IRSG
INTERNATIONAL REGULATORY STRATEGY GROUP

HM TREASURY

CONSULTATION AND CALL FOR EVIDENCE

Future financial services regulatory regime for cryptoassets

Memorandum from the International Regulatory Strategy Group (IRSG)

- 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 group supports a positive approach towards cryptoassets, whilst being mindful of risks. Moves for the UK to build a robust regulatory regime for cryptoassets in collaboration with industry are to be welcomed. Members of the IRSG include firms from the UK financial and professional services sector.

- Together with London's status as a global financial hub, the UK has the capital and expertise for investors with an interest in the opportunities presented by the greater automation and digitalisation of financial services. Achieving the right balance between fostering the right regulatory environment for cryptoassets to thrive, while protecting the interest of consumers, will require careful planning and adequate engagement with industry. Both outcomes can be achieved without compromising innovation nor consumer protection.

- We note that the definition for cryptoassets in the Financial Services and Markets Bill (FSMB) is drafted very broadly to be used as a catch-all term and that it would include cryptocurrencies, tokenised 'traditional' financial assets, and any digitally shared encrypted information which could be considered as having 'value'. It is important that when HM Treasury is considering responses and the regulators begin to develop the framework and specific rules for these activities and assets that the scope of what is regulated is made much tighter. The approaches put forward by HM Treasury are broadly reasonable, but as the regime begins to form it will be critical that definitions of activities and assets are made much more precise to give market participants clarity. It is particularly important that the mere use of DLT technology in the lifecycle of an asset does not of itself impact the regulatory treatment of that asset, particularly as convertibility and even fungibility of digital and traditional securities might be seen in the future.

- While the consultation and call for evidence for cryptoassets addresses a broad range of technical financial regulatory issues, we would suggest that HM Treasury take this into account alongside the essential data considerations in relation to cryptoassets. This includes not just non-personal data, but specifically the impact for personal data, particularly in relation to KYC obligations and ultimate beneficial ownership, and in relation to DeFi which is disintermediating institutional players and enabling individuals to transact in cryptoassets directly on a peer-to-peer basis. NFTs in particular may involve direct engagement with individuals, and personal data issues around security, confidentiality, cross-border data flows, accountability under data protection regimes, and data protection rights need to be addressed to ensure regulatory coherence between the financial services framework and data protection obligations. We suggest that HM Treasury use their 'have regard' power as is written in the FSMB to direct regulators to working through these considerations.

- The Digital Regulation Cooperation Forum (the voluntary grouping of the ICO, CMA, FCA and Ofcom) is demonstrating leadership and collaboration in relation to data issues which bridge multiple regulatory siloes in a constructive manner. We would encourage HM Treasury to engage with the Department for Science, Innovation and Technology on the data aspects of cryptoassets. We would also note that the current Bank of England Consultation on CBDCs includes a section on data protection and privacy issues, recognising the importance of addressing relevant data issues for cryptoassets and digital currencies. Consumer protection is an increasingly important factor for the effective regulation of cryptoassets, and both consumer protection and data protection considerations are therefore crucial in the evolution of policy and legislative approaches.

- The IRSG is keen to support HM Treasury in its inquiry into a future financial services regulatory regime for cryptoassets in the UK and is happy to provide further detail on any of the topics raised below. We focused our response on the following:

    - scope of the proposed regulatory framework (e.g. HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets, definition of "cryptoassets" and appropriate exclusions, use of Designated Activities Regime etc.);
    - delineation and interaction between the regime for fiatbacked stablecoins (phase 1) and the broader cryptoassets regime (phase 2);
    - proposed territorial scope and interaction with the existing OPE (overseas person exclusion);
    - challenges with MLR registration; and
    - treatment of NFTs and security tokens.

- We wish to particularly thank Clifford Chance LLP for their support in drafting this response.

BOX 2.B

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

   IRSG members agree in principle with the proposal to include cryptoassets in the list of "specified investments" in Part III of the Financial Services and Markets Act (FSMA)'s Regulated Activities Order (RAO), as this will enable specific regulated activities to be defined and for the Financial Conduct Authority (FCA) to implement tailored rules.

