DISCUSSION PAPER DP23/4
REGULATING CRYPTOASSETS - PHASE 1: STABLECOINS

The remit of the International Regulatory Strategy Group (IRSG), a joint venture between the City of London Corporation and TheCityUK, is to provide a cross-sectoral voice to shape the development of a globally coherent regulatory framework that will facilitate open and competitive cross-border financial services.

The IRSG welcomes the opportunity to respond to the FCA's Discussion Paper DP23/4: Regulating cryptoassets Phase 1: Stablecoins. In summary, the IRSG is supportive of the FCA's proposal for the establishment of a sound regulatory framework for fiat-backed stablecoins. We set out some key considerations below.

GENERAL ISSUES

In addition to specific responses to the consultation questions, we summarise some key concerns below:

Interplay with other regulatory regimes

Electronic Money Regulations

- The FCA's proposal does not set out in detail how the proposed regime is going to interlink with the existing framework for electronic money in the UK. HM Treasury (HMT) has acknowledged in its recent policy statement that "electronic money, as it exists now, and fiat-backed stablecoins are different products and HMT intends to put in place legislative clarification to ensure their legal separation."

- However, there are very clear similarities between electronic money and fiat-backed stablecoins and overlaps between the respective definitions so it is important that the rules that apply to stablecoins should be considered holistically, taking into account the future regime for electronic money in the UK. Fundamentally, some of the key features of the FCA's proposal in the DP would have the effect that fiat-backed stablecoins would qualify as electronic money. Specifically, it seems that both electronic money and fiat-backed stablecoins would be (i) monetary value as represented by a claim on the issuer (we note that the FCA is proposing that holders have a right to redeem the stablecoin against the issuer) (ii) stored electronically, (iii) issued on receipt of funds (at least where stablecoins are issued for cash); (iv) used for the purposes of making payment transactions and (v) accepted as a means of payment by persons other than the issuer. On that basis, it is unclear how the FCA will distinguish between both. More importantly, given the stringent requirements proposed to be applied to fiat-backed stablecoin issuers, we can see a risk that firms may prefer to rely on the electronic money framework in order to issue stablecoins in light of the fact that the electronic money regime does not preclude the use of distributed ledger technology for the issuance of electronic money. More importantly, the electronic money regime arguably also

allows investment of backing cash into high quality liquid assets, thereby creating an almost indistinguishable product but with a much lighter regulatory framework.

- Given the above, IRSG members would strongly support a framework that categorises fiat-backed stablecoins issued in token form as a sub-category of electronic money stablecoins. Such a categorisation would be consistent with the position under the EU's Market in Crypto-assets Regulation (MiCA) that stablecoins are e-money tokens. We note that Article 48 (2) MICAR stipulates that e-money tokens are deemed to be e-money within the meaning of the EU Electronic Money Directive 2009/110/EC and Art. 48(3), this has the effect that e-money token issuers are subject to some additional provisions in MiCAR in addition to the e-money regulations.

- More importantly, this approach would be aligned with the UK's ambitions to create a smart regulatory framework in that we would be modifying the existing regime instead of creating a new overlapping parallel regime which is likely to cause legal uncertainty.

<u>BoE regime for systemically important settlement assets</u>

- Under the current proposals, the BoE has powers to designate a stablecoin and its payment network as systemically important. Upon designation a fiat-backed stablecoin would be subject to various requirements that are not aligned with the position in the FCA's DP. For example, the BoE's proposal requires the existence of a central entity to govern the safe operation of the transfer function and to assess risk across the entire chain. However, many non-systemic stablecoins may be issued on decentralised platforms. So, a stablecoin issuer that becomes designated by the BoE would have to significantly change its business model in order to comply with the BoE's regime. By way of example, the BoE regime requires backing of stablecoins with central bank deposits. The proposed FCA regime requires backing with short-term gov debt instruments and cash deposits. The BoE regime proposes capital requirements that don't appear to fully align with FCA's proposed CRYPTOPRU. The BoE regime proposes holding limits which are not present in FCA regime. The BoE regime proposes using modified FMI SAR for firm failure. FCA regime proposes using standard corporate insolvency procedures.

- This creates two issues; it is a disincentive for any FCA regulated stablecoin issuers to become so widely used as to become systemic but more importantly the widespread adoption of a particular stablecoin may not be in the control of the issuer. It is imperative that the FCA aligns any future policy proposals with the BoE and takes into account how its regime would interact with that of the BoE.

<u>Security Tokens</u>

- In the DP, the FCA states that the new custody activities will apply to safeguarding of regulated stablecoins where issued by an authorised person and cryptoassets that already meet the definition of a specified investment, such as security tokens. This is a fundamental barrier to adoption and a significant deviation from the principle that the regulatory regime should be

technology agnostic. In this context it should be noted that in practice the majority of the traditional assets that custodians safeguard are "interests in securities" which are reflected in a dematerialised form or as register entries using electronic means. Therefore, the difference between a security token and any traditional interest in a security is that the technology used to record their ownership and transfers of the former is a distributed ledger.

- On the other hand, the most commonly used cryptoassets are issued on public, permissionless platforms. By definition, this type of ledger would be decentralised and transparent, as well as fully immutable in order to address the lack of oversight of the network.

