

# Future financial services regulatory regime for cryptoassets

## **Response to the consultation and call for evidence**

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# Foreword

The government's ambition to make the UK a global hub for cryptoasset technologies remains steadfast. To realise this ambition we must make the UK a place where cryptoasset firms have the clarity needed to invest and innovate, and where customers have the protections necessary for confidently using these technologies.

In February this year, the government published its consultation on the future financial services regulatory framework for cryptoassets. We set out extensive proposals for a UK regime, including plans to regulate core activities such as custody and lending, and to bring centralised cryptoasset exchanges into financial services regulation for the first time.

I am grateful to all of the firms and other interested parties that engaged so constructively with our consultation. The learnings gathered from our engagement have been invaluable for further informing our approach. While most aspects of our proposals were well-received by the large majority of respondents, we have modified certain features of our future framework to take onboard the evidence presented.

With the future regulatory framework now taking clear shape and the Financial Services and Markets Act now passed, the UK is the obvious choice for starting and scaling a cryptoasset business. The UK is the largest financial centre globally outside of the United States, and our tech industry is worth over \$1tn; we are only the 3rd country to hit this valuation after China and the US. This combined with world-leading systems of law and financial regulation makes for a potent combination. Unsurprisingly the UK consistently ranks at or near the top of research reports on 'crypto-readiness' and 'crypto-friendliness'.

I am very pleased to present these final proposals for cryptoasset regulation in the UK on behalf of the Government. I look forward to our continued work with the sector in making our vision a reality for the UK as a global hub for cryptoasset technology.

A handwritten signature in grey ink, appearing to read 'Andrew Griffith', is positioned above the name of the signatory.

Andrew Griffith MP, Economic Secretary to the Treasury

# Chapter 1

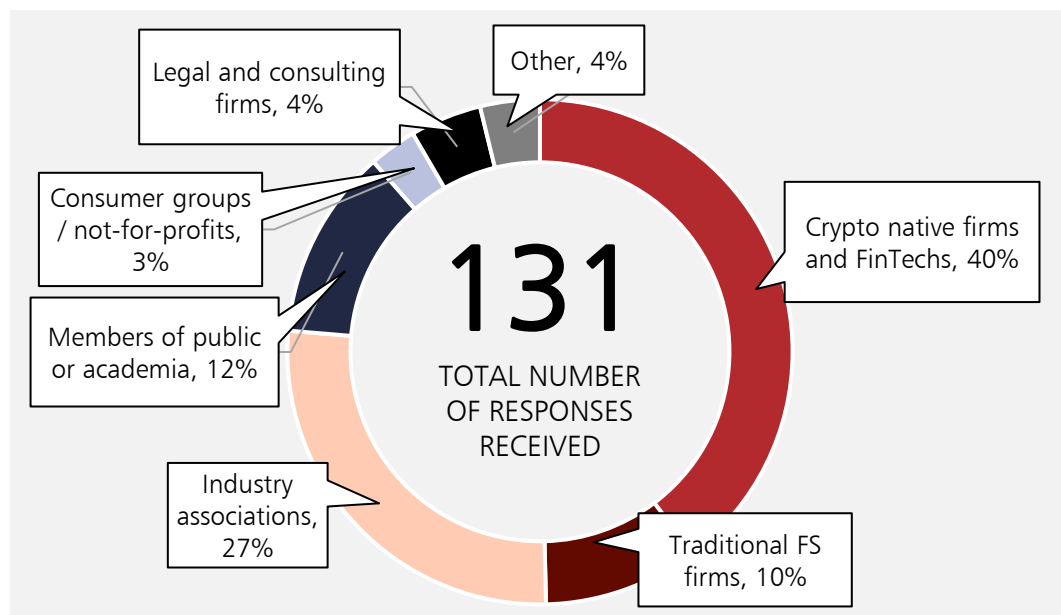
## Summary of feedback received

### Background

**1.1** This document is the government's response to the consultation and call for evidence on the future financial services regulatory regime for cryptoassets (Consultation), which was published on 1 February 2023 and closed on 30 April 2023. It outlines a summary of the Consultation questions and the responses received by HM Treasury, as well as the government's response, including how the consultation process influenced the further development of the policies and proposals consulted upon and next steps.