   However, clarity is needed on whether the intention is to (a) create a single additional specified investment ("Cryptoassets"), defined in line with the new FSMB definition, or (b) whether several specified investments covering the different types of assets will be created covering the different types of assets under the wider definition of cryptoassets included in the FSMB.

   IRSG members' preference would be for a single definition for consistency. However, we note that the FSMB definition is very wide and as currently drafted there is a risk that it would include a range of cryptographically secured digital assets that are clearly not cryptoassets, for example proprietary systems with an element of encryption or traditional securities issued in dematerialised form. In this respect, it is relevant to highlight that virtually every electronic system (regardless of whether or not it is centralised or decentralised) relies on encryption to transmit data packets which arguably have "value". This includes email messages, electronic share registers, commercial databases used by any institution (including the government), social media platforms, etc.. We would strongly suggest that further consideration is given as to whether such a wide definition is appropriate. While we appreciate the need to future proof the definition and that a reference to distributed ledger technology (DLT) seems to have been specifically avoided, we would note that the revised definition is so expansive that virtually any electronic system could arguably be caught. While not perfect, the EU's Markets in Crypto-Assets Regulation (MiCA) tries to resolve this by including a reference to "distributed ledger technology or similar technology" coupled with a number of exclusions which at least attempt to narrow the scope of the regulation. We would advocate for a similar but improved approach.

   Whether the FSMB definition is amended or not, to more precisely identify which assets are envisaged to be in scope we are of the view that exclusions are needed to increase clarity and precision to the new category of cryptoasset. Proposed exclusions include:

   - any cryptoassets that already qualify as another type of specified investment (including natively issued or tokenised shares or bonds or units in collective investment schemes, and blockchain-based commercial deposits, i.e. deposit tokens that represent deposits held by regulated financial institutions)[1]. If existing specified investments could also qualify as regulated cryptoassets, this could compromise the principle of same risk, same regulatory outcomes as it suggests that a traditional asset (which already qualified as a specified investment) should be treated differently or penalised simply because of the use of cryptographically secured technology rather than another type of underlying technology being used in that asset's lifecycle. Our view is that the treatment for existing specified investments should be consistent regardless of whether it is DLT-based if they otherwise meet any relevant conditions, to avoid any regulatory overlap or the potential for inconsistent rules applying. Regulation should aim to remain technology neutral to the extent possible;

- any cryptoasset that qualifies as a securitisation position under the securitisation regulation to the extent not already a specified investment;
- cryptoassets which merely act as register entries (which might be seen as a type of value or just DLT back end records) but which do not constitute separate investable assets or have a separate legal status, including those in closed loop systems;
- genuinely non fungible tokens (NFTs) which are not fungible between themselves, as long as those do not confer the rights of a financial instrument and are not used for financial services activities;
- central bank digital currencies; and
- settlement tokens that are used exclusively between participants of a payment system (this might include blockchain-based commercial deposits that are issued by regulated financial institutions).

HM Treasury should explicitly distinguish deposit tokens from stablecoins to avoid any potential confusion, and potentially subjecting blockchain-based deposits or deposit tokens (which meet the conditions of the existing category of "deposits") to any new cryptoasset regulation in addition to rules applicable to deposits. It is therefore important to clearly delineate what constitutes a "stablecoin" or "digital settlement asset" to make sure that those assets are sufficiently differentiated from blockchain-based deposits or deposit tokens. The latter should be excluded from the cryptoassets definition here and therefore out of scope for this phase but also for phase 1.

If HM Treasury's intention is to create several new specified investments covering the different types of cryptoassets rather than a single category, it should consider this very carefully, noting the differences between different types of cryptoassets and their risk profiles. In particular, it will be important to differentiate between the risks of cryptoassets based on private vs public blockchains, as well as cryptoassets

[1] The definition of "cryptoassets" in the FSMB is similar to that used in the UK Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations (MLRs), where the relevant guidance from the Joint Money Laundering Steering Group states "cryptoassets may be specified investments for the purposes of the [RAO]" , which creates a risk that a cryptoasset regulated under the new regime could also qualify as another specified investment.

where use of DLT is simply for register purposes as outlined in the list of exclusions above. HM Treasury and the FCA should be careful to avoid overgeneralising risks or technology issues that are specific to certain cryptoassets and networks by applying overly restrictive rules across the board.