- Security tokens characteristically share more in common with traditional securities (by definition, they are specified investments) and should not be differentiated based on their underlying technology alone. Fundamentally, it is therefore a matter for the issuer and the custodian to adequately assess, manage and mitigate any resulting risks that arise for the specific type of digital asset and technology. In line with the FCA's intention to follow a 'same risk, same regulatory outcome' and principles-based approach, it would be our recommendations that security tokens are not subject to the same custody regime as stablecoins or cryptoassets.

- Furthermore, the creation of a separate regulated activity and a separate CASS regime is likely to create unnecessary regulatory friction, costs and inefficiencies. More importantly, it will act as a deterrent to a potential wider adoption of DLT in traditional financial markets. Existing custodians are well equipped to safeguard and administer traditional interests in securities through the use of technology. As such, the IRSG members are of the strong view that the FCA should avoid blindly including the safeguarding and administration of security tokens into the regime that applies to the custody of fiat-backed stablecoins which are by their nature a very different instrument. On the contrary, the FCA may consider if the existing CASS regime requires clarification in order to facilitate use of DLT technologies for record keeping, accounts and reconciliation, specifically for permissionless blockchain structures, and for recording and reporting "atomic" settlement transactions. This would be a relatively low intervention method of improving the functionality of existing CASS rules and could deal with the matters raised in (3.20 - 3.26 of the DP23/4). **In the view of members, the existing, principles-based CASS regime provides an appropriate regulatory framework for the custody of security tokens.**

- The issue is exacerbated when considering the FCA's proposal that custody of fiat-backed stablecoins (and security tokens) would arise in circumstances where an overseas custodian is holding assets for a UK customer. That position would be entirely inconsistent with the way existing territorial scope of the activity of safeguarding and administering investments applies today. The implications of this policy change could have significant repercussions to the wider market.

- It is generally the case that custodians of securities based outside of the UK do not trigger the UK perimeter merely by having UK clients. This is important because there are networks of sub-custodians that provide services to UK based custodians all over the world. This enables UK based custodians to offer their UK clients the ability to hold securities in any jurisdiction

with the legal certainty that the sub-custodian would not breach the general prohibition. If the position changes in respect of security tokens, it may have the effect that overseas based securities custodians do not want to enter into sub-custody arrangements with UK custodians in respect of foreign issued security tokens.

- Any change in policy in respect of security tokens may have an important knock-on effect on the wider industry. Such inconsistency should be avoided.

- We note, that the FCA's proposal on this point is also inconsistent with the proposal by HM Treasury. In its October 2023 paper "*Update on Plans for the Regulation of Fiat-backed Stablecoins*", HM Treasury stated its intention to create a regulated activity under the RAO for custody comprising the safeguarding, safeguarding and administering, or the arranging such, of UK issued fiat-backed stablecoin (and security tokens). It states that custody of fiat-backed stablecoins issued outside of the UK will ***not*** be captured under this regulated activity under the RAO. In contrast, in its DP, the FCA states at para 2.24 that "*the Treasury intend to bring two new activities relating to regulated stablecoins covering **both issuance** in or from the UK **and custody** activities carried out from the UK or to UK based consumers.*"

<u>International Regimes</u>

- The proposal for overseas issued stablecoins seems very problematic. In particular the proposal is that there should be a framework whereby a UK based “payment arranger” is responsible for ensuring that any particular overseas coins that are to be used in UK payments meet the UK standards.
- This creates a series of issues, including that overseas stablecoins may decide to engage only with a single UK arranger, damaging competition. UK arrangers may also struggle to obtain all the necessary information to allow overseas coins to be used in UK payments. The overseas issuer may not have the data in a format that allows verification of UK standards.

Payment services

- As it stands, payment service providers falling within the stablecoin regime would also have to separately obtain a Payment Services Regime licence. There is a perception that the parallel frameworks will prove burdensome and more work should be done to harmonise the licencing requirements for stablecoins, e-money and payment services. More importantly, it is unclear how a payment services provider would be able to comply with the Payment Services Regulations 2017 when dealing with stablecoins. By way of example, how would it meet the safeguarding requirement for “relevant funds”? Would a stablecoin qualify as “relevant funds”? If so should stablecoins be safeguarded with a credit institution? More generally, it should be clarified which payment services would apply in respect of stablecoins. For example, would a custodian wallet provider that facilitates payments out of their wallet qualify as a PSP and trigger dual licensing requirements?

Redemption

- The FCA proposal is that stablecoin issuers must be able to satisfy a redemption request by the end of the 2nd UK Business Day following the request. However, there are concerns that such a stringent timing request is somewhat unrealistic considering that the ability to redeem is subject to banking rails and the reliability of a chain of intermediaries. More generally, the current model used by some stablecoin issuers is two tier, with no customer relationship with the ultimate holder of the coin. It is queried how feasible such a requirement would be for these issuers. More generally, requiring stablecoin issuers to redeem could arguably also lead to financial stability concerns. For example, through runs on the stablecoin causing temporary delays to and potentially exacerbating a situation where the stablecoin unpegs.

Custody

- It is arguable that the FCA proposal that issuers should appoint an independent custodian to hold the stablecoin backing assets on trust for coin holders sits somewhat uncomfortably with the existing CASS framework. In effect, this proposal means that existing custodians are required to hold backing assets in a different way to assets they hold for other clients.