### Summary of feedback

#### Profiling of respondents



Source: HM Treasury analysis of responses received

**1.2** HM Treasury received a total of 131 responses from a wide range of stakeholders. Around 50% of these were from firms and around 25% from trade associations. 12% of responses were from members of the public or universities, 4% from law and consulting firms, 3% from not-for-profits / consumer associations and 4% came from other categories of respondent (e.g. media organisations). Amongst the firms that responded, there was a broad array of business models including blockchain network providers, crypto exchanges, crypto compliance firms, companies specialising in web3 gaming / collectibles, crypto fund managers and specialist crypto custody providers. A number of traditional financial services firms also responded to the Consultation, including traditional banks and custodians, asset managers and payments providers.

**1.3** In addition, since publishing the proposals, HM Treasury has engaged with more than 80 organisations, mostly through a series of multilateral workshops and roundtables. The Financial Conduct Authority (FCA) also ran an engagement programme in parallel in anticipation of the rule making powers that will be granted to them.

**1.4** Since the publication of the original proposals there have been several important policy developments in the cryptoasset space:

- The Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023 (Financial Promotions SI) – which brings financial promotions relating to qualifying cryptoassets within the existing financial promotions regime - was made on 7 June 2023.<sup>1</sup> The FCA published its Policy Statement on financial promotion rules for cryptoassets and the Guidance Consultation on cryptoasset promotions in June.<sup>2,3</sup> The regime will come into force in October 2023.
- A Treasury Select Committee inquiry (“Fifteenth Report - Regulating Crypto”) was published in May 2023.<sup>4</sup> The government’s response was issued by HM Treasury and published on 20 July 2023.<sup>5</sup>
- The Financial Services and Markets Act 2023 (FSMA 2023) received royal assent on 29 June 2023.<sup>6</sup> FSMA 2023 contains important powers confirming the government’s ability to specify cryptoasset activities within the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO), and to designate activities as part of the Designated Activities Regime (DAR) as well as providing the regulatory powers necessary to

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<sup>1</sup> [The Financial Services and Markets Act 2000 \(Financial Promotion\) \(Amendment\) Order 2023](https://www.legislation.gov.uk/ukdsi/2023/01/1350100000000001/1) ([legislation.gov.uk](https://www.legislation.gov.uk))

<sup>2</sup> <https://www.fca.org.uk/publications/policy-statements/ps23-6-financial-promotion-rules-cryptoassets>

<sup>3</sup> [GC23/1: Guidance on cryptoasset financial promotions](https://www.fca.org.uk/publications/guidance/gc23/1) ([fca.org.uk](https://www.fca.org.uk))

<sup>4</sup> <https://committees.parliament.uk/publications/39945/documents/194832/default/>

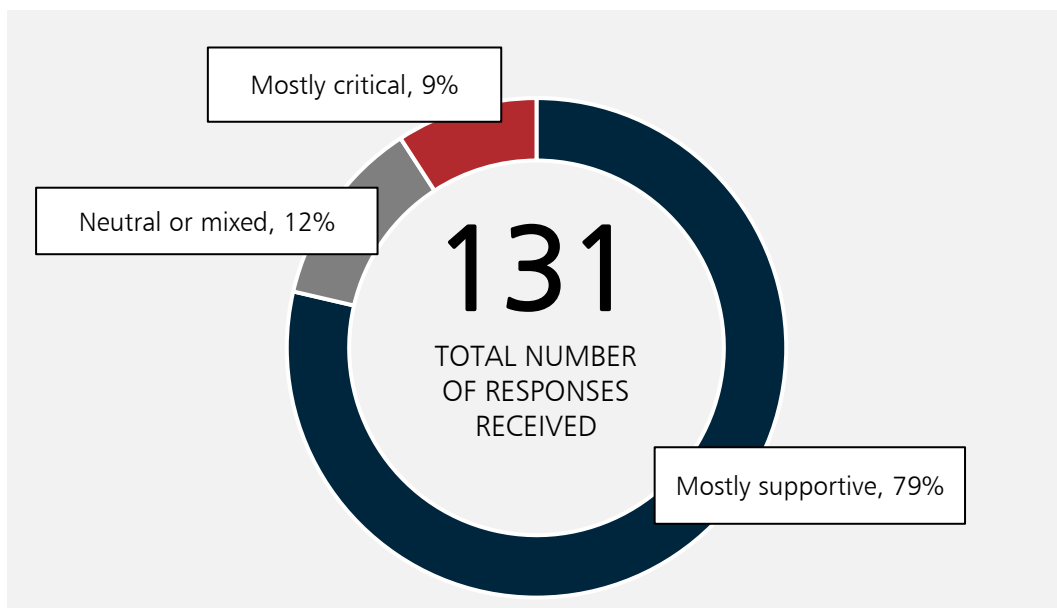
<sup>5</sup> <https://committees.parliament.uk/publications/40999/documents/199652/default/>