We would also encourage HM Treasury to take the opportunity to align definitions of cryptoassets within the UK regulatory framework. Based on the current proposal, the definitions for cryptoassets under the MLRs, the new proposed financial promotions regime, the new proposed stablecoin regime and this regime will broadly cover a similar class of assets but have slightly different scopes. This will make compliance complex and expensive for all market participants and it will be particularly difficult for smaller firms to navigate. These higher costs will likely be passed on to consumers. We note that firms will face potential criminal sanctions for any breach.

It would also be helpful if the definition of cryptoasset under the proposed UK regulatory regime and its exclusions aligned with the categories of prudential treatment under the new Basel Committee on Banking Supervision (BCBS) standard for cryptoassets, or at a minimum, that the BCBS' potential mapping was taken into consideration.

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

Yes, the IRSG agrees with HM Treasury's proposal to leave cryptoassets outside of the definition as a means of facilitating the development of a flexible and adaptable regulatory framework. This approach will also allow the FCA to create tailored rules that will apply to cryptoassets under the regulatory framework with appropriate divergence from existing rules. It will also allow to take account of specific features, rather than having a blanket application of existing rules that apply to MiFID financial instruments, for example, and which may not be fit for purpose.

However, as set out in our response to question 1 this does mean that having a set of clear exclusions to the definition of cryptoassets under the FSMB is critical. In the absence of such exclusions, among other unintended consequences, the definition of cryptoassets would include certain existing specified investments that have been issued or held using DLT (such as tokenised bonds or shares).

IRSG members would also urge HM Treasury to consider this proposal in light of the impact of the Edinburgh reforms, under which HM Treasury, the Prudential Regulation Authority (PRA) and FCA will have powers to amend legislation applicable to financial instruments. The result of this could be the creation of different regimes for financial instruments that are also cryptoassets. These powers should therefore be exercised with caution with the starting point, as outlined above, being that the mere use of DLT technology in the lifecycle of an asset should not impact its regulatory treatment, particularly as convertibility and even fungibility of digital and traditional securities might be seen in the future.

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

   In our view, the implication of the use of the DAR is that a person carrying on a designated activity will be obliged to comply with certain requirements specified by HM Treasury and/or the FCA, unless they benefit from an exemption. However, they will not be required to obtain authorisation as a condition to carrying on the activity. In order to be able to identify potential challenges, greater clarity is needed as to the exact activities that would be regulated using this framework. The consultation appears to suggest that HM Treasury is considering the use of the DAR in respect of (i) the offering of cryptoassets which do not meet the definition of a security token offering, and (ii) in the call for evidence in the context of DeFi regulation.

   The IRSG broadly supports an activities-based approach that would bring financial services performed in relation to regulated cryptoassets within an appropriate regulatory perimeter. As discussed, however, care should be taken to ensure the principles of 'same activity, same risk, same regulatory outcome' as well as technology neutrality are reflected. If the definition of cryptoassets doesn't exclude existing specified investments, the logical consequence would be that issuer of native digital securities (security tokens) would be treated as cryptoasset issuers and subjected to the DAR which would be inconsistent and create different outcomes as a result of using different technology.

   HM Treasury should consider parallel legislation which applies to other financial instruments, where relevant, and aim for consistency where appropriate with the use of the DAR for equivalent new designated activities for cryptoassets. For example, there should be consistent rules for the issuance and offering of cryptoassets vs financial instruments to the extent appropriate (e.g. in terms of trigger points), while allowing carefully considered divergences to be made to reflect the specific characteristics of (certain types of) cryptoassets.

   While further clarity is needed as outlined above, if HM Treasury proposes to use the DAR to regulate the offering of cryptoassets which do not meet the definition of a security token offering, we support its use in respect of the non-authorised token issuers who have to comply with a particular framework. Whichever activity the DAR covers, it should be possible for the requirements under the DAR to be delegated to an authorised firm who is providing a service, e.g. structuring the token issuance in accordance with applicable FCA rules, creating an exemption for the firm who would otherwise be subject to the obligations imposed by the DAR. This would be achieved by a specific exemption from the DAR regime for firms who have procured the services of an authorised service provider in respect of the DAR activity.

