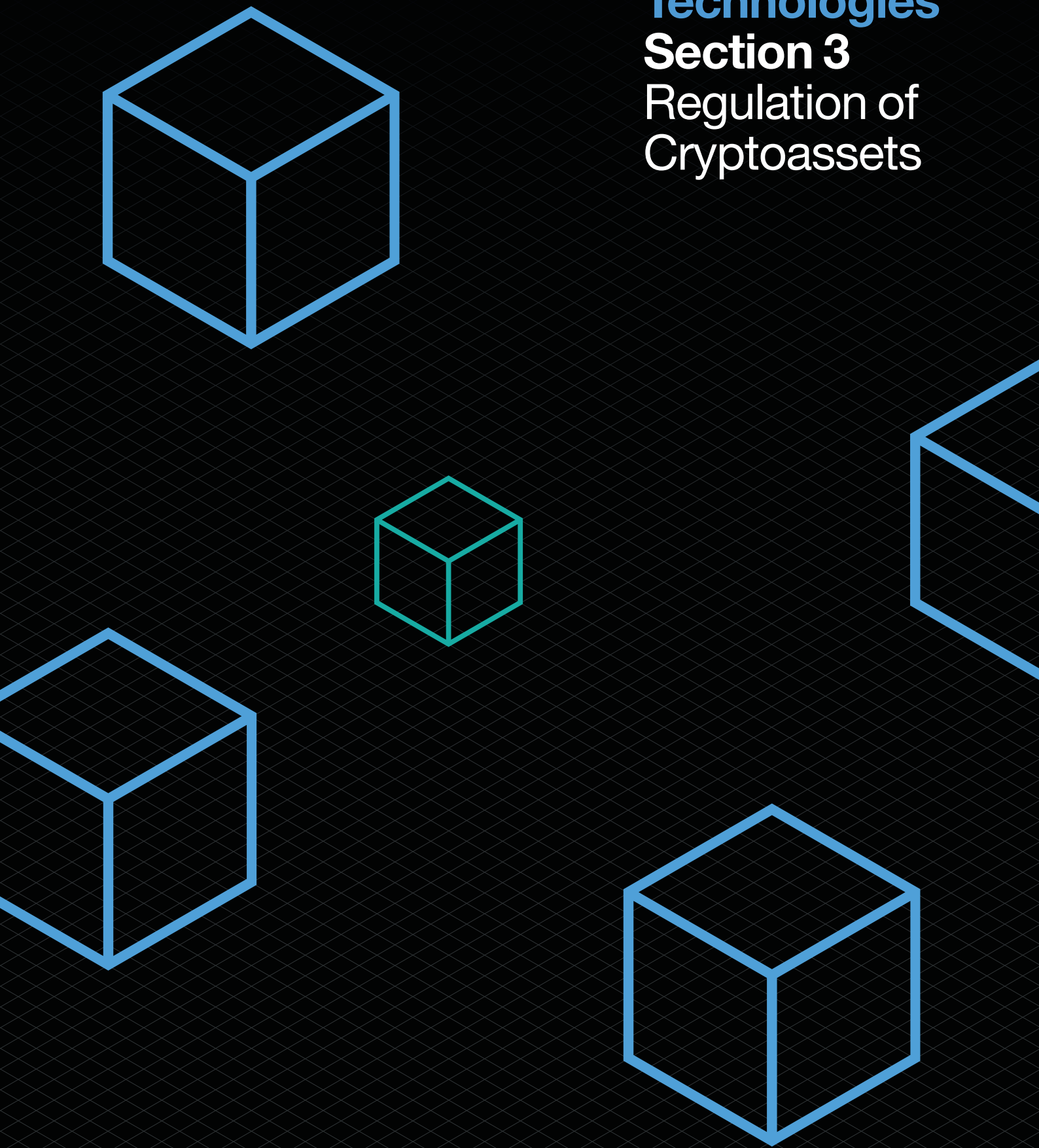
Part 1: Developing Technologies

Section 3 Regulation of Cryptoassets



Section 3: Regulation of Cryptoassets

Chloe Kearns, Morrison Foerster; Laura Douglas, Clifford Chance LLP; Martin Dowdall, Sidley Austin LLP

Introduction

At present, there is no specific UK regulatory regime for cryptoassets, other than in relation to anti-money laundering **(AML)** and counter-terrorist financing requirements for cryptoasset exchange providers and custodian wallet providers. Currently, the UK's approach to the regulation of cryptoassets is to consider which types of cryptoassets fall within the perimeter of the existing regulatory framework, based on a case-by-case analysis of the relevant cryptoasset's substantive characteristics. For those types of cryptoassets that do fall within the regulatory perimeter, different regulatory rules may apply depending on whether they are characterised as transferable securities, a deposit, electronic money (**e-money**) or another type of regulated financial instrument.

However, the scope of the UK's regulatory regime for cryptoassets will soon expand significantly. In particular, forthcoming legislation will extend the application of existing payment services and e-money regulation to fiat-referenced stablecoins and bring most cryptoassets within the existing financial promotions regime. The UK government is also consulting on a broader regime for the regulation of cryptoassets.

This chapter sets out:

— an overview of the current UK regulatory landscape, including:
  - gaps and issues within the existing framework;
  - regulatory intervention and enforcement to date; and
  - the broader legal context in the UK;

— an overview of proposed future UK regulation;

— a brief outline of the wider international regulatory context; and

— certain recommendations for UK regulators when designing the regulatory framework.

Current UK regulation

Categorisation of cryptoassets

The UK's current approach to regulating cryptoassets is articulated in the Final Guidance on Cryptoassets[5] **(the Final Guidance)**, published by the Financial Conduct Authority **(FCA)** in July 2019. The Final Guidance identifies the following categories of cryptoassets, which may be divided broadly according to their regulatory treatment:

A. Security tokens

Security tokens are cryptoassets which provide holders with rights and obligations similar to "specified investments" under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 **(RAO)**[6], such as shares, debentures or units in a collective investment scheme. Whether a cryptoasset constitutes a security token, i.e., a specified investment, will generally need to be assessed on a case-by-case basis.[7]

5 FCA, Guidance on Cryptoassets Feedback and Final Guidance to CP19/3 (Policy Statement, PS19/22) <https://www.fca.org.uk/publication/policy/ps19-22.pdf> Accessed December 2022.
6 The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/554.
7 The Final Guidance sets out a non-exhaustive list of factors that are indicative of a security token, including any contractual entitlement holders may have to share in profits or exercise control or voting rights in relation to the token issuer's activities. However, this factual analysis will often require the exercise of judgement when determining the extent to which a cryptoasset's substantive characteristics are similar to a particular type of specified investment.

B. E-money tokens

E-money tokens are cryptoassets that meet the definition of e-money under the Electronic Money Regulations 2011 **(EMRs)**.[8] For this purpose, e-money is defined as:

i. electronically (including magnetically) stored monetary value as represented by a claim on the issuer;
ii. which is issued on receipt of funds for the purpose of making payment transactions; and
iii. is accepted as a means of payment by persons other than the issuer (subject to certain exclusions set out in the EMRs).

Some aspects of the definition of e-money give rise to uncertainties, such as when a cryptoasset is considered "accepted as a means of payment" by a party. Additional ambiguities arise from the fact that the term "monetary value" is not defined, although this term is commonly understood to mean fiat currency. This particular characteristic may change during the life of a cryptoasset, meaning that a cryptoasset may become, or cease to qualify as, e-money at some point after its issuance.

The Final Guidance indicates that cryptoassets may move between categories throughout their lifetime.[9] This creates particular uncertainties, as an e-money issuer generally requires authorisation under the EMRs (unless it is a credit institution), whereas firms dealing in, or advising on, security tokens will typically need to be authorised under FSMA with the relevant regulatory permissions. As such, different ongoing conduct of business rules will apply depending on the type of cryptoasset.

Similar uncertainties arise in the case of 'hybrid' tokens which exhibit characteristics of more than one category of cryptoasset (such as security tokens and e-money tokens). It would therefore be helpful for the FCA to clarify how it expects firms to proceed in these cases.

C. Unregulated tokens

Unregulated tokens include all other types of cryptoassets which are not treated as regulated financial instruments or products. In general, this means that firms carrying on activities relating to unregulated tokens fall outside the regulatory perimeter. In practice, many 'cryptocurrencies' marketed to consumers currently fall within the category of unregulated tokens. There are, however, some exceptions to this, such as cryptocurrency derivatives.

Overview of current UK regulation

As noted above, cryptoassets that constitute e-money tokens will be subject to the EMRs. Below, we have set out a high-level overview of existing regulatory rules which apply to security tokens and other cryptoassets that fall within the regulatory perimeter, and to firms dealing with cryptoassets.