<sup>6</sup> [Financial Services and Markets Act 2023](https://www.legislation.gov.uk/ukdsi/2023/01/1350100000000001/1) ([legislation.gov.uk](https://www.legislation.gov.uk))

deliver a regulatory regime for the use of 'digital settlement assets' (DSA) in payments.

- The Law Commission published its Final Report on Digital Assets on 28 June 2023,<sup>7</sup> recommending selective reform and development of the private law on digital assets to secure the UK's position as a global financial hub.
- HM Treasury published a consultation on the Digital Securities Sandbox (DSS) in July 2023.<sup>8</sup> The DSS will be the first financial market infrastructure sandbox delivered under the powers granted as part of FSMA 2023 and will facilitate the testing and adoption of digital securities across financial markets.
- HM Treasury is also separately publishing an update on plans for the regulation of fiat-backed stablecoins (Stablecoins Update) which provides further clarity on activities relating to fiat-backed stablecoins and the delineation of phase 1 and phase 2 legislation.

## High-level sentiment analysis



Source: HM Treasury analysis of responses received

**1.5** In terms of general sentiment, around 80% of responses were broadly supportive of the government's overall approach. Approximately 10% had mixed or neutral feedback and the remaining 10% were critical of the proposals.

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<sup>7</sup> <https://www.lawcom.gov.uk/project/digital-assets/>

<sup>8</sup> [Consultation on the Digital Securities Sandbox - GOV.UK \(www.gov.uk\)](https://www.gov.uk/consultation-on-the-digital-securities-sandbox)

**1.6** The most critical responses included those from respondents who fundamentally disagreed with the proposal to bring cryptoassets into the financial services regulatory perimeter (on the basis that they should be banned or, for example, treated in line with gambling regulation) or otherwise disagreed with fundamental aspects of the proposal (e.g. to focus regulation on the activities rather than the assets).

**1.7** Figure 1.D. below contains a summary of the most prominent themes from the consultation feedback.

**Figure 1.D Most prominent themes from the Consultation feedback**

#	Theme	Summary of external feedback on theme	Chapter ref.	Number of respondents
<b>1</b>	Non-Fungible Tokens (NFT) & utility tokens	Clarify proposed treatment of NFTs and utility tokens – especially on what constitutes a financial services use case	CH 4	<b>25+</b>
<b>2</b>	Geographic scope	Give further consideration to the treatment of overseas firms, including making clear the applicability (or not) of the Overseas Persons Exclusion (OPE), reverse solicitation, and intra-group exemptions	CH 4	<b>25+</b>
<b>3</b>	Phase 1 versus phase 2	Delineate phase 1 and phase 2 activities in more detail, and give further consideration to potential challenges for firms and consumers	CH 3, stablecoin policy note	<b>25+</b>
<b>4</b>	Wholesale versus retail	Make stronger distinctions between services provided to professional / sophisticated investors versus retail consumers (e.g. lending, venue disclosures)	Various – e.g. CH 5, 6, 7 and 10	<b>25+</b>
<b>5</b>	Timelines	Provide more clarity on timelines for phase 1 and phase 2, and seek to accelerate the	CH 3	<b>20+</b>