   Finally, the FCA should have strict enforcement objectives in respect of the DAR framework to the extent that it is used to regulate certain activities. For example, the regime must allow the FCA to prevent overseas issuers or offerors who are not complying with applicable rules from carrying on their activities.

BOX 3.A

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

   Assuming this question concerns any existing MLR-registered firm which is seeking authorisation to carry on regulated activities in relation to cryptoassets that will be regulated under the new framework (rather than other regulated activities more generally), we propose that the regulatory framework creates a transitional regime based on achieving the following principles:

   - the authorisation process should not materially disrupt the ability of firms to continue carrying on existing business (assuming business is a regulated activity in a regulated asset class);
   - any additional applications or considerations should be proportionate and aim to avoid a complete review of a firm's activities where the firm's activities have been reviewed previously. The consultation notes that the FCA will endeavour to avoid duplicative information requests which is helpful;
   - firms should be given the opportunity to remedy any deficiencies within a certain timeframe; and
   - any additional specific rules that would have a large administrative burden should be introduced on a phased basis, provided that the impact of this for other market participants and consumers is considered and that it would not cause potential harm, be unfair or result in an unlevel playing field.

   We also encourage HM Treasury and regulators to reconsider the registration requirement under the MLRs with a view to removing it at the point the new comprehensive regulatory framework for cryptoassets comes into effect under FSMA (including appropriate transitional requirements for existing MLR-registered firms). This would help to level the playing field in terms of compliance with anti-money laundering rules between cryptoasset services providers and credit institutions, investments firms and other "relevant persons" as defined in the MLRs.

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

   The delineation and interaction between the two proposed phases of regulation is broadly clear, however, clarification is still needed on (i) the specific assets and functions in the scope of each phase and (ii) interaction between both phases.

   HM Treasury has stated that phase 1 would be achieved through amendments to, among others, the Electronic Money Regulations 2011 (EMRs) and the Payment Services Regulations 2017 (PSRs) and that the provision of payment activities and issuance of in-scope stablecoins would be subject to these regimes. It would therefore appear that phase 1 will create a regime for the issuance of certain fiat backed stablecoins and their use for payments, while issues relating to the trading/exchange of such stablecoins would be addressed under phase 2.

HM Treasury must further specify what constitutes an in scope "stablecoin" for purposes of phase 1. Where DLT is a means for recording ownership and transfers of an existing specified investment, this should not be treated as a separate stablecoin or even a separate cryptoasset, as there could be cases where none is created and those registered entries would not have a separate legal status. There should also be very clear delineation between categories taking into account scope of existing specified investments, so it is clear, for example, that a fiat backed stablecoin does not qualify as a collective investment scheme nor as an instrument creating or acknowledging indebtedness. The IRSG also urge HM Treasury to consider carefully the use of "used as means of payment" as this is a factual assessment which may differ at different points in time. To be workable for market participants there would need to be very clear prescribed criteria that would indicate how this test is met.

Further clarity is also needed on how the payment services framework and the electronic money framework interact, given that neither require FSMA authorisation but they do trigger separate authorisation requirements. There is also a risk that a Payment Services Provider under current proposals would be subject to two overlapping regimes when facilitating payments in stablecoins (the payment services framework and the regime in phase 2) which is likely to cause confusion and inconsistency. This is because once stablecoins qualify as cryptoassets that are regulated under the new framework, facilitating a payment could fall within the scope of dealing as agent or principal or arranging transactions in such stablecoins and holding stablecoins for a client could qualify as safeguarding and administering functions under the new proposed regime.

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

While there are advantages to a phased approach, this should be considered in the global context where other regulatory frameworks are being developed in many jurisdictions in parallel. For the UK to retain its competitive position in terms of encouraging both established and new firms to retain or establish cryptoasset businesses, it would be helpful to have clarity on the complete regulatory framework as soon as possible. While a phased regulatory framework may reduce compliance costs at the outset, it also has the potential to create market uncertainty, the ability for arbitrage and a misalignment on definitions of cryptoassets (within the UK and internationally). A phased approach also limits the ability of market participants to plan and expand their business offerings.

BOX 4.A

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

The IRSG would suggest some modifications to the proposed territorial scope.