A. Rules applying to security tokens

Different types of security tokens are subject to different regulatory rules. For example:

i. security tokens meeting the definition of "transferable securities" under the UK version of the Markets in Financial Instruments Regulation **(MiFIR)**[10] are within the scope of prospectus rules and requirements;

8 The Electronic Money Regulations 2011, SI 2011/99.
9 The Final Guidance, paragraph 22.
10 Regulation (EU) No 600/2014 of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Regulation (EU) No 648/2012 (Retained EU Legislation).

ii. security tokens that do not meet the MiFIR definition of transferable securities (for example because there are contractual restrictions on transfer) may nevertheless fall within the UK crowdfunding regime;[11]
iii. in other cases, security tokens may qualify as units in a collective investment scheme under section 235 of the Financial Services and Markets Act 2000 **(FSMA)** and/or an alternative investment fund (AIF) as defined in the Alternative Investment Fund Managers Regulations 2013.[12]

Determining the applicable regulatory rules for a given type of security token will be a question of fact requiring careful case-by-case analysis. The position is complicated by the lack of clarity over the meaning of some key terms in the relevant legislation.[13] A general clarification as to the meaning of "instruments of payment", as used in the definition of "transferable securities", would provide greater certainty to market participants.

B. Cryptocurrency derivatives

In April 2018, the FCA published a statement indicating that cryptocurrency derivatives may be financial instruments for the purpose of the EU Markets in Financial Instruments Directive **(MiFID2)**[14] (but that it did not consider cryptocurrencies themselves to be currencies or commodities for regulatory purposes under MiFID2). However, the FCA did not expressly indicate which categories of derivatives it considers cryptocurrency derivatives to be under Section C of Annex I MiFID2. The FCA should consider providing clarity on its position with respect to the classification of cryptocurrency derivatives; this point would have significant ramifications for firms that deal in cryptocurrency derivatives, as different rules apply to different classes of derivatives under MiFID2.

In the absence of additional guidance from the FCA, it seems likely that cryptocurrency derivatives will be treated as "other derivative contracts" under Section C(10) Annex I of MiFID2. However, a case-by-case analysis would be needed to determine whether the cryptocurrency derivative in question meets the conditions. For example, cryptoassets representing "rights to receive services" may not count as relevant underlyings for the purposes of Section C(10); similarly, not all physically-settled derivatives will fall within Section C(10). Alternatively, cash-settled contracts for differences (CFDs) relating to cryptocurrencies might fall within Section C(9), to the extent that they are regarded as "financial contracts for differences".

Even for cryptoasset derivatives that do not qualify as MiFID2 financial instruments, consideration would also need to be given as to whether such cryptoasset derivatives are nevertheless specified investments falling within one of the broader categories of futures, options and CFDs under the RAO.

The FCA has provided some guidance that would be relevant where a cryptoasset derivative falls within a broader category of specified investments. Recently, the FCA introduced new conduct of business rules restricting how firms can sell, market or distribute CFDs and similar products (including those that reference cryptocurrencies) to retail consumers.[15] On 6 January 2021, it also introduced a ban on the sale, marketing or distribution of derivatives and exchange of traded notes referencing cryptoassets to retail clients.[16]

11 Related financial promotion rules for non-readily realisable securities may also apply to other specified investments.
12 The Alternative Investment Fund Managers Regulations 2013, SI 2013/1773. A security token of this kind would attract application of specific regulatory rules such as the requirement for an AIF to be managed by an alternative investment fund manager (AIFM) responsible for compliance with the UK regulatory requirements applicable to AIFs and AIFMs.
13 For example, the term "instruments of payment" as used in the definition of "transferable securities" is not clearly defined. The test for determining whether a particular cryptoasset structure qualifies as an AIF is also complex, despite the existence of relevant case law and FCA guidance.
14 Council directive 2014/65/EU of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (2014) OJ L173/349. Post-Brexit, MiFID2 has been on-shored via statutory instruments and amendments to the FCA Handbook and the Prudential Regulation Authority Rulebook.
15 FCA, Restricting contract for difference products sold to retail clients (Policy Statement PS19/18, July 1019) <https://www.fca.org.uk/publication/policy/ps19-18.pdf>. Accessed December 2022.
16 FCA, Prohibiting the sale to retail clients of investment products that reference cryptoassets (Policy Statement PS20/10, October 2020) <https://www.fca.org.uk/publication/policy/ps20-10.pdf> Accessed December 2022; see also COBS 22.6.

C. Money Laundering Regulations

Regulators, including the FCA, have highlighted the risk of cryptoassets being used for financial crime.[17] Since January 2020, "cryptoasset exchange providers" and "custodian wallet providers" carrying on business in the UK have needed to be registered with the FCA and to comply with AML-related requirements set out under the UK's Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 **(MLRs)**.[18] Registration involves a detailed application process and the majority of applicant firms to date have withdrawn their application or been refused registration by the FCA. The FCA recently provided feedback to assist applicants in distinguishing between good- and poor-quality registration applications.[19]

In August and September 2022, the MLRs were amended to bring in additional requirements for registered cryptoasset businesses (i.e., cryptoasset exchange providers and custodian wallet providers that are registered with the FCA). Among other things, the amendments have:

i. introduced a change of control regime for the acquisition of registered cryptoasset businesses, which requires persons who wish to acquire or increase their existing control over such businesses to seek prior approval from the FCA before an acquisition can take place; and[20]
ii. extended the Financial Action Task Force's Recommendation 16 (known as the "Travel Rule") to cryptoassets. From 1 September 2023, registered cryptoasset businesses will be required to send and record information (including names and account numbers) relating to the originator and beneficiary of relevant cryptoasset transfers.[21]

Who falls within scope of the MLRs?

The definition of "cryptoasset" introduced under the MLRs is broad, encompassing both regulated and unregulated types of cryptoassets.[22] There are, however, some uncertainties as to what businesses and activities are captured by the definitions of "cryptoasset exchange provider" and "custodian wallet provider".[23] In particular:

i. The definition of "cryptoasset exchange provider" includes firms "exchanging, or arranging or making arrangements with a view to the exchange of" (i) cryptoassets for money, (ii) money for cryptoassets or (iii) one cryptoasset for another. HM Treasury's **(HMT)** response to its consultation on the relevant rules suggests that this language is intended to capture firms facilitating peer-to-peer exchange services or completing, matching, or authorising a transaction between two people. However, the words "arranging" or "making arrangements with a view" are also used in Article 25 RAO, where they carry a different meaning. In the context of Article 25 RAO, the FCA takes the view that "making arrangements with a view to transactions in investments" has a much wider scope and is not, for example, limited to arrangements in which investors participate. Guidance published by the Joint Money Laundering Steering Group **(JMLSG)**[24] aims to provide practical advice on this point but cautions that various types of activities may require case-by-case analysis.

17 See, for example, the FCA's Dear CEO Letter dated 11 June 2018 ("Cryptoassets and financial crime") <Dear CEO letter: Cryptoassets and financial crime (fca.org.uk)> Accessed December 2022.
18 Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, SI 2017/692. Cryptoasset exchange providers and custodian wallet providers also fall within the regulated sector for the purposes of the Proceeds of Crime Act 2002 and the Terrorism Act 2000. As a result, they are required, in practice, to report knowledge or suspicions of money laundering and/or terrorist financing to the National Crime Agency via Suspicious Activity Reports. Separately, from 30 March 2022, registered cryptoasset businesses have been required to submit an Annual Financial Crime Report (the "REP-CRIM return") to the FCA.
19 FCA, Cryptoasset AML/CTF regime: feedback on good and poor quality applications (25 January 2023) <https://www.fca.org.uk/cryptoassets-aml-ctf-regime/feedback-good-poor-quality-applications> Accessed March 2023.
20 Regulation 60B and Schedule B MLRs.
21 See Part 7A MLRs.
22 "a cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology and can be transferred, stored or traded electronically."
23 Regulation 14A MLRs.
24 The Joint Money Laundering Steering Group Guidance – Part II: Sector 22 (June 2020 (amended July 2020)) <https://jmlsg.org.uk/consultations/current-guidance/> Accessed October 2022. Practitioners may also wish to refer to guidance published by the Financial Action Task Force (October 2021) <https://www.fatf-gafi.org/publications/fatfrecommendations/documents/guidance-rba-virtual-assets-2021.html> Accessed December 2022.

ii. The definition of a "custodian wallet provider" refers to safeguarding, or safeguarding and administering, (i) cryptoassets or (ii) private cryptographic keys, on behalf of customers. However, it is unclear how a custodian could hold cryptoassets for another person without holding the private cryptographic key, based on our understanding of the operation of DLT blockchains and cryptoassets. It is therefore unclear when a service provider would be deemed to safeguard (or safeguard and administer) cryptoassets, as opposed to private cryptographic keys, for its customers.