#	Theme	Summary of external feedback on theme	Chapter ref.	Number of respondents
		overall implementation programme		
<b>6</b>	Security tokens	Make clear the proposed treatment of security tokens, and ensure overlapping regimes are avoided (e.g. through an explicit carve-out)	CH 2 and 8	<b>20+</b>
<b>7</b>	Token scope	Ensure cryptoasset definition used in secondary legislation is not too broad (e.g. make sure it excludes e-money, loyalty schemes, in-game money)	CH 2	<b>20+</b>
<b>8</b>	Staking	Provide clarity on the definition and future treatment of staking and consider accelerating legislation process. Consider carve-out from the scope of the collective investment scheme (CIS) regime	CH 12	<b>20+</b>
<b>9</b>	Disclosures liability	Ensure liability framework for disclosures is proportionate – especially for tokens without an identifiable issuer	CH 5	<b>20+</b>
<b>10</b>	Market abuse (cross-venue)	Consider a phased implementation approach towards market abuse surveillance obligations, recognising issues associated with cross-venue information sharing	CH 9	<b>15+</b>
<b>11</b>	FSMA authorisation process	Streamline authorisation process – in particular, consider appropriate transition pathways for firms registered with the FCA under its anti-money-laundering regime and/or already authorised under Part 4A of the Financial	CH 3	<b>15+</b>

#	Theme	Summary of external feedback on theme	Chapter ref.	Number of respondents
		Services and Markets Act 2000 (FSMA)		
12	Custody – scope	Clarify definition and scope for future regulated cryptoasset custody activities, especially with regards to self-hosted wallets and third-party arrangements	CH 8	15+
13	Investment advice	Reconsider sequencing of cryptoasset investment advice and portfolio management activities, and ensure these are included in the perimeter	CH 12	15+
14	SMEs	Take steps to minimise barriers to entry for smaller firms – e.g. through careful design of prudential requirements and issuance requirements	CH 5	15+
15	Cross-border enforcement	Clarify how cross-border enforcement can work in practice to ensure fair and level playing field for UK-regulated firms	CH 4, 9	10+
16	Permissionless blockchains	Ensure the regulatory framework appropriately reflects the risks associated with permissionless (public) versus permissioned (private) blockchains	CH 2	10+
17	Trading platform – scope	Clarify definition and scope for future regulated trading platform activities, e.g. with regards to airdrops and decentralised exchanges	Various - e.g. CH 5, 6 and 11	10+
18	Banning crypto	Ban certain cryptoassets from retail consumer use - or treat them akin to gambling rather than bringing them into the	CH 2	5+

#	Theme	Summary of external feedback on theme	Chapter ref.	Number of respondents
		financial services regulatory perimeter		
19	Transitional disclosure arrangements	Consider transitional disclosure arrangements for well-established tokens (e.g. Bitcoin) to differentiate them from recently issued tokens	CH 5	5+
20	International coordination on DeFi	Avoid front-running international work on DeFi by imposing a prescriptive domestic framework.	CH 11	5+

**1.8** HM Treasury has considered this feedback carefully and is setting out some modifications to the original proposals set out in the Consultation, as well as some actions to be taken forward to provide further clarity on key areas of interest:

- HM Treasury is publishing separately the Stablecoins Update which gives detail on the regulated activities and tokens which will be in scope for phase 1 and how these will be demarcated from phase 2 activities and tokens.
- Chapter 2 provides further guidance and reassurance regarding the intended outcomes for NFTs, utility tokens, security tokens and other data objects or ‘things’ which respondents were concerned could unintentionally be captured. It confirms that the proposed regime does not intend to capture activities relating to cryptoassets which are specified investments that are already regulated – e.g. security tokens. It also clarifies that activities relating to truly unique or non-fungible NFTs that are more akin to digital collectibles or artwork than a financial services (in the general sense) or product should not be subject to financial services regulation.<sup>9</sup>
- Chapter 3 includes updates on timelines for phase 2 legislation and further information on the future FCA authorisation process for cryptoasset activities.
- Chapter 4 acknowledges the need to mitigate the fragmentation of cryptoasset liquidity that could arise from a restrictive location and market access policy. The government will proceed with an

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<sup>9</sup> See chapters 2 and 4 for full details and qualifications

approach that facilitates access to international liquidity pools under specific circumstances.