The IRSG would like to emphasise that the existing overseas person exclusion (OPE) in the FSMA perimeter in the UK is a real strength of the UK regime (see IRSG Report - The UK regime for overseas firms) for the wholesale market, contributing to the UK's success as a global financial centre. This should be expanded to include relevant activities in cryptoassets, using a tailored approach with appropriate carve outs similar to the way that the OPE applies to securities for example. Further consideration may need to be given to the application of the OPE in the context of systemically important stablecoins.

Extending application of the OPE in this way seems to be aligned with HM Treasury's general policy approach to cryptoassets regulation. It would not only allow non-UK based participants to engage in UK markets, but also give legal certainty to UK authorised cryptoasset services providers that they do not risk breaching the general prohibition when dealing with an overseas firm, allowing UK firms to export their cryptoasset services across the world. This would also ensure that the overall regime for cryptoassets remains consistent with the existing regime that applies to traditional asset and cross-border access routes for other financial assets.

IRSG members note that HM Treasury is also considering the availability of a reverse solicitation and equivalence regime for cryptoasset services providers and would support this, in addition to expansion of the OPE. Where active promotion is not permitted on a cross-border basis, it would be helpful to have clarity that reverse solicitation should be possible.

We support use of an equivalence regime where this would allow mutual recognition of other international frameworks based on outcomes, but need clarity on how it would work in practice. Both of these regimes should be considered in light of other policy proposals and the impact this might have on existing products and markets. For example, the introduction of a reverse solicitation exemption must be considered as a distinct additional option alongside the extension of the financial promotions restriction to include "qualified cryptoassets" given that the existing financial promotions regime does not provide for such an exemption.

It will also be important for the UK to continue to work with the global regulatory community to align international regulation where possible and limit/mitigate fragmentation. It is important that the UK regime is not unnecessarily strict in comparison to other equivalent regimes as this could lead to providers being pushed out of the UK. It is also important that HM Treasury considers the availability of VPN tools which might allow businesses or consumers to attempt to evade territorial scope limitations. This highlights the importance of global coordination and the use of common principles across jurisdictions.

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

   The IRSG broadly agree, although it will be important to consider this in light of the "same activity, same risk, same regulatory outcome" principle.

We also support a principles-based approach regardless of the new form that actors conducting regulated (or yet unregulated) activities or new products might take to ensure that new activities are not inadvertently missed by overly narrow regulation or a restrictive regulatory approach.

It is critical that HM Treasury consider carefully any deviations between existing regulated activities and proposed new ones and the impact that this might have on market participants. For example, notwithstanding the purported focus on 'same activity, same risk, same outcome', it is suggested that the MLRs reference to not only safeguarding and administration of cryptoassets, but also just to safeguarding, should be carried across into the new regulation. While the broader wording works for the AML registration regime, we have concerns about proposing a new regulated activity which goes beyond existing parameters in Article 40 of the RAO. Introducing such a change would create significant uncertainty for market participants, unsettling widely agreed business models and market practice and potentially significantly increasing costs. If a new regime is introduced for cryptoassets specifically leaving the existing Article 40 regime untouched for securities generally, it would create an inconsistency if either holders of cryptoassets which are securities would be subject to a different test for custody than holders of other securities, or if holders of cryptoassets which are securities are subject to a different test than holders of other cryptoassets.

We also wish to re-emphasise the need for clarity in defining the scope of cryptoassets, and urge HM Treasury to confirm that the activities listed above should comprise only cryptoassets that are not covered by other categories of specified investments and that are included in the regulatory perimeter. It will be important to wait for the UK's FMI Sandbox to conclude before determining the precise regulatory regime which will cover clearing and settlement activities relating to pure cryptoassets, or at least for HM Treasury to acknowledge that regulation is likely to need to be adjusted to take into account findings from the Sandbox. We suggest that these activities should be included in the suggested scope of activities and that HM Treasury should provide guidance as to how they should be conducted.

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

Building on our response to question 6, a phased approach is not ideal as it will inhibit market participants from planning and taking the necessary steps to begin to build businesses and the wider ecosystem.