As regards the territorial scope of the MLRs, the FCA had stated that:

> *"just because a firm interacts with UK customers, does not mean it needs to be registered with us and adhere to the MLRs under the regime. The current regulatory scope for cryptoasset activities, which is set out in legislation, means overseas firms can relatively easily undertake cryptoasset activity in the UK but remain outside of the FCA's remit – which has created risks of regulatory arbitrage and a confusing position for consumers and firms."*[25]

On that basis, it seems the current focus of the FCA under the MLRs regime is on firms that provide cryptoasset exchange and custodian wallet services from the UK. However, the forthcoming extension of the UK regulatory financial promotions regime and licensing framework to capture cryptoassets more broadly will also impact non-UK firms seeking to promote or provide cryptoasset services on a cross-border basis into the UK (as discussed further below).

D. Licensing and conduct of business requirements

The licensing and conduct of business requirements that apply to firms dealing with cryptoassets differ depending on how the relevant cryptoasset is characterised under the current UK regulatory framework (in particular, whether the cryptoasset is a security token or e-money token) as well as the types of activity that the firm is carrying on in relation to the cryptoasset. A brief overview of the position is set out below.

i. Licensing and registration

Firms carrying out regulated activities in the UK with respect to security tokens or regulated cryptocurrency derivatives will need to be authorised under FSMA with the relevant regulatory permissions, just as they would when carrying out activities with respect to traditional types of securities. Issuers of e-money tokens will need to be authorised or registered as such under the EMRs (unless authorised as a credit institution) and firms dealing with e-money tokens may be carrying out regulated payment services requiring authorisation or registration under the Payment Services Regulations 2017 **(PSRs)**.[26] To carry out these activities in the UK without the necessary authorisation or registration is a criminal offence.

Firms dealing with unregulated cryptoassets (other than cryptoasset derivatives) will not be subject to licensing requirements under FSMA, the EMRs or the PSRs. However, cryptoasset exchange providers and custodian wallet providers are still required to register with the FCA under the MLRs (see above). Whilst not a formal licensing regime, FCA registration does involve the submission of detailed information about the firm and the FCA will only register a firm if it is satisfied the firm, its beneficial owners, officers, and managers are "fit and proper".

25 FCA written evidence to the Treasury Committee's inquiry into the cryptoasset industry (September 2022) <https://committees.parliament.uk/work/6843/the-cryptoasset-industry/publications/written-evidence/?SearchTerm=financial+conduct+authority&DateFrom=&DateTo=&SessionId=> Accessed December 2022.
26 Payment Services Regulations 2017, SI 2017/752.

Cryptoasset exchange providers and custodian wallet providers will also need to comply with the AML-related requirements of the MLRs on an ongoing basis, as will firms authorised (or registered) under FSMA, the EMRs and PSRs. The JMSLG sectoral guidance[27] relating to cryptoassets highlights various factors that give rise to money laundering and terrorist financing risks in this area (including some specific to cryptoassets, such as privacy or anonymity and the decentralised and cross-border nature of many cryptoasset structures) along with indicative practical mitigation strategies. These strategies may include blockchain analysis or tracing, as well as more traditional AML risk-mitigation strategies.

ii. Conduct of business rules

Firms that are authorised (or registered) under FSMA, the EMRs or the PSRs will be subject to ongoing conduct of business requirements in relation to their cryptoasset activities. Firms issuing security tokens that qualify as transferable securities will also be subject to prospectus rules and certain other ongoing requirements applicable to issuers of transferable securities (but will not generally require authorisation).

The statutory and regulatory rules setting out these ongoing conduct of business obligations are generally drafted in a technology-neutral manner. However, they do embed certain assumptions about how financial markets operate that do not necessarily hold true of cryptoassets. This creates challenges in interpreting and applying certain existing conduct of business rules to cryptoassets. There are also certain gaps and issues in current conduct of business rules that may require further adaptation to cater for cryptoassets, both in terms of enabling innovation and addressing risks specific to cryptoassets.

Issues and gaps under existing UK regulation

A lack of clarity under existing regulation gives rise to some uncertainty as to the scope and application of those rules. Two specific examples are set out below. More generally, as can be seen from the overview set out above, the scope of existing regulation is very limited. In general, many 'cryptocurrencies' constitute unregulated tokens and are not currently subject to existing regulation (beyond the MLRs regime described above, if applicable). There are a number of key areas in which there is currently no regulation. At present, for example, UK financial services regulators do not have conduct, prudential or consumer protection powers over the cryptoasset market. The FCA has warned that the lack of regulation gives rise to potential harm to consumers and market integrity.[28] Further, the Bank of England **("BoE")** has highlighted the need for enhanced regulatory frameworks to manage the systemic risks that will emerge should cryptoasset activity and its interconnectedness with the wider financial system continue to develop.

A. Custody of cryptoassets
As previously noted in this section, there remains uncertainty as to which services and activities, other than holding private keys for clients, may qualify as custody or safekeeping and administration of cryptoassets. At present, custody of cryptoassets is a regulated activity in the UK only in respect of cryptoassets that are regulated financial instruments. However, for these types of regulated cryptoassets, further questions arise about how FCA client asset rules under CASS[29] might apply. This is particularly the case, for example, where a regulated custodian safeguards a private key but cannot be said to safeguard the

27 The Joint Money Laundering Steering Group Guidance – Part II: Sector 22 (June 2020 (amended July 2020)) https://jmlsg.org.uk/consultations/current-guidance/ Accessed October 2022.
28 Aside from the harms caused by the promotion of cryptoassets to consumers, the FCA has recently warned, among other things, that the lack of safeguarding requirements for cryptoassets may allow firms to lend consumer assets to third parties to generate revenue, potentially putting those assets at risk; and that the absence of regulation relating to the trading of cryptoassets means that the cryptoasset market may be more vulnerable to traditional forms of market manipulation. See the written evidence submitted to the Treasury Committee by the FCA in September 2022.
29 The Client Assets sourcebook, the FCA Handbook.

cryptoasset itself, or where the cryptoasset may not be considered property (or an "asset" of the client) from a legal perspective.

B. Settlement of transactions in cryptoassets and implications of CSDR book-entry form requirements
Greater certainty would be welcomed around the concepts of settlement and settlement finality as they apply to cryptoassets, including consideration of the role of miners and other novel actors in the settlement process.

There are practical challenges in applying certain existing regulatory requirements governing post-trade market infrastructure to cryptoassets, including the Central Securities Depositories Regulation **(CSDR**). In particular, cryptoassets that are transferable securities and are traded or admitted to trading on a MiFID trading venue are subject to requirements under CSDR for the securities to be recorded in book-entry form in a central securities depository (**CSD**). There are different ways in which stakeholders may seek to meet this requirement, but each presents its own practical challenges.

One approach may involve the DLT platform operator (if one exists) becoming an authorised CSD under CSDR. This also raises questions about whether the DLT platform operator may be considered a "securities settlement system" under the Settlement Finality Directive and whether it may need to be designated as such. This would have significant regulatory and practical implications for the DLT network. For example, a securities settlement system needs to be operated by a "system operator", which would be particularly challenging for decentralised platforms. As noted above, only certain types of firms can be participants in a designated system, which may again cause issues if a DLT platform were designated where individuals are currently members.

An alternative structure could involve recording the cryptoassets in an existing authorised CSD and for one or more of the participants in the DLT network to also participate in the relevant CSD. In this case, the settlement of transactions as between the DLT network participants outside of the CSD may qualify as settlement internalisation, which is permitted under CSDR, subject to certain reporting requirements. However, this may not always be a viable practical solution. The new UK FMI sandbox (as discussed below) is expected to allow for possible solutions to these types of practical issues to be explored in a controlled environment.

The broader legal context in the UK

It is important for market participants to understand how cryptoassets are treated from a broader legal perspective, in addition to understanding the regulatory characterisation and treatment of cryptoassets. Key issues include whether English law recognises cryptoassets as property and, if so, how they can be transferred, how security can be taken over them and how ownership rights can be enforced.

A. The treatment of cryptoassets as property
In November 2019, the UK Jurisdiction Taskforce issued a statement (the **"Legal Statement"**), which confirmed that cryptoassets are capable of being owned and transferred as property under English law and that smart contracts are capable of constituting binding legal contracts. Whilst the Legal Statement itself is not binding, these questions have also been considered by the English courts, notably in the case of AA v Persons Unknown,[30] where Mr Justice Bryan expressly considered the Legal Statement and agreed with its conclusions, holding in this case that Bitcoin was a form of property capable of being the subject of a proprietary injunction. Subsequent decisions have likewise recognised that cryptoassets are capable of being treated as property.

