatory environment should be confident in its ability to understand the actors and/or processes involved in the issuance of stablecoins and cryptoassets and understand how regulatory requirements and mandates may be enforced for these structures where necessary to protect the interests of UK consumers, ensure a competitive market and continue to enable competition.
- The government and UK regulators should look to work with their international counterparts in order to clearly establish consistent regulatory approaches to extra-national or international offerings of cryptoassets and stablecoins. This could include authorisation of issuance by firms within other nation states and the agreement of the application of UK regulation on extra-territorial basis as well as internationally agreed processes to bring secure appropriate influence over extra-nationally issued cryptoassets or stablecoins.
- It is expected that any location or legal entity requirements considered by government would be based on materiality and any degree of systemic risk that the use of stablecoins issued by any entity poses to the UK financial ecosystem.
- Issuance of stablecoin based services offered to UK consumers or businesses, or other services broadly analogous to the provision of e-money under existing regulation should retain the same location and legal entity requirements as existing regulation.

19. Are there any areas of existing regulation where clarification or amendments are needed to support the use of security tokens?

A significant barrier to the development of a secondary market for security tokens is how existing rules will apply in a DLT context. Current markets rules were not written with crypto assets in mind, and there are examples where they may be impossible or challenging to apply. At this stage it is difficult to identify an exhaustive list of regulatory barriers, because the market is still at an early stage of development. However, a certain degree of flexibility will be needed in terms of how firms should interpret and regulators should apply markets rules in a DLT context. Regulators should provide guidance to firms, to deliver greater regulatory certainty.

The biggest obstacle is the essential role of a Central Securities Depository (CSD) in a market where CSDs are currently not generally engaging with security tokens. The UK should consider whether current CSD rules are fit for purpose in a DLT environment, the extent to which the role of a CSD continues to be necessary for ecosystems utilising DLT and whether other market players could contribute to any of the functionality that is traditionally provided by a CSD.

Further guidance on the interpretation of existing rules in the DLT context would also provide greater confidence e.g. rules on custody (CASS).

20. What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

We welcome HM Treasury's efforts to identify and address the potential regulatory and legal challenges to the adoption of DLT based technologies by financial market infrastructure and intermediaries. UK Finance consider that it is important to separate the use of DLT as a technology versus its application in financial markets. To this end, we note the government's observation that the FCA's Regulatory Sandbox programme has demonstrated the capacity to issue 'equities, bonds and structured products on the Ethereum blockchain' and that these tests have enabled securities issuance to take place 'more efficiently; faster and cheaper when compared to traditional issuances, while increasing the transparency of ownership.' It is not necessarily UK Finance's role to comment on the specific technical capability of new technology; however we understand that similar gains of efficiency, speed, cost and transparency could be gained through the application of new technologies to existing processes necessary for trading, clearing and settlement.

We understand that, for many financial institutions, the use cases for DLT typically involve existing financial markets intermediaries using the technology to help perform, replace or render obsolete various existing processes through the use of a trusted, shared database. The primary objectives of these initiatives are to

I. Reduce risk across all market participants, primarily driven by the ability to transact with complete certainty on a DLT network and the ability to achieve synchronised settlement with the potential to significantly reduce liquidity risk, settlement risk, credit risk and operational risk across the financial sector;

II. Increase efficiencies (e.g. streamlining of processes, a reduction in failed transactions);

III. Provide new product functionalities (e.g. the ability to transact on an intraday basis and the ability to mobilise illiquid collateral);

IV. Provide greater certainty regarding title and record keeping given the DLT is a single source of truth for all market participants; and

V. Reduce costs throughout the pre and post trade lifecycle.

We expect to see this trend continue and potentially accelerate for infrastructure relating to traditional financial instruments (including dematerialised securities).

Use cases for DLT in the trading, clearing, settlement and custody infrastructures are wide-ranging and fall into three broad categories:

I. Using DLT to optimise or replace existing processes (e.g. clearing and settlement, payment processing, issuance of securities, tracking securities lending transactions and matching OTC derivatives terms to create on-chain confirmations) – DLT technology may provide the ability to significantly reduce risk and fragmentation across the financial sector whilst also offering new capabilities e.g. the ability to transact on a T+0 basis;

II. Using smart contracts to automate the trade lifecycle (daily mark-to-market processes for swaps, processing derivatives contracts, processing contract expirations and rollovers); and

III. Using DLT to open up access to smaller and less liquid markets (raising capital for hedge funds, automating ownership tracking of commodities markets, tracking private ownership and funding platforms).