The consultation suggests that Phase 2 would create the regulatory framework for the main exchange and investment activities, with the exception of custody of fiat backed stablecoins. It should be noted that due to the fragmentation of regulatory frameworks across jurisdictions and the parallel implementation of MiCA, cryptoasset exchanges may decide not to establish their operations in the UK. The regime for dealing in cryptoassets as a principal or agent or facilitating access to underlying customers onto internationally active exchanges will therefore become crucial, and HM Treasury may want to prioritise the position in respect of cryptoasset services providers that execute orders for clients on non-UK trading venues in Phase 2.

We would also like to highlight that proposed amendments to the RAO to include the custody of fiat backed stablecoins would not be consistent with the position of safeguarding electronic money where providers can hold e-money for others without triggering licensing requirements.

Given the increasing amount of market activity in relation to digital securities it might also be advisable to prioritise developing a clear regulatory framework there, following the principle of "same activity, same risk, same regulation" and technology neutrality, including clarifying how existing regulation should apply in the meantime. Most importantly, IRSG members require clarity on how the existing framework applies to specified investments that use DLT. As outlined above, clarification of the definition of cryptoassets including the provision of adequate exclusions will be crucial, for example to distinguish between security tokens that qualify as an existing specified investment and the new category of other "cryptoassets".

It would also be helpful to have further information around the proposed timeframes for future phases covering validation and governance activities to avoid delaying the implementation of a holistic UK cryptoasset regime.

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

The recent failures of some high-profile exchanges appear likely to have been driven by alleged fraudulent activity rather than vertical integration. Nevertheless vertically integrated market structures may exacerbate risks and also create issues related to conflicts of interest (both disclosing and managing them), competition and fair access.

We therefore agree that an authorised entity that carries on several regulated activities should be subject to the rules that apply in respect of each of those activities, and we suggest using organisational information barriers and/or systems and control mechanisms that have yet to be applied to cryptoasset service providers to mitigate risks. The IRSG is generally supportive of an approach based around the principles of operational and, when needed, legal separation, mandated disclosure and management of significant conflicts of interest to regulators and functions being performed (or not performed) in the same legal entity as other functions relating to cryptoassets. Strong supervision and education for regulators will also be important.

We also propose that guidance should be provided on the risks of combined activities and controls thereon. The consultation notes in paragraph 4.10 that further consideration will be given in relation to this but does not state timing or direction. This could cause difficulties and greater expense for businesses further down the line if it comes too late.

The principle of "same activity, same risk, same regulatory outcome" is crucial in this context. Regulation should provide for functional and operational segregation between the different functions performed by a vertically integrated business model, as well as adequate disclosures to be made to avoid conflicts of interest/misuse.

In terms of additional risks, we would highlight the impact of such entities issuing their own settlement assets (e.g. contagion risks and wrong way risk). Regulated financial institutions are already subject to strong regulation and supervision regarding safety and soundness and protection of customer assets and prudential and market-based rules prohibiting activity that has been seen among certain new crypto entrants.

As the crypto market grows, regulated financial institutions may contribute their know-how, expertise, standards, risk management and overall conduct rules for operation of their business to raise the bar on the standards for this market.

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

IRSG members believe that it would be difficult to create a commodity-linked token which would not be in scope of the existing regulatory framework. For example, depending on the features of any particular commodity-linked token it is likely that it would qualify as one of a share, contract for difference or collective investment scheme (CIS).

However, it is important that HM Treasury considers the implications of this as the existing regulatory regime for these types of investments is not adequate to regulate commodity-linked tokens, particularly when contrasted with other jurisdictions developing their own stablecoin frameworks such as the EU's MiCA which specifically introduces a category of asset referenced tokens or ARTs. By way of example, if in the UK, the same tokens were treated as CIS or alternative investment funds (AIFs), this would not be a satisfactory outcome as this would have the result that UK cryptoasset services providers would not be allowed to carry on activities in respect of these assets. In addition, these regimes have strict requirements regarding marketing and diversification which would make it impossible to issue commodity linked tokens.

It is necessary to create an exclusion and separate regulatory regime for asset-backed stablecoins in comparison to other regulated investments to enable this distinct type of stablecoin to be issued and traded in the UK. In particular, asset-backed stablecoins should not qualify as CIS or as AIFs, especially where the reserve/reference assets are administered as a whole and (i) the asset backed stablecoin grants token holders any form of right in respect of the reserve/reference assets or (ii) where the asset backed stablecoin's value is determined by reference to the performance of the reserve assets. Clear delineation should be provided to give market participants legal certainty and regulatory clarity.