Prudential requirements

- The current FCA proposal does not contain specific figures on, for example, the permanent minimum cap and assets under management that stablecoin firms may be required to maintain. Consequently, there are concerns surrounding the inability of potential in-scope participants to consider the likely effects of the regime on their businesses.

SPECIFIC RESOPNSES

Chapter 2: A new stablecoin regime

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

- The new regime should differentiate between the regulation of wholesale and retail issuances and use cases.
- A flexible market where wholesale stablecoins are available will promote broader market adoption as the diverse use cases in the wholesale sector can vary in terms of asset backing sophistication and legal arrangements.
- The FCA is proposing 100% backed stablecoins with any purchaser having the right to redeem. Having the issuer's liability backed 1:1 with backing assets in this way makes sense in a retail context.
- However, for wholesale use cases, the protections and rights available to the acquirer could be relaxed and offer more flexibility. For example, it should be possible where wholesale stablecoins are issued by a bank, for the level of backing assets to be reduced through credit risk mitigation techniques available under the existing prudential framework.
- In a wholesale context, users are sophisticated enough to assess, understand and mitigate the risks of new asset types. The regime for backing assets could be designed to be more lenient in this context.

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

- IRSG members broadly agree with the assessment in the DP.
- We have identified in our response to question 1 the importance of enabling a wholesale market for stablecoins, particularly in the context of financial market transactions.
- For sophisticated users, the wholesale use case for fiat-backed stablecoins is an important one as it can be a key driver of digital technology that would enable wider innovation in the financial markets. Generally speaking, the creation of a legally certain and sophisticated stablecoin framework will enable the use of digital assets in

wholesale markets, fostering innovation and aligning with wider UK policy. For example, fiat-backed stablecoins could be used to facilitate the settlement of issuances being undertaken in the proposed new FMI Digital Securities Sandbox.

- IRSG members believe that it is imperative to have a sophisticated regime that effectively enables the transparent, disciplined, and effective development of markets and infrastructures.

Chapter 3: Backing assets and redemption

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

- In principle, IRSG members are supportive of the proposed approach.

- However, we would encourage the FCA to build as much flexibility as possible into the proposed framework. Whilst the proposed approach should be the standard position, it should be possible for issuers to propose a different composition of backing assets which may include a combination of high-quality liquid assets, credit protection mechanisms and/or insurance.

- This would align with the position that has existed with respect to electronic money for a long time and which seems to have adequately addressed the risks for retail end users. IRSG members are of the view that both regimes should align to the extent possible, which would have the advantage of consistency for firms operating across, as well as customers using, both product types.

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

- From the IRSG perspective, a key consideration should be to make the UK regime as flexible and welcoming of innovations as possible in line with the government's broader stated policy aims. Therefore, we would welcome the ability to use partial backing in other currencies as this facilitates flexibility for market participants.

- We can see that the use cases for fiat-backed stablecoins backed by more than one currency could be significant and, as long as the risks relating to partial backing in another currency are adequately disclosed to the users of the stablecoins, this would be seen as positive as it would drive innovation.

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

- In order to make the business model for the issuance of stablecoins commercially viable, members would agree that issuers should be allowed to retain for their own benefit the revenue derived from interests and returns from the backing assets. Any stablecoin regime needs to be set up so that it is capable of being profitable – otherwise it will inherently be unstable.

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

i. Are there any practical, technological or legal obstacles to this approach?

- We understand that, notwithstanding the generic references to "client assets", the proposal is that cash held as backing assets for fiat-backed stablecoins should be held by the issuer of the stablecoin subject to rules similar to the Client Money Rules, including the trust created by the Client Money Rules. There is no provision in CASS currently for the creation of a similar trust for non-cash assets, any such proposal would be very novel and require careful consideration. If creation of a statutory trust for non-cash assets is what is intended, it would be helpful to understand more from the FCA about the proposal and the powers that it would be relying on to do so.

- On the basis that the new rules and trust terms would not be the same as the existing Client Money Rules, cash constituting backing assets for fiat-backed stablecoins could not be held in the same client money accounts as other client money held by the issuer (if the issuer were subject to the existing Client Money Rules for other purposes), since this would result in the commingling of funds subject to different trust terms. For the same reason, backing assets for different stablecoins could not be held in the same client money accounts. This may increase costs and make the process unwieldy for custodians/ issuers.

- Aside from this, we are not aware of any practical, technological or legal obstacles to the creation of a separate adapted form of the Client Money rules for the holding of cash backing stablecoin.

- As a general point, we would flag that digital assets can be held in different ways and that different DLT set ups will use different encryption techniques (so, for example, not all private DLT systems will use public-private key cryptography). We suggest that the adapted regulatory regime should avoid prescribing specific technological arrangements in order not to stifle innovation or inadvertently preclude certain platforms or products.

ii. Are there any additional controls that need to be considered?

- In practice, the amount of cash held as backing assets for a fiat-backed stablecoin may be reduced over time if the bank holding such cash for the issuer is able to exercise set-off rights over such cash. It may therefore be appropriate to consider whether the exercise of set-off rights should be prohibited accordingly.

- For public confidence and trust, issuers should be required to publicly disclose the value and composition of their backing assets.

iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?