30 AA v Persons Unknown [2019] EWHC 3556 (Comm).

Not every use of DLT will result in creation of a cryptoasset that qualifies as property under English law. A clear example is where DLT is used for record keeping purposes only, for example, if DLT is used in the book-building phase of a digital securities issuance. In other cases, a cryptoasset (or crypto-token) may be a digital record of ownership of a traditional asset (whether physical property such as real estate or art or an intangible asset such as a dematerialised security) rather than the asset itself.[31] As well as determining the legal rights and remedies that may apply in respect of the cryptoasset, understanding whether it is itself an asset, or property, is relevant when considering whether certain regulatory rules apply, such as the FCA's client asset rules.

In July 2022, the Law Commission of England and Wales published a Consultation Paper setting out its recommendations for law reform in respect of certain digital assets as objects of property rights, inviting feedback by 25 November 2022.[32] The Consultation proposed introducing a third category of personal property called "data objects", intended to deal specifically with digital assets, which do not seem to fit neatly into either of the two existing categories of property under English law, namely things in possession and things in action. Whilst to date, English case law has been flexible enough to recognise that digital assets including Bitcoin and non-fungible tokens **(NFTs)** can attract property rights, the sub-classification as a particular type of property will impact questions such as how to establish ownership of the asset, how it is transferred, whether the asset can be held on trust and how security can be granted over it, how it is treated in insolvency and what remedies may be available in a claim involving cryptoassets.

B. Issues relating to conflicts of laws
There are often difficult questions about which law will apply to proprietary aspects of dealings in cryptoassets – namely, whether English law is the relevant law to decide these questions in respect of a particular cryptoasset. These conflicts of laws issues are particularly acute for native cryptoassets and decentralised, permissionless structures where it is very difficult to conclude that the cryptoasset is situated in any particular jurisdiction. In light of this, the Legal Statement indicates that the normal rules on applicable law may well not apply but that it is unclear which rules should apply instead.

A change to the law as well as international cooperation will likely be needed in order to resolve these conflicts of laws issues satisfactorily. In the meantime, firms issuing cryptoassets could seek to increase legal certainty by specifying which law should govern the proprietary aspects of dealings in the cryptoassets as part of the underlying DLT structure – although this solution may not always be practicable or sufficient.

Regulatory intervention and enforcement

Given the narrow scope of the UK cryptoasset regulatory regime, the FCA currently has limited powers to intervene or take enforcement action against cryptoasset businesses.

To date, as might therefore be expected, there has been limited public intervention or enforcement action of this kind. In June 2021, the FCA publicly imposed requirements on one FCA-authorised firm operating in the cryptoasset industry, stipulating that the firm was not permitted to undertake any regulated activity in the UK without the FCA's prior consent. It also warned that another leading cryptoasset business may have been providing financial services or products in the UK without the required authorisation. Further, in March 2022, the FCA issued a warning to operators of crypto ATMs in the UK (none of whom have been registered with the

31 The Law Commission Consultation Paper mentioned below proposes imbuing such crypto-tokens with "property" status in their own right (in a similar way to the fact that a piece of paper is property in its own right, regardless of what is written on it).
32 Law Commission, Digital Assets: Consultation paper (Consultation paper 256, July 2022) <Digital assets | Law Commission> Accessed December 2022.

FCA under the MLRs to date) to shut down their machines or face enforcement action. It has since announced that it is working with law enforcement partners, including local police forces, to "disrupt and disable illegal Crypto ATMs" and that it has exercised its powers to enter and inspect the premises of certain suspected illegal operations.[33]

Beyond the limited intervention set out above, the FCA's actions have largely focused on raising consumer awareness of the risks associated with investing in cryptoassets,[34] as well as reminding authorised firms with exposure to cryptoassets of the need to, among other things,[35] manage financial crime risks, and managing the regulatory 'gateway' by refusing numerous applications for registration under the MLRs where firms were found not to have met the required standards (and, in some cases, working with firms to improve their systems and controls).

Looking ahead, we expect to see an uptick in intervention and enforcement action when the future UK regulatory changes outlined below are implemented and, in particular, once the financial promotions regime has been extended to unregulated cryptoassets. Consistent with this, the FCA warned in a statement published in February 2023 that it will take "robust action" against firms breaching the financial promotions requirements for cryptoassets once they come into force.[36]

Future regulation in the UK

Addressing key gaps in existing regulation has been a priority for HMT, the FCA and the BoE, and the UK is due to implement significant changes to the existing regulatory regime. An overview of the expected changes is set out below. Further, as explained below, the UK is consulting on the shape of a wider UK regulatory framework for cryptoassets.

Stablecoins and central bank digital currencies (CBDCs)

A. Regulation of fiat-linked stablecoins

In April 2022, HMT published its response to its consultation on the UK regulatory approach to cryptoassets, stablecoins, and the use of distributed ledger technology in financial markets (the **Stablecoin Consultation Response**).[37]

The Stablecoin Consultation Response confirmed that HMT plans to extend regulatory authorisation, governance, conduct of business, and reporting requirements under existing payment services and e-money regulations to include certain activities relating to fiat-linked stablecoins. HMT has identified the regulation of stablecoins as a priority given the potential for stablecoins to become a widespread means of payment.

The Stablecoin Consultation Response's proposals are limited to stablecoins that reference a single fiat currency or a basket of fiat currencies. However, these proposals will apply to firms engaged in "activities that issue or facilitate the use of stablecoins used as a means of payment" as well as firms that provide or arrange custody of stablecoins.

Additionally, the definition of "electronic money" under the EMRs will be extended to include fiat-linked stablecoins. As a consequence, holders of such

33 FCA press release (February 2023) "FCA takes action against unregistered crypto ATM operators in Leeds" Accessed February 2023.
34 See, for example, the consumer warnings issued by the FCA on 11 January 2021 and 11 May 2022, alongside comments in various FCA speeches.
35 See the notice issued by the FCA on 24 March 2022 to all authorised firms with exposure to cryptoassets; the joint statement on sanctions and the cryptoasset sector issued on 11 March 2022; and the Dear CEO Letter titled "Cryptoassets and financial crime" issued on 11 June 2018.
36 FCA, "Cryptoasset firms marketing to UK consumers must get ready for financial promotions regime" (February 2023) <Cryptoasset firms marketing to UK consumers must get ready for financial promotions regime> Accessed February 2023.
37 HMT, "UK regulatory approach to cryptoassets, stablecoins, and distributed ledger technology in financial markets: Response to the consultation and call for evidence" (April 2022) <O-S_Stablecoins_consultation_response.pdf (publishing.service.gov.uk)> Accessed December 2022.

stablecoins will have a statutory right to redeem their coins on demand and at par value. In recognition of the fact that the holder of a stablecoin may not always have a relationship with the issuer, the proposals provide that holders should generally be able to make a claim against either the issuer of the stablecoin or the customer-facing entity as appropriate. Issuers of fiat-linked stablecoins will also need to safeguard funds received in exchange for stablecoins on a one-to-one basis.

References to custodial services are intended to capture wallet providers as well as exchanges offering similar services. Such firms will be subject, among other vthings, to:

- prudential and organisational requirements;
- reporting requirements;
- conduct of business requirements;
- operational resilience requirements;
- custody/safeguarding requirements; and
- consumer protections.

B. Provision for stablecoin regulation and proposed digital settlement assets regime under the FSMB

Following the publication of the Stablecoin Consultation Response, a draft of The Financial Services and Markets Bill 2022 **(FSMB)** was published. That draft is currently making its way through Parliament. The FSMB will pave the way for the regulation of fiat-linked stablecoins, and possibly the regulation of other cryptoassets (in relation to which, please see further below).

Specifically, the FSMB introduces powers for HMT to bring stablecoins used as means of payment and similar "digital settlement assets" **(DSAs)** within the scope of regulation. DSAs are defined as a digital representation of value or rights, whether or not cryptographically secured, that:

i. can be used for the settlement of payment obligations;
ii. can be transferred, stored or traded electronically; and
iii. uses technology supporting the recording or storage of data (which may include DLT).

The definition of DSAs is potentially very wide and one which, as explained below, can be expanded by HMT in future. Under the FSMB, as currently drafted, HMT is to be granted a range of powers to regulate services and activities relating to DSAs. In particular, HMT will:

- be empowered to establish an FCA authorisation and supervision regime for issuers of DSAs and payment service providers using DSAs, drawing broadly on existing e-money and payments regulation to mitigate conduct, prudential and market integrity risks;
- have powers to recognise operators of systemic payment systems using DSAs and service providers to those payment systems, bringing them within scope of BoE supervision, via amendments to its existing powers to recognise systemic payment systems under the Banking Act 2009. Similarly, the Payment Systems Regulator (**PSR**) will have powers to regulate payment systems using DSAs, including powers to give directions relating to direct and indirect access to such systems; and
- be empowered to extend the FMI special administration regime **(SAR)** to systemic DSA firms, with appropriate modifications. The FMI SAR is a bespoke administration regime for recognised payment and settlement systems and service providers to mitigate the risks to financial stability associated with their failure. In May 2022, HMT consulted on how it intends to extend the FMI SAR to systemic DSA firms, including how the FMI SAR would take precedence over the payment and e-money special administration regime **(PESAR)** in cases of overlap.[38]

38 HMT, "Managing the failure of systemic digital settlement asset (including stablecoin) firms: Consultation" (May 2022) <https://www.gov.uk/government/consultations/managing-the-failure-of-systemic-digital-settlement-asset-including-stablecoin-firms> Accessed December 2022.