In the longer term, it is possible that DLT may result in more fundamental changes to market infrastructure as a potential catalyst for disintermediation. This will almost certainly be the case for digitally native assets where end-users may have direct access to platforms and data.

As always, the government and regulators have a key role in driving innovation through giving comfort to firms that the introduction of new technology to achieve the same business processes by more efficient and effective means does not fall afoul of current, or future, regulation and that the introduction of these new technologies does not adversely affect the ability of financial institutions and regulators to manage risk inherent in the financial ecosystem.

The ability for UK regulators to provide this assurance, while also ensuring that any UK rules align with international approaches is considered a key success factor for the UK market.

We also note the following potential benefits of DLT adoption within a permissive and positive regulatory environment:

- Increased transparency and ease of auditing as all transactions are digitally approved and recorded.
- Immutable records (depending on the type of DLT used, once a record is completed it cannot be changed).
- All transactions require consensus from stakeholders before being saved as an immutable record.
- Reduced trade lifecycle costs for FMIs and end investors through automation and greater certainty of record keeping.
- Single shared truth 'golden record' of ownership, confirmation terms, etc.
- No duplication of record keeping across multiple intermediaries - reducing the need for reconciliations, increasing certainty, fewer disputes/shortfalls etc.
- Fewer settlement delays and fails.
- Accelerated settlement cycle reducing counterparty risk for assets traded on spot.
- Collateral management with increased scope for automation and use of smart contracts.
- Improved regulatory reporting and with the potential provide regulators with direct access to trade data.

21. What are the potential drawbacks of DLT for wholesale markets and FMIs?

As noted before; the introduction of DLT technology in wholesale markets does not necessarily change the fundamental businesses processes pursued by firms; instead, it grants the industry opportunities to derive efficiencies in existing processes. The following are not necessarily drawbacks. Instead they may be better described as challenges that markets face when adopting DLT solutions:

- Scalability and performance: For DLT to ensure its key features of security and consensus a high level of computation is required. The larger the network the greater the computational resource required.
- Immutability: The fact that some DLT implementations are designed to be computationally impossible to redact has huge benefits from an audit perspective however it may also present challenges for providing appropriate functionality for dispute resolution, amendments and corrections where these may be necessary.
- Disintermediation: In many use cases DLT is potentially a catalyst for disintermediation and changes the way existing processes are implemented. This will naturally present challenges as to how the new processes will be governed and regulated (see below).
- Interoperability: Piecemeal approach and lack of interoperability could lead to further fragmentation and failure to realise the benefits for end customers.
- Off-chain transactions and ownership: A DLT ledger may not be treated as the definitive record of legal title unless statute has given it binding effect[2]. Even where participants have agreed that the ledger will be treated as the definitive record of legal rights this would not bind third parties who haven't agreed to the rules of the system[3]. However, there may be a legitimate role for off-chain rights pursuant to trusts, security interests etc.

22. Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation be optimised for DLT?

UK Finance consider that it is important to separate cryptoassets from the broader range of alternative use cases for DLT as, by broad example, a record keeping technology for financial markets. While a technology agnostic approach to regulation is supported, we consider that even regulations that are drafted with the intention of being technology agnostic may contain inherent assumptions regarding market structure and related processes that can unintentionally hinder the adoption of DLT. The current UK regulatory framework has evolved to reflect the existing market infrastructure (involving exchanges, CCPs, custodians, CSDs etc.) and typically assumes that each maintains their own independent systems, books and records. Consequently, many regulatory requirements in the UK and elsewhere in the world are carefully designed to mitigate specific risks that arise from chains of intermediaries each maintaining separate databases on independent systems. However, these rules may not fully contemplate the opportunities of utilising DLT to provide a trusted shared database that is relied directly upon and updated by the consensus of its participants.