- In principle, an issuer which holds its own stablecoin is in the same position as any other holder of such stablecoin, and, if each stablecoin is intended to be issued on the same terms as and fungible with each other stablecoins of the same issue, all stablecoins, whether held by the issuer or not, should be backed by cash held by the issuer on trust for the holders of the issued stablecoin.

- However, the FCA may wish to consider whether any policy considerations affect this. Under the existing Client Money Rules, in relation to non-MiFID business a firm holding money for an affiliate must not hold that money as client money unless certain exceptions apply (for example, the affiliate has notified the firm that the money belongs to a client of the affiliate, or the affiliate is treated as an arms' length client). We understand that the reason for this rule is to limit the potential risk of adverse impact on the client money pool in the event of affiliates becoming insolvent at the same time as the firm itself. Such a risk is increased where the entity for whom client money is held by the issuer is the issuer itself. The FCA may therefore wish to consider whether, for example, on distribution of the client money pool, holders of stablecoins other than the issuer should be paid out first.

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

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

- It is important to be clear that in this context the backing assets consist of cash and government treasury debt instruments that mature in one year or less.

- As we understand it, the models proposed are: (a) any cash backing the stablecoin must be held for the issuer by a third party (which may be a bank or a payment institution or a custodian); or (b) the cash or assets backing the stablecoin are held by a third party (a bank, a payment institution or custodian) directly for the holders of the stablecoin. We understand that the FCA views (b) as the model involving an "independent custodian", although as noted above in this context the holder of the cash is providing banking or payment services, not custody services. A custodian would be holding backing assets.

- It is unclear why model (b) would be necessary, and we are not aware that such arrangement is required in any similar context (a fund depositary may have obligations to act in the interests of investors in the fund, but holds fund assets for the fund, not for investors in the fund). Further it would increase the potential liability of the custodian, which would have a knock-on impact on cost and liability management frameworks, both of which would likely become more onerous.

- It is unclear whether the FCA is proposing that the issuer should not be permitted to hold cash underlying stablecoin with a bank or payment institution in the same group as the issuer. (Under the existing Client Money Rules, a firm is permitted to hold a maximum of 20 per cent of its total client money with entities in the same group as the firm, subject to a limited exception).

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

- In principle, and subject to any enhance rights that might be granted, we understand that: (1) under model (a), a holder of stablecoin would have contractual rights against the issuer, and a beneficial interest in the cash / assets held by the issuer under rules similar to the client money rules, but such holder would not have rights against the entity holding the cash/ assets for the issuer (subject to any FSCS protection which might be provided to holders as beneficiaries under a trust); (2) under model (b), a holder of stablecoin would have contractual rights against the issuer, and a (presumably secondary) claim against the third party for the cash (it is unclear if this would be an unsecured contractual claim, or a claim to a deposit or safeguarded cash held by a payment institution, or a beneficial interest in an amount held on trust by the third party with another entity).

- If this is correct, under model (a) the holder of stablecoin would have the benefit of its rights under the client money trust, although would be exposed to the risk of the issuer's failure to maintain sufficient funds in the client money account, as well as the credit risk and counterparty risk of the issuer.

- Under model (b), the holder of stablecoin would have the benefit of rights against both the issuer and the third party, although the nature of the rights against the third party is unclear. The holder would potentially be exposed to the risk of credit risk and counterparty risk of both the issuer and the third party and, possibly, any other entity through which the third party holds cash for this purpose. In practice, a third-party

holding cash directly for the holders from time to time may face difficulties in complying with AML and KYC requirements, including monitoring compliance with issues such as sanctions. The increased liability undertaken by the third party under model (b) is also likely to be a significant factor governing the use and adoption of such a model.

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

- Rights of holders of stablecoin could be enhanced by guarantees or indemnities provided by third parties in favour of holders from time to time, but there would be a cost to this.

- Some additional protection could be made available by extending FSCS protection to holders of stablecoin.

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

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

We note that the FCA states that consumers would have had to complete all the relevant AML/CTF checks in order to redeem. The redemption period will be 24 hours after those redemption checks have been completed. For widely used retail fiat-backed stablecoins, this may pose significant operational challenges, particularly if there are many small redemption requests.

This may prove particularly challenging for newer, smaller market participants who might not have the capacity to deal with redemption requests so quickly.

Members suggest considering a simplified approach for de minimis redemption requests. For example, it could be an option to allow redemption requests of up to £1000 to have no or a very limited KYC process where the redemption is going to be made to a UK bank account. The assumption here is that KYC/AML would have been conducted already.

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

IRSG members believe that a regulated issuer should be able to outsource or involve a third party in the redemption process because that is in line with the existing industry approach to processing equivalent requests.

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

Members suggest considering restrictions on the amounts of redemptions permitted within a given period this is to enable the Issuer to manage liquidity, particularly if the redemption periods are short.

Chapter 4: Other key expectations of stablecoin issuers

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

- Yes, and it should be noted that the Consumer Duty should apply in proportion to the target market envisaged.

- Also, the Consumer Duty should apply in a manner which is proportionate to the nature of the services provided by the issuer and the "custodian" (the holder of the cash backing the stablecoin). In particular, to the extent that the entity holding the cash for the issuer has a relationship with the issuer but not the holders of stablecoin, and simply provides services agreed with and as instructed by the issuer, it is unclear to what extent the third party holding the cash for the issuer would determine or have a material influence over the outcomes for consumers holding stablecoins.