An important distinction between the two special administration regimes is that the FMI SAR would impose an objective on administrators to pursue the continuity of a failed payment system's services ahead of the interests of its creditors, whereas the focus of the PESAR is on the prompt return of customer funds. As both objectives may be important in the case of a failed systemic DSA firm, HMT's consultation proposed that the FMI SAR for systemic DSA firms impose an additional objective on administrators, covering the return or transfer of funds and custody assets. The BoE would also be required to consult with the FCA before exercising its powers under the FMI SAR with respect to a systemic DSA firm.

C. BoE work on a proposed UK CBDC

For a number of years, the UK has been considering whether to introduce a retail CBDC that would complement existing forms of central bank (and commercial bank) money. A retail CBDC would be a new form of digital money, denominated in Sterling and issued by the BoE, that could be held and used by retail end users, i.e. consumers.

In March 2020, the BoE published an initial discussion paper on CBDC, which outlined a possible approach to the design of a UK CBDC.[39] Responses were published in July 2021[40]. In April 2021, the Bank and HMT set up a joint CBDC Taskforce to coordinate the exploration of a potential UK CBDC. Alongside this, the BoE published a discussion paper on new forms of digital money (including both systemic stablecoins and a UK CBDC) in June 2021,[41] which assessed and sought feedback on the possible opportunities and risks that a UK retail CBDC could bring.

Following the initial work of the CBDC Taskforce during 2021 and 2022, in February 2023, HMT and the Bank of England published a consultation[42] on the design of a potential UK retail CBDC. This consultation paper sets out analysis conducted by HMT and the Bank of England to date on the potential case for a UK retail CBDC and seeks feedback on the key features of a potential retail CBDC model. If the UK does decide to proceed with a retail CBDC, this will be a major infrastructure project spanning several years. Therefore, it is expected that the earliest 'go-live' date for a UK CBDC would be towards the end of this decade.

HMT consultation on future financial services regulatory regime for cryptoassets

In February 2023, HMT published a consultation and call for evidence on the future financial services regulatory regime for cryptoassets **(the Cryptoasset Consultation)**.[43] The Cryptoasset Consultation sets out the UK government's proposal to regulate cryptoassets other than fiat-referenced stablecoins.[44]

The Cryptoasset Consultation closes on 30 April 2023. The UK government has not yet confirmed when it plans to implement the new regulatory proposals, but final rules could be made during 2024-2025 and possibly even earlier.

39 BoE, "Central Bank Digital Currency: opportunities, challenges and design" Discussion Paper (March 2020) <https://www.bankofengland.co.uk/paper/2020/central-bank-digital-currency-opportunities-challenges-and-design-discussion-paper> Accessed December 2022.
40 BoE, "Responses to the Bank of England's March 2020 Discussion Paper on CBDC" (June 2021) <https://www.bankofengland.co.uk/paper/2021/responses-to-the-bank-of-englands-march-2020-discussion-paper-on-cbdc> Accessed December 2022.
41 BoE, "New forms of digital money" Discussion Paper (June 2021) <https://www.bankofengland.co.uk/paper/2021/new-forms-of-digital-money> Accessed December 2022.
42 HMT, "The digital pound: A new form of money for households and businesses?" (February 2023) < https://www.gov.uk/government/consultations/the-digital-pound-a-new-form-of-money-for-households-and-businesses> (accessed February 2023).
43 HMT, "Future financial services regulatory regime for cryptoassets Consultation and call for evidence" (February 2023) <https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1133404/TR_Privacy_edits_Future_financial_services_regulatory_regime_for_cryptoassets_vP.pdf> (accessed February 2023).
44 The UK government's approach to the regulation of fiat-referenced stablecoins is set out in the Stablecoin Consultation Response. See above for a description of these proposals.

In the Cryptoasset Consultation, HMT rules out creating a bespoke regulatory regime for cryptoassets. Instead the Cryptoasset Consultation proposes:

— extending the scope of FSMA to cover a wide range of cryptoasset services thereby requiring firms providing these services to be authorised under FSMA;

— utilising the Designated Activities Regime **(DAR)** (a proposed regulatory framework to be created by the FSMB) to impose requirements on certain cryptoasset activities even when such activities are not subject to an authorisation requirement under FSMA or otherwise;

— imposing disclosure and transparency obligations on issuers of cryptoassets and the operators of trading venues where cryptoassets are traded; and

— introducing a market abuse regime for cryptoassets.

A. Extension of FSMA to cryptoasset services

In-scope cryptoassets

The Cryptoasset Consultation proposes introducing the FSMB definition of "cryptoasset" into FSMA. The FSMB defines cryptoassets as:

"any cryptographically secured digital representation of value or contractual rights that—

(a) can be transferred, stored or traded electronically, and

(b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)."

This is a broad definition and the Cryptoasset Consultation sets out the following indicative, non-exhaustive list of the types of cryptoassets that could be subject to regulation under these proposals.

— exchange tokens;
— utility tokens;
— NFTs;
— asset-referenced tokens;
— commodity-linked tokens;
— crypto-backed tokens;
— algorithmic tokens;
— governance tokens; and
— fan tokens.

The UK government's intention is to include cryptoassets in the list of "specified investments" in Part III of the RAO. This clarifies that persons (natural or legal) who are carrying out certain activities involving cryptoassets "by way of business" would be performing regulated activities and therefore require authorisation under Part 4A of FSMA. The effect of this is that the FCA will be able to exercise its general rule-making powers in relation to cryptoasset activities. This will allow the FCA to write tailored rules for cryptoassets as opposed to simply applying existing rules for traditional financial instruments.

In-scope activities

The Cryptoasset Consultation sets out a list of illustrative cryptoasset activities that HMT proposes to bring within the regulatory perimeter.[45] These activities are:

45 This Cryptoasset Consultation also lists the activities that are within the scope of the Stablecoin Consultation Response. In this section we focus only on those activities that are not covered by this earlier consultation. The Cryptoasset Consultation notes also that additional activities such as mining or validating transactions or operating a node on a blockchain may be addressed in future regulation.

i. issuance activities:

a. admitting a cryptoasset to a cryptoasset trading venue; and
b. making a public offer of a cryptoasset (including as part of an ICO);

ii. exchange activities: operating a cryptoasset trading venue (the exchange of cryptoassets for other cryptoassets, the exchange of cryptoassets for fiat currency and the exchange of cryptoassets for other assets (e.g. commodities)) [46];

iii. investment and risk management activities:[47]
a. dealing in cryptoassets as principal or agent;
b. arranging (bringing about) deals in cryptoassets; and
c. making arrangements with a view to transactions in cryptoassets;

iv. lending, borrowing and leverage activities:
a. operating a cryptoasset lending platform; and

v. safeguarding and/or administration (custody) activities:
a. safeguarding or safeguarding and administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset.

HMT states that its intention is to incorporate the full scope of activities that currently require registration under the MLRs into the regulatory perimeter of FSMA. This reduces the scope for potential confusion as to which regime applies but does mean that cryptoasset firms currently registered under the MLRs will need to seek authorisation going forwards and be subject to additional regulatory obligations. The Cryptoasset Consultation states that the FCA will adopt a timely and proportionate authorisation process for complete and accurate applications and will endeavour to avoid duplicative information requests of businesses, taking into account the supervisory history of businesses during the authorisation process.

The Cryptoasset Consultation notes also that additional activities such as mining or validating transactions or operating a node on a blockchain may be addressed in future regulation.

Proposed territorial scope

The UK government proposes to regulate cryptoasset activities that are provided from the United Kingdom or to customers in the United Kingdom (regardless of where the service provider is located).

HMT states in the Cryptoasset Consultation that this approach is in line with other areas of the UK's regulatory perimeter. However, some key features of existing regulatory regimes are not mentioned in the Cryptoasset Consultation. In particular, the "overseas person" exclusion in the RAO, and the general "characteristic performance" test, are not mentioned. It is also not entirely clear whether the territorial scope of the activities identified in the Stablecoin Consultation Response will be the same as for the activities addressed in the Cryptoasset Consultation given the former is based on the existing payment services regime and the latter on FSMA. Regarding the former, the FCA has stated that it: "would not generally expect a payment services provider incorporated and located outside the UK to be within the scope of the regulations, if all it does is to provide internet-based and other services to UK customers from that location."[48]

46 The Cryptoasset Consultation states that post-trade activities may be covered in a future phase of regulation.
47 The Cryptoasset Consultation states that providing investment advice and managing portfolios of cryptoassets may be covered in a future phase of regulation.