- Chapter 5 restates the government’s position on issuance and disclosures, noting that the recklessness and negligence liability standards will enable market participants to manage their liability so long as they make reasonable enquiries. The government is also supportive of the use of publicly available information to compile appropriate parts of the disclosure / admission documents.<sup>10</sup>
- Chapter 9 sets out a modified approach towards market abuse obligations on cryptoasset exchanges, acknowledging the potential need for a staggered implementation for cross-venue data sharing obligations.
- Chapter 12 features a clear direction of travel and plan of action on staking to inform the government’s view on a set of critical questions and provide regulatory clarity to industry in an accelerated way versus the previous plan. An engagement programme with external stakeholders has already been launched to inform this work.
- Other topics in Figure 1.D. are discussed in various chapters as indicated in the table. Where a significant number of respondents set out a proposed way forward that is different to the government’s proposed approach, the rationale underpinning the government’s decision is set out in this Response.

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<sup>10</sup> Though persons preparing disclosure/ admission documents would need to be clear on where this information originated and the level of due diligence they had done over it

## Chapter 2

# Definition of cryptoassets and legislative approach

### Recap on original proposals from the Consultation

**2.1** The Consultation set out government's intention to include the financial services regulation of cryptoassets within the regulatory framework established by FSMA, rather than develop a standalone bespoke regime, and to include cryptoassets in the list of 'specified investments' in Part III of the RAO. This would require firms undertaking activities involving cryptoassets by way of business to be authorised by the FCA under Part 4A of FSMA and make available the FCA's general rule-making powers. The Consultation also referred to the government's ability to use the DAR to designate certain activities in order to make regulations relating to the performance of that activity. The Consultation noted that it is not government's intention to expand the definition of 'financial instrument' in Part 1 of Schedule 2 to the RAO to include currently unregulated cryptoassets (though those cryptoassets that already qualify as financial instruments, such as security tokens, will continue to do so).

#### **Question 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.

**2.2** HM Treasury received 80 responses to this question. 94% of responses agreed or generally agreed with the proposal, and 6% disagreed. Of those who supported the proposal, the main arguments in favour revolved around the fact that this would be a relatively pragmatic and flexible way of bringing cryptoasset activities into the regulatory perimeter, thereby addressing the most critical risks and creating a more level playing field for market participants. Respondents also noted that this approach would be broadly consistent with most other major jurisdictions.

**2.3** Among those that were generally in favour, it was however noted that the FSMA 2023 definition of cryptoasset was very broad and therefore there was a risk of creating overlapping regimes for existing specified investments (e.g. e-money, security tokens or tokenised deposits), inadvertently capturing data objects such as book entry tokens, or casting the net too broadly by capturing NFTs or utility tokens which are not used for one of the regulated activities in Table 4A of the Consultation within financial services markets or as a financial services instrument (in the general sense), product or investment.

**2.4** Those that disagreed with the proposal were mostly of the view that cryptoassets (or at least certain types of cryptoassets – such as unbacked cryptoassets) should not be given legitimacy through being incorporated into the financial services regulatory perimeter (the ‘halo effect’ argument). Some of these respondents called for outright bans, or restrictions to prevent retail consumers from being able to purchase cryptoassets. Other suggestions included treating retail purchases of unbacked cryptoassets as a form of gambling. A small number of respondents agreed with the need to apply financial services regulation but disagreed with the mechanism of using the RAO, arguing that a standalone bespoke regime would offer greater flexibility and would be more proportionate given the nascency of the sector. Some respondents argued that HM Treasury’s approach should be much more cognisant of the risks associated with permissioned (private) vs permissionless (public) blockchains – typically arguing that the risks associated with the latter were generally higher and different in nature. A few responses suggested that the legislative and regulatory framework should actually be fundamentally structured around this distinction.