- To the extent that fiat-backed stablecoins are for wholesale markets only, the Consumer Duty should not be relevant.

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

- Regulated stablecoins should not be in the category of 'restricted mass marketed investments'.

- Once the proposed regime is in place as described, stablecoins will be closer to electronic money than other cryptoassets. Therefore, it would be more consistent with the policy intentions of the financial markets money regime to take stablecoins out of the restricted category.

- Generally, the new framework imposes such controls on the issuer and gives legal certainty to coinholders that the risk profile of these assets is very different to that of other cryptoassets and therefore, it makes no sense that they should be restricted as marketed investments.

- Therefore, the same frictions that apply for the advertising of qualifying cryptoassets should not apply to regulated stablecoins. Instead, they should be treated like electronic money which is not within the scope of the financial promotions regulations.

Chapter 5: Custody requirements

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

- No. While it is recognised that some providers do allow individual client wallet structures and this should not be prevented, it is not clear why individual client wallet structures should be mandatory. Generally sufficient protection for clients should be provided by the requirement for custodians of regulated cryptoassets to segregate the firm's own cryptoassets from all clients' cryptoassets by recording the firm's assets in wallets/records on the relevant system which are separate from the wallets/records used to record client assets (omnibus client accounts). Furthermore, the current CASS framework does not prescribe the use of individual client wallet structures.

- The required standard should be that client assets are segregated at least into omnibus client accounts.

- The rules should also take into account and permit the possibility of the custodian using sub-custody arrangements, where one wallet provider may be holding their custody assets with another provider or further sub-delegation. This is permitted in relation to the holding of traditional securities and therefore for consistency we suggest that it should also be allowed in relation to cryptoassets.

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

- There is a preliminary point to be noted in relation to this question in that there may not be legal certainty as to the situs of the assets in all jurisdictions relevant to the holding of the cryptoassets. The effect of this is that the trust arrangements, which would typically exist where custody services are provided under English law, may not be recognised in other jurisdictions, particularly where an issuer or custodian is based in other jurisdictions.

- While there is a strong likelihood that a UK incorporated custodian would be subject to the laws applicable in England which do recognise trust arrangements, those with international operations and who are servicing retail clients may not always have that benefit.

- Of course, a similar risk exists in the traditional securities markets. However, in the securities market this is a risk that has been identified and managed for many years now, so the market is fully aware of how it works. With digital assets, many

jurisdictions are unclear about how they would treat these, and so there is an increased legal risk.

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

- Member's are of the view that there should be as much flexibility in permitted uses as long as risks have been adequately disclosed to the client and where relevant a record of the client's specific instruction. This includes the use of cryptoassets as collateral, for staking and other uses.

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

- The proposals regarding "adequate organisational arrangements" are comparable to the current requirements for custody of securities, therefore a consistent approach is reasonable, subject as noted below.

- The proposal to impose a specific level of liability on custodians of cryptoassets is wholly new and is not consistent with existing regulatory requirements for custodians. In this respect, this will create a significant difference between requirements applicable to custodians of securities, and to custodians of cryptoassets.

- The new liability to be imposed on custodians of cryptoassets is to be specified in legislation by HMT, not the FCA rules. This is a potential concern for custodians, since not only is imposition of such liability wholly new, but there will be little flexibility of application and interpretation (or scope for waivers) if specified in legislation rather than FCA rules.

- Aside from modifications necessary to reflect the particular nature of cryptoassets, in principle the regulatory requirements for custody of cryptoassets should be as similar as possible to the requirement for custody of securities, to minimise inconsistency of regulation. On this basis, it would be preferable that custodians of cryptoassets are not subject to specific liability requirements or other rules which are more onerous than existing requirements. This would also ensure that the custody requirements were not so burdensome as to become inhibitory to new market participants.

Q17: Do you agree with our proposals on reconciliation? If not, please explain why not?

- We understand that the proposal that custodians should "take appropriate steps to cover any shortfalls that arise if discrepancies are not resolved following reconciliations" will mean applying rules similar to CASS 6.6.54R, rather than imposing liability on the custodians. On the basis that the new rules are consistent with the existing CASS rules, this approach seems reasonable.

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

- It is important to clarify what is meant by use of "third parties". The existing CASS rules applicable to custody of securities do not limit the entities to which a custodian may delegate the holding of securities, although they do impose certain requirements regarding selection, appointment and periodic review. Use of third parties for other purposes is not restricted, except to the extent that such use may fall within requirements regarding outsourcing. For regulatory consistency, we would recommend that a similar approach is adopted for custodians of cryptoassets (bearing in mind that there will be certain differences of application – for example, holding cryptoassets through a particular DLT system is not, and should not be treated as, "delegation" to that system).

- [From a technological perspective, there are various ways in which stablecoins and other cryptoassets can be held which should be considered as the regime is developed and particularly when provisions around third parties are being considered. Cryptoassets are typically held in wallets, but this is not always the case.

- Public blockchains typically use public-private key cryptography, where the holder of the private key is generally considered to obtain the technological benefits of the assets.