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

As algorithmic stablecoins do not have any reference or reserve asset that guarantees their value, investors would broadly be exposed to similar risks as investors who invest in other unbacked cryptoassets. On that basis we agree with HM Treasury's proposal that algorithmic stablecoins should be regulated in the same way as unbacked cryptoassets.

We note that some changes or additional disclosures may be required if such stablecoins are marketed as pegged to or representations of a fixed fiat amount. If the approach above applies, it could be argued that this should be prohibited.

We also suggest that it should be possible to have fiat currency backed stablecoins to be structured so that the reserve assets can be invested into high grade collateral, in line with BCBS prudential standard group 1 classification criteria.

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

No, it is unclear in the context of the consultation when an NFT will qualify as a specified investment. It is crucial that this is clarified so that the market is clear when NFTs fall within regulation and when they do not, as well as the rationale for the distinction.

The consultation states: (emphasis added) "*NFTs would have the potential to be in included in the future regulatory perimeter if they were used in one of the activities in Table 4A. If an NFT or utility token is not used in such a way, it would not fall into scope of financial services regulation unless – as a result of the particular structure and characteristics of the NFT or utility token –* ***it constitutes a specified investment and the activities carried on in relation to the token constitute regulated activities*** *that fall within the existing perimeter.*" It remains unclear in this context when an NFT is deemed to qualify as a specified investment. For example, would an exchange trading NFTs be in scope or out of scope of the perimeter? Trading is an activity in Table 4A, so the question remains whether NFTs are in scope or not. It is critical that clear tests apply for when an NFT or utility token will be within the scope of the regulatory perimeter or not. We note that an NFT is merely non fungible within the relevant blockchain it was created on, but there is nothing to prevent issuers from creating a series of technologically unique NFTs which have fungible rights between them. It follows that a technology agnostic test would be to consider whether an NFT is truly objectively unique or not (e.g. through looking at individual pricing for the particular NFT, whether it is used in a closed loop/open market etc).

NFTs can also be fractionalised, and the test should apply test in this context too, i.e. where fractional entitlements of a unique artwork are fungible with each other this would be within the definition of cryptoassets vs fractional NFTs that are linked to individual and truly non-fungible pixels of the artwork instead for example.

In line with the tech neutral approach we have proposed, NFTs should not be treated differently from other regulated cryptoassets purely based on the fact that they are created as non-fungible objects within the blockchain in which they exist and should be evaluated based on their characteristics and the type of rights conferred instead. NFTs used for financial purposes and traded on a secondary market as specified investments or regulated cryptoassets should clearly be included in the regulatory framework.

BOX 7.A

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

    We agree with HM Treasury's proposed approach of using the MiFID-derived rules as the basis of a regime for cryptoasset intermediation activities.

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

    While regulation should take into account the unique challenges that the characteristics of the cryptoassets marketplace may present, we believe that the cryptoassets market intermediation regime should broadly have the same standards and impose the same obligations as comparable traditional activity.

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

    We agree that the prohibitions against market abuse should be broadly similar to those in MAR. However, we note that the MAR definition of inside information is largely incompatible with the cryptoasset market and may be relevant only to a limited portion of cryptoassets – likely stablecoins only. This would therefore need to be adjusted to capture all relevant cryptoassets.

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

    The additional requirements in the proposed approach may be considered onerous and therefore have the effect of disincentivising trading venues to establish in the UK. It is therefore crucial that the requirement for venues to monitor transactions is applied proportionately.

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

We broadly agree with this proposal. However, further guidance will need to be provided to ensure that it is clear in what circumstances and what types of information held by a regulated firm in respect of any cryptoasset would constitute inside information, as well as the requirements for management of such information.

BOX 10.A:

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

We broadly agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities. However, we are concerned that including this as a separate new regulated activity is not consistent with existing practice in the securities lending market.

A loan of a cryptoasset which transfers title would typically be treated as selling the cryptoasset outright, with an obligation from the purchaser to re-sell the asset in due course consistent with typical securities lending transactions. Therefore, a regulated firm who intermediates cryptoasset loans would be arranging exchanges of cryptoassets or dealing in cryptoassets as agent. Our view therefore is that this new regulated activity of operating a cryptoasset lending platform is not required and could be addressed in a way more consistent with the existing equivalent regime for securities.