## **Question 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.

**2.5** HM Treasury received 68 responses to this question. 82% of respondents agreed or generally agreed with the proposal, while 10% disagreed and 7% of responses were neutral or mixed.

**2.6** Those who were generally supportive of the proposal noted that applying an existing regime to cryptoassets – a relatively new asset class with unique features and risks – would likely result in unsuitable and potentially onerous regulation. Even among supportive responses, however, there was some concern that not including cryptoassets within the definition of financial instruments could lead to uncertainty, including but not limited to how the cryptoassets regime and the financial instruments regime would interact.

**2.7** At least one respondent queried how the proposal not to include cryptoassets within the definition of financial instruments would impact other legislation using that term. This is not dealt with in this chapter but for further information see chapter 8. Other responses highlighted the need to ensure consumers who purchase cryptoassets benefit from the same level of safeguards as the holders of assets that do fall within the definition of financial instruments.

**2.8** Those who disagreed with the proposal generally did so on the basis that it would be a positive step to bring cryptoassets within the scope of the existing, well-developed regime for financial instruments. At least one response noted that the list of financial instruments is already relatively expansive and queried why – given the breadth of assets covered – it could not also extend to cryptoassets.

### **Question 3**

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

**2.9** HM Treasury received 53 responses to this question. Of those, 38% indicated that there were possible challenges, while 30% of responses were mixed or uncertain. 32% of respondents did not identify any potential challenges.

**2.10** A common theme among responses was the need for greater clarity on when HM Treasury would consider using the DAR to legislate for cryptoasset activities and, where it decided to do so, what the regime would look like. Some respondents suggested that HM Treasury should be required to consult in circumstances where it proposed to use the DAR to provide greater clarity to industry. Some respondents recognised the benefits offered by the DAR in terms of flexibility, but nevertheless felt there was some risk in two regimes – the DAR and the RAO – coexisting and potentially overlapping. At least one respondent queried how monitoring and enforcement would work under the DAR regime and made the point that if overseas enforcement under the DAR was more difficult, that might strengthen the case for the government/regulators to require cryptoasset firms to establish in the UK. HM Treasury's assessment was that many of the concerns raised arose from lack of familiarity with the DAR, given its novelty. Most respondents pointed out potential challenges and risks in a constructive way but did not seem to be implying that the use of the DAR was unworkable.

**2.11** Among those responses that were neutral or mixed, there was likewise a call for greater clarity as to how and when the DAR would be used. At least one respondent highlighted the need to ensure the DAR provided consumers with safeguards equivalent to those in the RAO.

## Government response

**2.12** In general, the government intends to proceed as proposed in the Consultation. In particular, the government will expand the list of ‘specified investments’ in Part III of the RAO and thereby require firms undertaking relevant activities involving cryptoassets by way of business to be authorised by the FCA under Part 4A of FSMA. FSMA is well-established and understood by firms. In line with feedback received, the government continues to consider that developing a fully bespoke regime outside of the FSMA framework would risk creating an un-level playing field between cryptoasset firms and the traditional financial sector. The government’s approach would also be in line with the approach taken by numerous other jurisdictions.

**2.13** Likewise, the government does not plan to expand the definition of ‘financial instruments’ in Part 1 of Schedule 2 of the RAO to include presently unregulated cryptoassets. Notwithstanding some limited feedback to the contrary, the government agrees with the majority of respondents that retrofitting the existing financial instruments regime to cryptoassets would likely result in unsuitable and potentially onerous regulation.

**2.14** The government considers that the DAR is a strong, flexible tool that will likely form part of the delivery of the future financial services regulatory regime for cryptoassets.

### **Definition of cryptoassets**

**2.15** The government has received a high volume of feedback – both in responses to the Consultation and through wider stakeholder engagement – to the effect that the definition of cryptoassets in the Consultation is overly broad. As set out in Chapter 2 of the Consultation, the definition (which is taken from FSMA 2023) is drawn broadly so as to capture all current types of cryptoasset and ensure the government has the power to regulate not only those types of cryptoasset that currently exist but also those that may exist in future.