- However, in private blockchains and other DLT platforms, the technological set up may not correlate with this and there may be other ways in which control over cryptoassets can be exercised. As such, the regulatory framework should avoid prescribing technological arrangements in order not to stifle innovation.

- In terms of segregating and holding digital assets, it is possible to hold digital assets in the same way as securities accounts, such as in an omnibus account. It is also possible to have individual user wallets which segregate the assets in the chain. Both these options could then also be available via sub-custody arrangements, for example, where a stablecoin issuer engages another technology provider to facilitate their holding of cryptoassets.]

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

- IRSG members believe that it would be reasonable to impose requirements which are consistent with the existing requirements for custodians of securities. The suggestion that client disclosure requirements should include Proof of Reserves (PoR) seems to go beyond this and, in practice, may be difficult to achieve and potentially onerous.

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

- Entities which provide custody services as well as other services in the context of traditional securities are not currently required to separate custody functions into a separate legal entity, therefore it is unclear why this would be justifiable in the context of custody of cryptoassets.

- We understand that the FCA's proposal is to enable adequate management of conflicts of interest and insolvency remoteness. However, it is not clear that requiring to separate the custody and other functions would provide the intended benefits. In particular we note that the UK operates a sophisticated regulatory framework where there are existing requirements for the management of conflicts of interest in the contexts of investment firms. It is unclear why the FCA is of the view that these requirements could not be applied to cryptoasset services providers.

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

- We agree with the principle that client assets held in custody must be protected in the scenario of the insolvency of the custodian, and acknowledge that a provider would be exposed to greater risks that may result in distress or insolvency where the same legal entity provides both custody services and wider exchange or other cryptoasset services.

- However, as these proposed new rules will also apply to digital securities, the proposal will impact the wider market for custody and traditional custodians as well as dedicated cryptoasset exchanges. We therefore think it is important to create a level playing field for market participants that is aligned with the existing framework.

- There is no requirement under MiFID that would currently limit an MTF or regulated market from providing custody and settlement services for participants in respect of

instruments traded for participants on their venue. Restrictions do apply under the current regime to own-account trading.

- We note that typically in traditional finance, trading and settlement arrangements do not occur in real time, which means that exchanges usually do not provide custody solutions. With the evolution of technology, this should in theory be possible and so the traditional market may develop to adopt a more similar approach.

- In our view, to the extent that the regulatory framework recognises that client assets are held on trust, the provider is required to put in place controls to segregate assets, and the functions of custody and settlement are required to be managed independently to avoid conflicts of interest, it should be possible to allow custody as well as wider exchange or other cryptoasset activities to be provided through the same legal entity.

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

- Although we note the proposals that custodians should hold the custody assets for the benefit of the issuer's clients so that redemption requests can be adequately met, the custodian's relationship should be with the issuer as its client only and should not be expanded to include a relationship with its clients' tokenholders.

- If custodians would be required to directly interact with clients for redemption requests, we anticipate that large additional operational costs would be incurred as a result which would significantly impact the market. This would particularly be the case for those wholesale market custodians which do not currently operate a retail business and so would have any kind of existing infrastructure or policies in place that would facilitate interactions with retail users.

Chapter 6: Organisational requirements

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

- We agree that existing systems and control requirements under SYSC should apply to the stablecoin sector.

- Financial services providers already rely heavily on technology across their businesses, with most systems operated electronically and wide and increasing use of data, cloud and AI among others. While DLT has some distinct features, particularly in the case of public networks with their scope for broader connectivity and resulting distinguishing risk considerations, there is no evidence to suggest that the approach for cybersecurity and operational resilience requirements should be materially different to the comprehensive approach that is used effectively more generally for financial services to enable safe and secure innovation. [In some cases, certain uses of DLT may actually enable risk mitigants, including building in access rights and KYC/AML compliance through permissioning.]

- To the extent that there are systemically important providers of technology, it would be most appropriate to regulate them separately under a specific framework, for example under an expanded version of the critical third-party framework that is being introduced under FSMA 2023.

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

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

- As outlined in our response to Q23, we agree that existing systems and control requirements under SYSC should apply to the stablecoin sector, including in relation to operational resilience, and would prefer to avoid the introduction of a bespoke and potentially inconsistent new regime. Systemically important providers of stablecoin technology could be regulated under a specific framework, for example, aligned with the critical third-party framework that is being introduced under FSMA 2023.

- The consumer protection and business considerations in the digital finance industry are not dissimilar from those faced in the traditional finance industry. This is especially the case given that increasingly traditional finance relies on digital technology. Consequently, we think that transposing the existing operational resilience

framework to stablecoin firms is an efficient and effective way to ensure robust standards across firms.

- [Cyberattacks are not unique to DLT. While there are certain DLT-specific cyber security considerations such as "crypto bridge attacks", "sybil attacks" and "51% attacks", such attacks are very rare, owing to the difficulty and economic cost involved in successfully carrying them out. The high standards of existing risk management frameworks, regulatory requirements, and oversight can be applied to manage DLT-specific cyber risks. These could be augmented with the introduction of specific new DLT-related risk mitigations, for example, incentives to select public, permissionless DLT networks with a track record of proven cryptography and effective consensus mechanisms, and a wide network of validation nodes or the adoption of defined criteria for permissioned applications on the network to identify users.