48 Section 15.6 of Chapter 15 of the FCA's Perimeter Guidance Manual (PERG).

Exemptions and equivalence

The Cryptoasset Consultation proposes an exemption from authorisation for non-UK firms providing services to UK customers from outside the UK on the basis of "reverse solicitation" (i.e. where services are provided by non-UK firms entirely at the initiative of the UK customer). HMT notes in the Cryptoasset Consultation that any such exemption would be defined so as to prevent misuse and regulatory arbitrage. On this basis, we might expect this exemption to be defined narrowly. HMT will also pursue equivalence arrangements that would allow firms authorised in other jurisdictions to conduct cryptoasset activities in the UK if they are subject to equivalent standards in their home jurisdiction and suitable cooperation mechanisms exist between the relevant UK and overseas regulators.

B. Designated Activities Regime (DAR)
HMT is also proposing to regulate other cryptoasset activities under the DAR. This would allow regulators to impose direct requirements on firms carrying on such activities, even where they fall outside of the authorisation regime under FSMA or otherwise. The DAR could even be used to ban certain activities. One example given in the Cryptoasset Consultation (which the UK government is considering) is a requirement for certain public offers of cryptoassets to be conducted via a regulated platform.

C. Disclosure and transparency obligations
The Cryptoasset Consultation proposes an issuance and disclosures regime for cryptoassets. This will be based on the approach taken in the forthcoming Public Offer and Admissions to Trading Regime with suitable tailoring to the unique features of cryptoassets.[49]

Disclosure requirements will apply to firms when (i) admitting a cryptoasset to a trading venue and/or (ii) making a public offer of cryptoassets (including ICOs).

The Cryptoasset Consultation proposes:

i. imposing a minimum standard of information that must be disclosed to investors which will be based on a "necessary information" test;
ii. putting in place arrangements to ensure liability and compensation for untrue or misleading statements included in disclosure documents;
iii. a requirement for an appropriate level of due diligence of the contents of disclosure and admission documents;
iv. an appropriate level of protection for investors in relation to marketing materials. Trading venues will need to impose rules governing marketing materials and product appropriateness; and
v. controls and procedures to prevent harmful offers (e.g. measures to detect fraud). Trading venues will be required to reject the admission of cryptoassets to trading where they consider that they may result in investor detriment.

D. Market abuse regime for cryptoassets
The Cryptoasset Consultation proposed a market abuse regime for cryptoassets. This will be a dedicated regime based on, but separate from, the UK Market Abuse Regulation **(MAR)**.[50]

The regime will apply only to cryptoassets that are traded on UK trading venues making it narrower in scope than MAR which applies to financial instruments traded on EU as well as UK trading venues.

The proposed market abuse regime would impose obligations on in-scope trading venues, and offences would apply regardless of where the person is based or where the trading takes place.

49 See Financial Services and Markets Act 2000 (Public Offers and Admissions to Trading) Regulations 2023 < https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122741/Draft_SI_Admissions_to_Trading_and_Public_Offer_Regime.pdf> (accessed February 2023).
50 UK MAR is based on the EU Market Abuse Regulation (596/2014) brought into UK law through the European Union (Withdrawal) Act 2018 (EUWA).

Market participants will be required to establish systems and controls to prevent and detect market abuse. All regulated firms conducting cryptoasset activities will be required to disclose inside information and maintain a list of persons with access to such information.

Call for evidence on other areas

In the Cryptoasset Consultation, HMT requests additional evidence on the following areas that could potentially be regulated in the future:

i. Decentralised finance;
ii. Other cryptoasset activities including post-trade activities (e.g. clearing and settlement in relation to cryptoasset transactions), cryptoasset investment advice, cryptoasset portfolio management, crypto mining and validation; and
iii. Sustainability of cryptoasset activities.

Promotion of cryptoassets to UK consumers to be regulated

At present, the marketing of unregulated cryptoassets to UK consumers is not subject to FCA regulation and is overseen only by the Advertising Standards Authority.[51] Although the Advertising Standards Authority has issued numerous rulings to cryptoasset firms in relation to misleading advertising, it has very limited powers in comparison with the FCA and cannot, for example, impose fines on firms that are in breach of its rules.

In January 2022, HMT published its response to its consultation on bringing certain cryptoassets into scope of the FCA's existing financial promotions regime (the **Financial Promotions Consultation Response**). The Financial Promotions Consultation Response confirmed that HMT intends to bring the marketing of "qualifying cryptoassets" to UK consumers within scope of that regime.[52] The definition of "qualifying cryptoassets"[53] is expected to capture a wide range of unregulated cryptoassets, subject to some exclusions, such as NFTs. The regime will apply even where the person communicating the promotion is based overseas[54], and regardless of how the promotion is communicated (for example, whether the relevant adverts are placed through traditional print or on social media).

A related consultation on the draft FCA rules for the promotion of cryptoassets and other high-risk investments closed in March 2022.[55] The final rules for cryptoassets have not yet been published. However, the FCA has indicated that those rules will closely follow the final rules for high-risk investments, which were published in August 2022 and came into force on 1 February 2023.[56]

The FCA consultation indicates that firms looking to market relevant cryptoassets to UK consumers will need to satisfy numerous requirements when designing and communicating adverts. Among other things, it is likely that firms will be required to ensure that relevant adverts:

— are fair, clear, and not misleading;

— include a prescribed risk warning in a prominent place;

— do not include any form of incentive to invest;

51 The relevant rules are set out in the Advertising Code (The UK Code of Non-broadcast Advertising and Direct & Promotional Marketing, also referred to as the "CAP Code") and specific guidance was issued in relation to cryptoasset adverts in March 2022 (see the Enforcement Notice titled "Advertising of Cryptoassets: Cryptocurrencies", issued by the Committee of Advertising Practice on 22 March 2022). Among other things, firms must make clear that cryptoassets are not regulated by the FCA and are not protected by the UK's financial services compensation schemes.

52 HMT, "Cryptoasset promotions: Consultation response" (January 2022) <Cryptoasset_Financial_Promotions_Response.pdf (publishing.service.gov.uk)> Accessed December 2022.

53 HMT has indicated that it will adopt the following definition: "any cryptographically secured digital representation of value or contractual rights which is fungible and transferable".

54 Firms that intend to obtain a licence or an anti-money laundering registration with an overseas regulatory authority, instead of the FCA, should be aware that they will still need to comply with these rules, to the extent that they promote relevant cryptoassets to UK consumers.

55 FCA, "Strengthening our financial promotion rules for high risk investments, including cryptoassets" (Consultation Paper CP22/2, January 2022), <CP22/2: Strengthening our financial promotion rules for high risk investments, including cryptoassets (fca.org.uk)> Accessed December 2022.

56 FCA, "Strengthening our financial promotion rules for high-risk investments and firms approving financial promotions" (Policy Statement PS22/10, August 2022) <PS22/10: Strengthening our financial promotion rules for highrisk investments and firms approving financial promotions (fca.org.uk)> Accessed December 2022.

— are reviewed and approved by an FCA-authorised firm with competence and expertise in the cryptoasset market and the required permissions to approve such promotions.[57]

Further, firms will need to ensure that "direct offer financial promotions" (i.e., promotions that contain an offer or invitation to enter into an agreement and a mechanism by which customers can respond in order to invest their money) are communicated only to customers that the firm has categorised as more sophisticated, and that first time investors are given a 24-hour cooling off period.[58]

It is unclear precisely when the new rules will be implemented, although we expect this to happen during 2023.[59] In a statement published in February 2023, the FCA warned firms to start preparing now for the new regime.[60]

Other relevant changes

Other proposed changes to UK regulation include those set out below.

A. UK FMI sandbox
The UK Financial Services Bill 2022 is expected to make relevant legislative amendments empowering HMT, the FCA and the BoE to create statutory rules for the development of so-called 'FMI sandboxes'. Unlike the existing regulatory sandbox that is operated by the FCA, these new FMI sandboxes will enable HMT to disapply certain legislative (statutory) provisions that would otherwise apply to financial market infrastructure, in order to generate a test environment. The powers are wide enough to enable the creation of settlement mechanisms for payments and financial instruments using DLT and related technology, including digital assets and stablecoins. As part of the UK government's package of financial services reforms announced in December 2022 (referred to as the 'Edinburgh Reforms') the Chancellor confirmed plans to launch the FMI sandbox in 2023.[61]

B. Decentralised structures and DAOs
In general, current legal and regulatory frameworks are not particularly well-adapted to truly decentralised structures. In fact, there are greater challenges in applying concepts of 'same risk, same regulation' to decentralised structures where regulatory supervision and accountability mechanisms may need to be designed differently from those applied to existing regulated firms.