The main additional challenge we would identify is the need to address DeFi lending in parallel. We note that the consultation specifies that the majority of crypto lending is undertaken through decentralised or semi-decentralised platforms. This would mean that DeFi would need to be brought expressly within scope for inclusion of this additional regulated activity if there is to be a level playing field for this activity, otherwise even more activity is likely to be driven into the decentralised and unregulated space.

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

As outlined in response to question 31, we do not agree with inclusion of a new activity of cryptoasset lending and would instead encourage that cryptoasset lending should be treated in an equivalent manner to securities lending arrangements.

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

While we do not believe that the inclusion of an additional regulated activity in relation to cryptoasset lending is required, we do agree with including rules that would require enhanced transparency for cryptoasset lending transactions involving retail investors.

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

Yes, we are of the view that regulatory treatment should differ depending on whether arrangements involve title transfer or where they do not, but transfer restrictions are included as different risk profiles apply. It is less clear whether the categories specified (eg lending vs staking or supplying liquidity) will always fall into the category indicated in the question as this will depend upon the specific operational arrangements in place. For example, certain staking arrangements enable the asset to remain in-wallet, whereas others require the asset to be transferred to a different wallet (e.g., one operated by a smart contract or a third party). Therefore, it is critical that the regulatory framework is flexible and considers what is happening to cryptoassets in different types of arrangements rather than applying a blanket approach to staking.

As outlined above, lending arrangements where title is transferred should be treated in the same way as securities lending transactions are currently. In the UK, each leg of a securities lending transaction qualifies as a separate buy or sell transaction.

BOX 11.A

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

We agree with the assessment of the challenges of regulating DeFi. However, as outlined above, any potential exclusion of "decentralised activities" could risk creating a bifurcated market for certain cryptoasset services and lead to an even greater portion of certain activities being driven towards unregulated decentralised equivalents. We are therefore of the view that it is critical to the development of a successful and sustainable cryptoassets ecosystem that DeFi is brought within the perimeter of the regulatory framework to the extent possible.

We note that the FSMA envisages the granting of an authorisation to unincorporated associations, general partnerships and other undertakings that resemble decentralised organisations that operate, or govern the smart contracts that facilitate DeFI services. Therefore, it is at least theoretically possible that instances where centralised actors, such as founding members or large governance token holders, could be subject to authorisation. It is not clear to us why the consultation is proposing the creation of a separate regulated activity. The principle should be that, where a decentralised organisation is concerned with providing a regulated activity, FSMA should apply either to grant an authorisation or to bring relevant enforcement action. This would require certain clarifying changes to be made to FSMA, for example, how the threshold conditions can be met with a decentralised organisation.

There are clear challenges with enforcement in relation to DeFI that would need to be carefully considered. However, although the circumstances may be new, in most cases the principle is not new to the FCA as it deals with similar enforcement issues in relation to traditional financial instruments, for example where an unauthorised overseas entity commits fraud in purporting to sell shares in the UK. There will be circumstances where new policy decisions will be required, for example, where a DeFI protocol is based on code contributed to by multiple coders but only one of those coders is based in the UK. More consideration should be given to what should be the right approach in terms of enforcing against the single UK coder or all equally.

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

We agree that there should be the same regulatory outcomes across comparable DeFi and CeFi activities. We note that there is important work being done in this area by the Law Commission and international actors, and are also generally supportive of the need for international alignment. However, as outlined above, any potential exclusion of DeFI risks creating a bifurcated market for certain cryptoasset services and could result in an even greater portion of certain activities being driven towards unregulated decentralised equivalents. In our view, the regulatory framework for DeFi needs to follow the regulatory framework for CeFI as quickly and as closely as possible.

As the UK regulatory framework is so broad and flexible, we would suggest that HM Treasury and the FCA give careful consideration as to whether it is necessary to create new activities and different regulatory tools or whether existing rules could be relied on, for example, the rules in relation to the authorisation of unincorporated associations, general partnerships and other undertakings that resemble decentralised organisation mentioned above.

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