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

- The proposal to use the existing UK financial crime framework for the issuance and custody of stablecoins appears an appropriate and proportionate approach and would align with the existing requirements for crypto exchanges and custodian wallet providers who are already subject to the MLRs 2017, although the requirements under FSMA are wider.

- The extension of the regulatory perimeter is welcomed and will bring issuers and custodians subject to the general regulatory requirements and business standards currently applicable to all authorised firms under FSMA 2000. This can only result in enhanced internal controls and consumer outcomes.

- Despite the additional cost to many firms, the requirement to appoint an MLRO under SYSC 6.3.9 responsible for the oversight of the AML activities of the firm is appropriate to help address any risks that might arise from stablecoins potentially being used by bad actors for fraudulent purposes and the resulting potential risk to consumers.

- At the moment, there is no clear guidance on whether public blockchains will be able to be used for stablecoins under the new framework. It would be helpful for the FCA (or HMT) to confirm this. Assuming that at least non-systemic stablecoins will be able to be issued via public blockchains, the industry will need guidance on how to deal with gas fees from a financial crime perspective, among other things. For example, if the framework was applied in such a way that users would need to conduct KYC on everyone to whom gas fees are payable, it is unclear how this would work in practice.

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

- Yes, we broadly agree with the proposal for the existing Senior Managers and Certification Regime to regulated stablecoin issuers and custodians. There should be a consistent and proportionate application of the rules, so we would expect that exemptions would apply consistent with those set out in the existing regime which is suggested by the FCA's reference to applying the current 'enhanced criteria' categorisation to regulated stablecoin issuers and custodians.

Chapter 7: Conduct of business and consumer redress

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

- Provided that the Principles for Businesses and other high-level standards are applied in a proportionate way, and in a manner which is consistent with the approach for other regulated activities, we think this would be a reasonable approach.

- Paragraph 7.10 of the Discussion Paper states that firms holding regulated stablecoins for retail consumers, including sub-custodians, are likely to be subject to the Consumer Duty "as they typically face customers more directly". It is unclear why sub-custodians (as distinct from custodians holding directly for retail customers) would be any more likely to be subject to the Consumer Duty than sub-custodians holding securities for custodians whose clients are retail customers, particularly in light of the fact that they cannot influence the customer outcomes. See for example FG22/5, para 2.15, re firms operating within a mandate/with no discretion over customer outcomes.

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

- Given the similarities between the activities being conducted and the benefits deriving from clear and consistent application of rules, we would recommend that the approach taken for conduct of business requirements for stablecoin issuers and custodians is aligned with the rules that electronic money issuers and service providers are subject to under the Payment Services Regulations 2017 and The Electronic Money Regulations 2011.

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

- Access to current consumer redress mechanisms including the Financial Ombudsman Service and the procedures set out in the FCA's DISP sourcebook is appropriate and proportionate and supports the principles and purpose of the Consumer Duty, which applies even where an indirect customer relationship exists.

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

- If FSCS cover were extended to cover the issuance and custody of stablecoins, this would essentially preserve the singleness of money. Stablecoins would be as safe as consumer deposits which, in day-to-day parlance, are treated as the consumer's own money, despite being credit exposures to a commercial bank. Extending FSCS cover to give stablecoins the status of a protected claim would put the UK in a strong competitive position in the context of developing digital payments.

- Nevertheless, this status would come with costs. In order to be covered by the FSCS, issuers and custodians would need to pay a levy. This payment is mandatory where FSCS applies, so issuers would not have the ability to "opt out" and likely would be passed on to users in increased service costs.

- A potential middle ground could be to limit FSCS cover to retail stablecoin uses only, with wholesale users therefore subject to the credit protection risk of the backing assets.

- We note that there is no FCSC protection for electronic money and that the market has been comfortable without this given there are ring-fenced backing assets available. As outlined above, there are similarities and overlap between fiat-backed stablecoins and electronic money and so it would make more sense to align the position for stablecoins with electronic money than it would for deposits where users do not have the benefit of any backing assets and are therefore more exposed to the operational risks of a business.

Chapter 9: Managing stablecoin firm failure

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

- We understand that the proposal is to apply rules similar to CASS 7A to fiat-backed stablecoins. The underlying principle seems to be that on a failure of a stablecoin service provider (which from the discussion paper appears to be broader than just an issuer or a firm holding backing assets), underlying assets should be pooled rather than seeking to allocate losses to particular customers who may be said to have suffered a loss. Cryptocurrencies may make it technically feasible to allocate losses to individual customers, but as a matter of general principle we agree that a loss pooling approach is likely to be fairer.

- It may be appropriate for pooling events to operate differently at different stages in a chain of custody. For example: "Alice" holds "Bill Coins" with "CX Platform" that in turn deposits Bill Coins in an omnibus account with a "Depositary". If Bill Coins fails, it may be appropriate that a pooling event occurs so that Alice shares losses equally with CX Platform's other equivalently situated customers. Similarly, if Depositary fails, there may be a pooling event – and Bill Coins could come under an obligation to make Alice whole for any loss. If Bill Coins "breaks the buck" (see below on potential causes of this) then it may be that there is a pooling event; but it might also not be appropriate for Bill Coins to be suspended while distributions are made – it may be better (and indeed unavoidable) for Bill Coins to continue trading, but at whatever discount to par value users consider appropriate.