In November 2022, the Law Commission of England and Wales launched a call for evidence on how decentralised autonomous organisations **(DAOs)** can be characterised and how they might be accommodated under English law.[62] This will be an important piece of the jigsaw in designing a future regulatory framework that could accommodate regulation and supervision of DAOs.

57 Pursuant to a planned exemption announced by HMT in February 2023 (see HMT "Government approach to cryptoasset financial promotions regulation policy statement") firms that are registered with the FCA under the MLRs will be able to issue their own cryptoasset financial promotions and will not need to obtain approval from an FCA-authorised firm. HMT, "Government approach to cryptoasset financial promotions regulation policy statement" (February 2023) <Government approach to cryptoasset financial promotions regulation policy statement - GOV.UK (www.gov.uk)> (accessed February 2023).
58 Specifically, investors who are categorised as "restricted", "high net worth", or "certified sophisticated".
59 For completeness, before the financial promotions regime can apply to cryptoassets, FSMA and the Financial Services and Markets Act (Financial Promotion) Order 2005 will need to be amended, and the FCA will need to publish its final rules. HMT has not yet brought forward the relevant draft legislation. The FCA has indicated that it will publish its final rules when such legislation has been made. For completeness, firms are due to be given a four-month transitional period (reduced from six months, pursuant to an announcement by HMT made in February 2023 – see HMT "Government approach to cryptoasset financial promotions regulation policy statement").
60 FCA, "Cryptoasset firms marketing to UK consumers must get ready for financial promotions regime" (February 2023) <Cryptoasset firms marketing to UK consumers must get ready for financial promotions regime> Accessed February 2023.
61 UK Government, "Financial Services: The Edinburgh Reforms" (December 2022) <https://www.gov.uk/government/collections/financial-services-the-edinburgh-reforms> Accessed December 2022.
62 Law Commission, "Decentralised autonomous organisations (DAOs)" Call for evidence (November 2022) <https://www.lawcom.gov.uk/project/decentralised-autonomous-organisations-daos/#:~:text=We%20launched%20a%20public%20call,now%20and%20in%20the%20future> Accessed December 2022.

HMT's Cryptoasset Consultation includes a call for evidence on how the UK should approach regulation of decentralised finance (DeFi). HMT indicates it intends to take a proportionate, innovation-friendly approach, but also sets out its intention that DeFi should be regulated in such a way as to ensure the same regulatory outcomes are achieved as for other cryptoasset activities. HMT notes this may take longer to achieve due to the rapidly evolving nature of the sector and globalised and borderless nature of DAOs and other DeFi structures. The call for evidence identifies one possible way of regulating DeFi activities as creating a new regulated or designated activity of "establishing or operating a protocol" but asks for broad feedback on how DeFi could and should be regulated in the UK.

C. Changes to criminal legislation
Separately, and whilst this chapter is not intended to address the implications of existing criminal legislation in the UK for cryptoassets, we note that there have also been proposed changes to such legislation. For example, the Economic Crime & Corporate Transparency Bill, which was presented to Parliament on 22 September 2022, makes certain amendments to the Proceeds of Crime Act 2002 that are intended to help law enforcement agencies, such as the National Crime Agency, to seize, freeze and recover cryptoassets used by criminals to launder the proceeds of crime.

What else might we expect?

HMT has confirmed its intention to expand the regulatory perimeter in order to capture a wider range of cryptoassets, including those used for investment purposes. Once the FSMB gains Royal Assent (expected in Q2 2023) HMT will be able to lay secondary legislation setting out the detail of the extended regulatory perimeter covering DSAs and other cryptoasset activities. The FCA will then need to consult on relevant rules to bring the regulatory regime into operation. These are expected to include minimum capital, liquidity and other prudential requirements for firms requiring authorisation under the new regime, as well as ongoing conduct of business rules for authorised firms and rules on admission and disclosure requirements where cryptoassets are traded in the UK. Firms that are already authorised under FSMA would also need to apply for a variation of their permissions to include newly regulated cryptoasset activities.

HMT indicates in its February 2023 consultation that once phases 1 and 2 of the new UK cryptoasset regulatory framework are in place, it may consult further on regulating additional cryptoasset-related activities to the extent they are not already covered – such as safeguarding and administration services for stablecoins, other post-trade activities, aspects of advising and managing and validation and governance of protocols.

More generally, we expect the regulation of cryptoassets to remain subject to scrutiny and discussion by regulators and the UK Government going forward. Other developments which practitioners and market participants may wish to monitor include the Treasury Committee's ongoing inquiry into the cryptoasset industry. The inquiry, which was launched in July 2022, has a wide scope and is considering, among other things, the UK's regulatory response to cryptoassets to date, including how regulation can strike a balance between protecting consumers and encouraging innovation.[63] To date, the Committee has received evidence from market participants, consumer interest groups and the FCA, among others. We expect that the Committee will report on its findings and issue a series of recommendations once the inquiry concludes, possibly sometime in 2023.

63 The scope of the inquiry is wide-ranging and is intended to consider the role of cryptoassets in the UK, including the opportunities and risks posed to consumers, businesses, and the Government; the opportunities and risks that the introduction of a BoE CBDC might bring; and the potential impact of DLT on financial institutions and financial infrastructure, among other things.

The international context

The European Union

The EU's proposed Markets in Crypto-Assets Regulation **(MiCA)** will, assuming that it is approved by the European Parliament, establish a regulatory framework for cryptoasset services across the EU. MiCA applies to the issuance, offering to the public, and admission to trading of cryptoassets as well as the provision of certain cryptoasset services in the EU.

MiCA defines a "crypto-asset" as a "digital representation of a value or a right which may be transferred and stored electronically, using distributed ledger technology or similar technology". This is a broad definition and would likely capture coins such as Bitcoin and Ethereum. MiCA further defines three subcategories:

A. "Asset-referenced token", defined as "a type of crypto-asset that is not an electronic money token and that purports to maintain a stable value by referencing to any other value or right or a combination thereof, including one or more official currencies". This includes stablecoins linked to multiple fiat currencies and/or other assets or indices;

B. "Electronic money token" or "e-money token", defined as "a type of crypto-asset that purports to maintain a stable value by referencing to the value of one official currency". This includes stablecoins linked to a single fiat currency; and

C. "Utility token", defined as "a type of crypto-asset which is only intended to provide access to a good or a service supplied by the issuer of that token".

MiCA does not apply to cryptoassets that are "unique and not fungible with other crypto-assets" meaning many NFTs will fall outside MiCA. However, NFTs that are not truly unique and fractional interests in NFTs may fall within the scope of MiCA.

The new regulation is not expected to take effect until 2024. Specifically, certain provisions in MiCA relating to issuers of asset-referenced tokens and e-money tokens will apply from 12 months after the date MiCA enters into force. All other provisions will apply from 18 months after the date MiCA enters into force. MiCA also includes limited transitional measures for certain cryptoasset service providers.

Separately to MiCA, Regulation (EU) 2022/858 sets out a pilot regime for market infrastructures based on DLT **(the DLT Pilot Regime)**. The DLT Pilot Regime lifts certain requirements of the existing regulatory framework on a temporary basis, in order to allow financial market infrastructure operators and new entrants to use blockchain technology to operate a multilateral trading facility and/or a securities settlement system for tokenised financial instruments (or "security tokens"). The DLT Pilot Regime will allow companies to test their DLT and assess how it operates, or should operate or adapt, in a regulatory environment to meet the relevant requirements. It is intended to offer a safe environment to operate a DLT market infrastructure for up to six years, subject to periodic reviews by supervisors.

The United States

Since cryptoassets have numerous potential applications, various US government authorities at both the state and federal level are helping to shape the regulatory landscape that surrounds them. In the capital markets context, both the Securities and Exchange Commission (**SEC**) and the Commodity Futures Trading Commission (**CFTC**) exercise regulatory authority over cryptoassets that is not clearly defined. Historically, the SEC has regulated "securities", while the CFTC has regulated commodities and derivatives; however, the universe of cryptoassets does not squarely fit into any of these categories. Banking regulators have provided some guidance to financial institutions on their ability to engage in cryptoasset activities. In particular, the Office of the Comptroller of the Currency (OCC) has published several Interpretive Letters clarifying that banks are allowed to engage in certain activities involving cryptoassets, provided they do so in a safe and sound manner and after notifying their primary federal regulator.