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[2] Para. 132 of the "Legal statement on cryptoassets and smart contracts" as published by the UK Jurisdiction Taskforce in November 2019 (the "**Legal Statemen**t")

[3] Para. 134 of the Legal Statement

Given the technology agnostic approach taken by government to the classification of stablecoins and other cryptoassets and, subject to the discussion below, we broadly agree that a similar technology agnostic and permissive approach should be applied to the broader use of DLT as a record keeping technology in financial markets. Our members believe the UK should prioritise and move forward with

I. Making changes early to rules where clear obstacles exist to the development of a secondary market for security tokens (e.g. rules in CSDR) and to deliver regulatory certainty;
II. Conducting a review of markets rules to identify where further barriers may exist;
III. Providing guidance to firms on how the UK will apply existing markets rules in a DLT context; and
IV. Taking a flexible regulatory approach to adapt to innovations in the market.

This approach may include a testing regime, so that firms can test DLT products with exemptions to rules, but it is important that any sandbox/pilot does not detract from providing firms with the regulatory certainty they need to invest.

We also recommend that the UK authorities draw on their world leading experience of DLT use cases, for example through the FCA Sandbox, to conduct a comprehensive examination of the existing UK regulatory framework to identify and review any regulatory requirements that may unintentionally inhibit the adoption of DLT.

We suggest that the UK authorities draw on their existing experiences, to provide formal recognition where appropriate that market participants may seek to deploy DLT in use cases that nullify the risks that existing regulations are intended to mitigate or may provide an alternative means of complying with the relevant policy objective. For example, it is conceivable that certain regulatory requirements in the Client Assets Sourcebook and/or Conduct of Business rules relating to reconciliations, custody shortfalls and record keeping requirements could be sufficiently mitigated or may even become functionally redundant in the context of certain safekeeping use cases for DLT. In such cases regulatory guidance is welcome because uncertainty relating the use of DLT naturally inhibits the wider adoption by existing market participants.

We note that the EU has recently proposed a five-year pilot scheme for DLT technology representing the first EU supra-national sandbox regime. The EU proposals include a number of exemptions from aspects of EU regulation that may inhibit the use and application of DLT technology by market participants including:

I. Exemption from the requirement in CSDR for transferable securities to be recorded with a Central Securities Depositary;
II. Allow for cash payments using settlement coin (described as commercial bank money in a tokenised form or e-money in the proposed MiCA regulation); and
III. DLT securities settlement systems may be exempted from the rules relating to the notion of 'securities account' or 'book-entry form'.

We have a number of observations regarding the EU pilot regime as currently designed. Firstly, that an extended pilot may have a chilling effect on innovation because of the lack of regulatory certainty. Secondly, a narrow scope of exemptions from markets does not provide sufficient flexibility to address further regulatory obstacles that may arise. And thirdly, caps on the size of the transactions that can participate in the pilot, significantly limits the innovative cases the pilot can be used for.

The work of the FCA as a pioneer of sandbox testing is particularly informative and we expect that regulators may draw on these experiences to ensure that DLT sandbox testing may ambitiously

expand the scope of initiatives considered to include a broader range of use cases and potential relief from existing rules that may otherwise give rise to tensions or inhibit the use of DLT technology.

Another important legislative barrier to the broader financial markets' adoption of both cryptoassets and traditional financial instruments that are recorded on DLT is it the ability to take an effective security interest over such assets in order to treat such assets as financial collateral. The Legal Statement[4] published by the UK Jurisdiction Taskforce provided a welcome summary of the current status of relevant English law but it remains a long way from providing the high degree of legal certainty or a practical means of perfection required by regulated market participants. In particular, it may be helpful to clarify that such assets may qualify as "financial collateral" for the purposes of the UK Financial Collateral Arrangements (No 2) Regulations 2003 (SI 2003/3226) (FCA Regulations 2003) ("FCAR"). Additionally, the concept of the "possession and control of the collateral taker" which already presents challenges in the context of traditional dematerialised securities may prove even more challenging in the context of DLT. Such concepts may need further clarification and should be designed to afford market participants with the maximum flexibility to define for themselves the degree of control required, the degree of collateralisation intended (including partial collateralisation of exposures), automated substitutions and release of excess and in each case whether these terms are enshrined in writing or expressed by a developer in code (for example using a smart contract). Terminology relating to "accounts" and "book-entry" may also need to be clarified and evolve accordingly.