- That notwithstanding, and as noted above, there is currently no provision in CASS for the creation of similar arrangements for non-cash assets. Consequently, any such proposal would be very novel and require careful consideration. If creation of a statutory trust for non-cash assets is what is intended, it would be helpful to understand more from the FCA about the proposal and the powers that it would be relying on to do so.

- There may also potentially be confusion/overlap with formal insolvency processes when applying the existing CASS rules to regulated stablecoin issuers and other firms holding backing assets for regulated stablecoins. It would be important for the relevant procedures to be delineated.

- It is also not clear from the discussion paper, whether 'failure' is intended to cover only situations where a stablecoin issuer or custodian firm is subject to financial failure or operational failure or both. For example, the application of the pooling events in a failure caused by operational issues may give rise to temporary concerns relating to access to the assets, whereas financial distress resulting in formal insolvency may give rise to both immediate access issues and also potential losses.

There needs to be clarity on the types of triggers and whether they give rise to more than a temporary issue that may be resolvable or a more permanent issue that results in terminal failure.

- In circumstances where a formal insolvency process ensues, the CASS rules need to be able to operate coherently with those insolvency processes. In this regard, existing ordinary insolvency processes which focus on creditors' interest (rather than clients) may not be well suited to dealing with ensuring the return of client assets. Therefore, consideration should be given in respect of resolution regimes that either can be used to restore solvency (e.g. bail-in of the capital buffers) or facilitate a transfer of client assets to solvent parties, or whether the introduction of a bespoke special administration regime to provide insolvency practitioners with additional powers for example to conduct reconciliations of client positions and deal with return of client assets, including the setting of bar dates for distributions, akin to the investment bank special administration regime is desirable. There may be certain entities that would already be within the existing scope of the investment bank special administration regime.

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

- We agree that consideration ought to be given to a bespoke resolution regime, in particular to facilitate the transfer of client assets to a third party, with appropriate safeguards. Where this is not possible, a special administration regime to facilitate the return of client assets may be appropriate.

- Consideration should also be given on the use of existing restructuring mechanisms such as schemes of arrangement or restructuring plans to facilitate distributions in the event of firm failure.

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

- We agree with the overall approach to post-failure trading and in particular that secondary trading ought not to be inhibited as it would potentially distort and undermine the market more generally, including in relation to any realisations by an insolvency practitioner. These risks ought to part of the transaction analysis and made clear in particular to any retail consumers at the outset.

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

- Safeguards in terms of backing assets, reporting and reconciliations would also be useful safeguards to have in place prior to any failure.

- Additional protections in the form of bar dates to effect distributions might be useful from an insolvency practitioner's perspective, so that those distributions cannot be upset at a later date. Notifications and approval from court as to distributions may also be useful in terms of protecting consumers, so that that are not prejudiced by the prompt return.

- We think such safeguards may be best dealt with in a bespoke special administration regime.

Chapter 10: Regulating payments using stablecoins

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

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

- If payment arrangers hold cryptoassets as part of their services, we see no reason why similar custody requirements should not apply.

Chapter 11: Overseas stablecoins used for payment in the UK

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

- From a practical standpoint, if the issuance and custody of stablecoins are subject to significantly more onerous regulations in the UK than elsewhere, this may affect the fees and costs associated with these activities. Therefore, the market may seek to make use of overseas stablecoins if they prove to be cheaper or less administratively complex.

- We have concerns about the proposal to introduce a "payment arranger" framework which would see a new authorisation under the PSRs enabling an authorised firm to assess and approve an overseas stablecoin to be used as a means of payment in the UK. Any framework which requires domestic firms to vouch for the compliance of an overseas firm is potentially problematic, for example, the similar Benchmarks regime did not work effectively in practice.

- One challenge is that overseas firms may not be willing to engage with payment arrangers in providing additional information for validation, leaving local firms to independently validate additional information and in some cases being unable to proceed. This could also operate as disincentive to engage with more than one arranger once there is already one payment arranger in place who has conducted the checks. The first UK payment arrangers would consequently be at a competitive advantage to subsequent market participants, and could concentrate business with a first mover advantage.

- In addition, if the local firm must be satisfied as to the compliance of an overseas firm based on its own understanding of the regime, this may result in divergent approaches between UK payment arrangers. This may exacerbate the issue above, with overseas issuers choosing to engage with particular UK payment arrangers who are seen as more user friendly than others and significantly could result in inconsistent rules being applied leading to the potential for confusion and distortion in the mark.

- By forcing such an approach, the framework may in practice be deemed to be too burdensome and expensive for overseas issuers to comply with and they may choose to restrict activity in the UK as a result focusing attention elsewhere. This could have a significant impact on the development of the UK market and put the UK at a competitive disadvantage.

- One alternative solution could be to provide an exemption from the regime where a stablecoin can demonstrate that it meets equivalent requirements on the basis of a registration made to the FCA. There is precedent for such an approach, as seen with the Recognised Overseas Investment Exchanges, for example this could enable MiCA tokens to be used in the UK.

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

- Please see response to Q39. We have concerns about the introduction of a payment arranger regime and would suggest that this proposal is reconsidered in light of the potential market impact and based on experience elsewhere (eg with the Benchmarks regime).

February 2024