In March 2022, President Joe Biden issued an executive order, which called for an interagency process to examine the risks and benefits of digital assets. Further, numerous federal regulators and members of the United States Congress have expressed a desire to regulate cryptoassets more closely. In the absence of Congressional action, federal law enforcement authorities have taken action against entities involved in cryptoasset activities. For example, in February 2022, the SEC brought an enforcement action against a crypto lending company for offering unregistered securities that were in the form of digital assets.[64] State enforcement authorities have also taken an active role in cryptocurrency regulation and enforcement. For example, the Texas State Securities Board has, to date, entered into more than 50 administrative orders involving individuals and cryptocurrency entities.[65] Numerous states also introduced legislation regarding cryptocurrency and other cryptoassets during their last legislative sessions. These developments, along with recent high-profile cryptocurrency and cryptocurrency exchange failures, could lead to greater oversight of cryptoassets in the near future.

Other international developments

A. BCBS consultations on the prudential treatment of cryptoassets
In December 2022, the Basel Committee on Banking Supervision **(BCBS)** published its framework setting out international standards for the prudential treatment of cryptoassets, for implementation by 1 January 2025.[66] Once implemented by BCBS member jurisdictions, this framework will apply to banks' exposures to cryptoassets (and may also be applied to other financial institutions subject to regulatory capital requirements based on BCBS standards).

The final BCBS prudential standard on banks' cryptoasset exposures divides cryptoassets into two broad groups:

i. Group 1: cryptoassets including tokenised traditional assets (Group 1a) and cryptoassets with effective stabilisation mechanisms (Group 1b). Cryptoassets need to meet strict classification conditions to fall into Group 1. Group 1b stablecoins must be issued by supervised and regulated entities and have robust redemption rights and governance. Algorithmic stablecoins are not eligible to fall within Group 1b. Group 1 cryptoassets are generally subject to capital requirements based on the risk weights of underlying exposures as set out in the existing Basel Framework.

ii. Group 2: other cryptoassets (such as Bitcoin) which do not meet classification conditions and which are considered to pose additional and higher risks. These cryptoassets would be subject to a new, conservative prudential treatment, including a 1250% risk weighting and an aggregate exposure limit. Under the proposed framework, it is not generally possible to use Group 2 cryptoassets for hedging purposes, except to a limited degree where Group 2 cryptoassets meet certain "hedging recognition criteria". These are referred to as Group 2a cryptoassets, with Group 2 cryptoassets where hedging is not recognised falling within Group 2b.

BCBS's consultation on the prudential framework published in summer 2022[67] had proposed a mandatory 2.5% "infrastructure risk add on" to address unforeseen risks associated with DLT. However, in response to issues raised in industry responses to the BCBS consultation, the final BCBS standards no longer require the infrastructure risk add-on to be applied automatically. Instead,

64 SEC, "BlockFi Agrees to Pay $100 Million in Penalties and Pursue Registration of its Crypto Lending Product" (Press Release, February 2022) <https://www.sec.gov/news/press-release/2022-26> Accessed December 2022.
65 See Texas State Securities Board, "Cryptocurrency Enforcement" <https://www.ssb.texas.gov/cryptocurrency-enforcement> Accessed December 2022. See also Texas State Securities Board, "Texas State Securities Board Joins with Other State Regulators to Settle with Digital Asset Lending Platform BlockFi for $50 Million for Sales of Unregistered Securities" (Press Release, February 2022) <https://www.ssb.texas.gov/news-publications/texas-state-securities-board-joins-other-state-regulators-settle-digital-asset> Accessed December 2022.
66 BCBS, "Prudential treatment of cryptoasset exposures" (December 2022) <https://www.bis.org/bcbs/publ/d545.htm> Accessed December 2022.
67 BCBS, "Prudential treatment of cryptoasset exposures - second consultation" (June 2022) < Prudential treatment of cryptoasset exposures - second consultation (bis.org)> Accessed December 2022.

authorities will be empowered to activate such an add-on based on any observed weaknesses in the infrastructure on which particular cryptoassets are based. This is an important change, as there had been concerns in the industry that an automatic infrastructure add-on would make it economically unviable for banks (or other firms subject to Basel standards) to hold and trade even in Group 1 cryptoassets, such as tokenised securities and fiat-backed stablecoins.

The consultation response also clarifies that it does not intend for custodians to apply credit, market, and liquidity risk requirements of the framework to customer assets (again, a potential concern that had been raised in consultation responses). Nevertheless, UK national policy makers will need to give these issues careful consideration in the development of prudential rules relating to cryptoasset exposures, with international implementation of the Basel Framework expected by 1 July 2025.

B. International standards for globally systemic stablecoins
In October 2020, the Financial Stability Board **(FSB)** published a set of 10 high-level recommendations for the regulation, supervision and oversight of global stablecoin (GSC) arrangements.[68] Those high-level recommendations called for the regulation, supervision and oversight of GSCs in a proportionate manner, in order to address associated financial stability risks posed by GSCs, under the principle of 'same activity, same risk, same regulation'.

In October 2022, the FSB published a review of those high-level recommendations for GSCs,[69] in which it proposed certain updates in order to address recent market developments (including the Terra-Luna collapse in May 2022). Among other things, the FSB's review noted that most existing stablecoin arrangements do not meet the FSB's existing high-level recommendations to be GSCs and proposed extending the scope of the recommendations to stablecoins with potential to become GSCs. Comments were due by 15 December 2022 and the FSB aims to finalise its updated high-level recommendations for GSCs by July 2023.

In July 2022, the Bank for International Settlements' Committee on Payments and Market Infrastructures **(CPMI)** and the International Organization of Securities Commissions **(IOSCO)** also published final guidance on stablecoin arrangements.[70] That guidance confirmed that the Principles for Financial Market Infrastructures (PFMI) should apply to systemically important stablecoin arrangements for the transfer of stablecoins, thus extending existing international standards for payment, clearing and settlement systems to cover systemically important stablecoin arrangements. The CPMI and IOSCO indicated they will continue to examine regulatory, supervisory and oversight issues associated with stablecoin arrangements and coordinate with other standard-setting bodies.

C. FSB consultation on regulation of cryptoasset activities
In October 2022, the FSB also published a consultation on a proposed framework for the international regulation of cryptoasset activities, based on the principle of "same activity, same risk, same regulation".[71] The proposed framework includes nine recommendations on regulatory, supervisory and oversight approaches to cryptoasset activities and markets, which aim to address associated financial stability risks and promote a consistent regulatory framework, and to strengthen international cooperation, coordination and information sharing globally. Comments were due by 15 December 2022.

68 FSB, "Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements" (October 2020) <https://www.fsb.org/2020/10/regulation-supervision-and-oversight-of-global-stablecoin-arrangements/> Accessed December 2022.
69 FSB, "Review of the FSB High-level Recommendations of the Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements: Consultative report" (October 2022) <https://www.fsb.org/2022/10/review-of-the-fsb-high-level-recommendations-of-the-regulation-supervision-and-oversight-of-global-stablecoin-arrangements-consultative-report/> Accessed December 2022.
70 CPMI and IOSCO, "Application of the Principles for Financial Market Infrastructures to stablecoin arrangements" (July 2022) <https://www.bis.org/press/p220713.htm> Accessed December 2022.
71 FSB, "International Regulation of Crypto-asset Activities: A proposed framework – questions for consultation" (October 2022) <International Regulation of Crypto-asset Activities: A proposed framework – questions for consultation - Financial Stability Board (fsb.org)> Accessed December 2022.

High-level considerations for the UK regulator when designing the framework

We consider that any resulting expansion in the UK regulatory perimeter should adopt the principle of "same activity, same risk, same regulation". Care should be taken as to how new rules may interact with the existing regulatory frameworks (such as e-money regulation) and any overlaps should be addressed. It is also important to ensure that definitions and taxonomies are carefully calibrated based on the substantive characteristics of the relevant cryptoassets to (i) avoid unhelpful overlaps between regimes and (ii) ensure uses of DLT as a pure record-keeping tool are not inadvertently captured. In this respect, we consider the definition of cryptoasset used in the MLRs is likely too broad for use in any potential new licensing regime. As such, we would welcome the introduction of a narrower definition.

It is also necessary to carefully consider the territorial scope of any new licensing regime for firms (i) dealing in or (ii) providing services relating to, relevant types of cryptoassets, particularly in light of the cross-border nature of many cryptoasset structures. We would welcome clear rules or guidance on when activities will be considered to have been carried on in the UK, in order to provide greater certainty to market participants. We also advocate for the introduction of appropriate carve-outs from licensing requirements for overseas firms carrying on activities on a cross-border basis, for example, via extension of the overseas persons exclusion **(OPE)** to relevant cryptoasset-related activities. Such carve-outs are necessary for the avoidance of duplication and overlaps with other jurisdictions' rules; as such, the introduction of such carve-outs would be in line with the UK's broader policy and approach with respect to the territorial scope of financial services regulatory regimes.