We also note that the EU are conducting a review and consultation on the EU Financial Collateral Directive and Settlement Finality Directive, considering amongst other issues the expansion of these regimes to cover cryptoassets and DLT. We strongly recommend that the UK authorities should be conducting a similar exercise with a view to expanding these protections to include these assets, DLT and providing greater legal certainty for a secured party taking collateral. By providing these stable foundations UK authorities can begin to take the discussion a step further to evaluate the eligibility of such assets as collateral for regulatory capital purposes (e.g. UK CRR/CRD IV) and/or regulatory margin requirements (e.g. UK EMIR) when appropriate. Finally, English law remains a preferred choice of law for financial markets participants and the UK has the opportunity to lead such changes to relevant legislation that now only needs to be implemented in the UK (rather than, in the case of an EU Directive, consulted among and implemented across 27 individual member states each with different perspectives and priorities on insolvency law).

23. What are the wider industry incentives or obstacles to the adoption of DLT in wholesale markets and FMIs in the UK?

Over the past decade market participants have invested almost all of their technology budgets in maintaining and enhancing their existing systems to perform the tasks and meet the deadlines necessary to comply with the enormous package of international regulations that have been implemented since the 2008 financial crisis. This has been compounded by the challenges for financial markets participants preparing for the UK's withdrawal from the European Union. These efforts have left minimal time and resource available for research, development and implementation of new technologies including DLT. A period of regulatory stability and economic incentives (for example research and development tax credits) may assist financial market participants to reallocate resources towards innovation and growth opportunities involving DLT.

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[4] Legal statement on cryptoassets and smart contracts" as published by the UK Jurisdiction Taskforce in November 2019 (the "**Legal Statemen**t")

24. If market coordination is required to deliver the benefits of DLT, what form could it take?

We consider that regulators may have existing mechanisms to support appropriate market co-ordination through functions such as the FCA's Sandbox functions. Additionally, there are existing market bodies which may be able to provide the means for industry co-ordination which may not require regulatory leadership. Further, it is unclear at this juncture what market coordination may be required to deliver the benefits of DLT. In the event that market coordination is required, it may be better to allow for industry to propose approaches that will achieve beneficial outcomes.

25. Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

Common standards on the principles that the government has outlined within their consultation are essential to the adoption of DLT and other new technology in financial markets. Almost all the use cases that DLT addresses require network effects to reach a critical mass before the solution can be effective. Current use cases either target a very narrow scope or are built in silo from the rest of the front to back processes that they address. Having a governance structure that can consider interoperability between parallel use cases across industry verticals and horizontals as well as encourage common users to adopt a single solution will really benefit the growth of DLT within the industry. We believe that Governments, regulators and industry bodies are in a position to help drive this, should the industry benefit from such leadership.

26. What should the UK government and regulators be doing to help facilitate the adoption of DLT/new technology across financial markets/FMIs?

Our members note their continued interest in the work of the Bank of England on a Central Bank Digital Currency. Our members believe a wholesale CBDC could remove layers of inefficiencies, reduce the cost of transactions for corporates and financial institutions and unlock value end-to-end across the whole market; it would be a 'quick win' for the UK as noted in the Kalifa Review.

As always, the government and regulators have a key role in driving innovation through giving comfort to firms that the introduction of new technology to achieve the same business processes by more efficient and effective means does not fall afoul of current, or future, regulation and that the introduction of these new technologies does not adversely affect the ability of financial institutions and regulators to manage risk inherent in the financial ecosystem.

We reiterate that UK has 'long been recognised as a world-leader in financial technology' and UK Finance and its members believe that this consultation is an key opportunity for the government to set out a clear approach to ensure that the UK is able to continue to lead and embrace innovative technology and practices that have the potential to deliver numerous benefits to UK consumers and businesses. UK Finance consider that it is important to separate cryptoassets from the broader range of alternative use cases for DLT as, by broad example, a record keeping technology for financial markets. We also wish to emphasise that there are important benefits for market participants of international regulatory harmonisation. We believe that the UK authorities can be instrumental in influencing the development of a common regulatory approach/framework across the major economies/regions in order to protect the key benefits of DLT outlined in the earlier responses. We note that such endeavours take time to evolve and therefore encourage the UK authorities continue

to maintain an open and permissive domestic approach that also provides the necessary foundations of regulatory and legal certainty required by market participants to pursue innovations involving DLT.

27. Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

Yes, we support this.

28. Do you have any views on how the government should bring these tokens into the regulatory perimeter in the future?

It is a point of intellectual curiosity that there may be little which separates tokens identified by the government as stabletokens unbacked by fiat currencies or assets is simply the mechanisms by which the value of the particular stabletoken is 'stabilised'. Conversely, most unregulated cryptoassets outside of the regulatory perimeter also often have mechanisms in place to incentivise their use and produce inflationary, or possibly deflationary, effects. As government and regulators gain greater comfort with the use by the market of stabletokens and cryptoassets more widely, it is suggested that similar approaches to stablecoins outlined above, cognisant of the many legal, political and economic ramifications which have still to be worked through, may prove fruitful for the regulatory community. Our view is that the introduction of new technologies does not necessarily alter the business processes undertaken by financial markets and regulation should reflect regulation by activity, and not by technology.

Under the current situation, we reiterate our comments regarding the ability for the UK to continue as a world-leader in the use of financial technology and, in light of the use of these tokens by retail consumers, suggest that the government and regulators may be advised to create a positive and clear environment for these speculative activities to take place and outline a path to future legislation in order to create a transparent and open environment for the activities of firms in the meantime. Such a positive environment will facilitate competition and innovation by allowing firms to invest in and develop new services using new technologies with a clear understanding of the regulatory environment.

29. What are the risks and opportunities you see in relation to Decentralised Finance (DeFi)?

Decentralised Finance (DeFi) presents significant financial crime risks due to these (often) peer-to-peer transactions being inherently less visible to regulated entities, and therefore open to abuse by criminals. Here, learning from international approaches may be beneficial. For instance, the December 2020 US Financial Crimes Enforcement Network's Advance Notice of Proposed Rulemaking sought to impose obligations upon Virtual Asset Service Providers to obtain counterparty names and physical addresses when certain thresholds were breached on transactions to or from unhosted wallets. If this approach was adopted, it would contain significant potential learnings for the UK.

We see the following risks as particularly relevant to DeFi:

- **Customer protection –** There is a risk of customer reimbursement being entirely inaccessible in DeFi. If a bank account password is forgotten, a customer can contact their bank to reset the password. Such an option is not necessarily accessible in DeFi as there is no one to contact in instances where passwords to wallets are forgotten. Additionally, there does not yet appear to be equivalent of a Financial Ombudsman Service or the Financial Services Compensation Scheme for cryptoasset transactions.

- **Anonymity –** There are significant “anonymisation” risks associated with cryptoassets which poses an increased risk from a financial crime perspective. While blockchain itself is designed to be traceable, transactions through unhosted wallets do not carry a wallet-owner’s name and other identifying details that are currently required for payments between accounts held at different financial institutions.
- **Transparency –** Specialist analytical technology can be used to trace such transactions, but such technology is used sporadically. This degree of intrinsic anonymity, especially when combined with anonymising tools such as “tumblers” further increase financial crime risks, as do certain specialist assets such as “privacy coins”.
- **Jurisdictional –** There are also jurisdictional risks to consider as no jurisdiction or link to a particular exchange is attached to DeFi transactions.

There is to our knowledge no significant consideration yet in the UK of ways to deal with the financial crime risks associated with DeFi, for instance through unhosted wallets. The US are considering mandating obliged cryptoasset exchanges to collect information both from their customers (with hosted wallets/accounts) and from the counterparties’ unhosted wallets once certain payment thresholds are reached. The UK should consider similar initiatives to deal with the risks presented by transactions that otherwise (without the use of specialist technology) have limited traceability.

As per previous comments, it is important that persons and entities undertaking the same activity, at the same risk, should be subject to the same regulation and UK Finance and our members look to continue working with the regulators to understand how this principle may be applied to DeFi use-cases.

30. Do you have any evidence of risks to consumers when using tokens as a form of speculative investment or through DeFi that may be of interest to the government and UK authorities?

Anecdotally, we have been made aware by members of customers who have made speculative investments in Bitcoin or other tokens and this investment resulting in a loss. We do, however, believe that, on a general basis, customers who invest in Bitcoin or other tokens are aware of the risks associated with a speculative investment in Bitcoin or other tokens.

There are nonetheless risks that extend beyond the risk of financial loss based on a speculative investment. These include fraud risks, the risk of lack of customer protection, and the risk of irretrievable loss of investment if a password to a DeFi wallet is forgotten. Consequently, we are of the view that government and UK authorities should seek to find ways to bring DeFi into the regulatory fold.

If you have any questions relating to this response, please contact Austin Elwood, Manager Payments Policy (austin.elwood@ukfinance.org.uk)

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