**2.16** The Consultation noted that future financial services regulation of cryptoassets created using HM Treasury’s powers will typically apply to a particular subset of cryptoassets depending on the matter being regulated and will accordingly use a narrower definition to capture these. That notwithstanding, the government is keen to reassure industry regarding some specific examples raised in feedback. The precise legal mechanism for distinguishing between tokens that are in and out of scope will be set out in the relevant secondary legislation and FCA rules.

**2.17** As a general principle, the government’s intention is that cryptoassets not being used for one of the regulated activities in Table 4A of the Consultation within financial services markets or used as a financial services instrument (in the general sense), product or investment should fall outside the future financial services regulatory

regime.<sup>11</sup> Such cryptoassets may, though, still fall within existing regulated activities or financial instruments, products or investments, such as where they are the underlying asset or property for a CIS. Where firms have specific concerns over whether a particular cryptoasset or product would fall within the regime, a useful heuristic may be to consider how a similar product or activity (if there is one) would be treated in the traditional finance context (in line with the principle of “same risk, same regulatory outcome”).

**2.18** Likewise, the government does not intend to capture cryptoassets which are specified investments that are already regulated. This includes, but may not be limited to, security tokens representing debt or equities. Insofar as certain cryptoassets fall within the scope of already applicable existing regulatory regimes, they will largely continue to be regulated in line with the relevant existing rules and regulations. For example, firms carrying out regulated activities involving security tokens will need to obtain relevant permissions or fall within exemptions under the regulatory frameworks applicable to traditional financial services, and could be subject to existing requirements such as those relating to issuance. However, the unique qualities of cryptoassets will likely require a small number of specific adjustments to these existing regimes (for instance around custody—dealt with in more detail in Chapter 8) but the government does not expect these to be extensive. To the extent specific changes are required to accommodate for distributed ledger technology (DLT), these will likely be taken forward through the DSS initiative.

**2.19** The government received a significant number of responses requesting further clarity on the proposed treatment of NFTs and utility tokens. These categories of token are discussed in Chapter 4.

### **Calls to ban cryptoassets or regulate cryptoassets as gambling**

**2.20** The government acknowledges the responses it received suggesting that certain cryptoassets should be banned or treated as gambling. As set out in its response to the Treasury Select Committee,<sup>12</sup> the government firmly disagrees with the suggestion that retail trading and investment activity in unbacked cryptoassets should be regulated as gambling rather than a financial service. Such an approach would run counter to globally agreed recommendations from international organisations and standard setting bodies (SSBs) and would risk

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<sup>11</sup> At various points, this document refers to certain categories of cryptoassets or activities falling outside the future financial services regulatory regime for cryptoassets or includes wording to that effect. Such references refer to the regime that is the primary focus of this Consultation, namely that governing new regulated activities under the RAO and/or designated activities under the DAR. Such wording should not be taken to mean that said cryptoassets or activities might not be regulated under other regulatory regimes either now or in the future (including but not limited to the financial promotions regime, applicable existing regulatory regimes for traditional securities or generally applicable areas of law such as in relation to anti-money laundering/counter-terrorism financing or fraud).

<sup>12</sup> <https://committees.parliament.uk/publications/40999/documents/199652/default/>

misalignment with international standards and the approaches of other major jurisdictions, including the EU.

**2.21** Regulating cryptoasset activities as gambling would also risk creating unclear and overlapping mandates between financial regulators and the Gambling Commission. Furthermore a system of gambling regulation could fail to appropriately mitigate many of the risks identified in the Consultation, including those associated with market manipulation, prudential arrangements, and deficiencies in core financial risk management practices. These are more appropriately addressed through financial services regulation.

**2.22** The proposal to ban cryptoassets similarly fails to address other risks associated with the industry. There would be adverse consequences in terms of innovation, and there is no guarantee that banning cryptoassets would protect consumers, given high public demand and the availability of services in other jurisdictions. Indeed, many countries that have banned cryptoassets – or significantly restricted their uses – have higher adoption rates than the UK.

**2.23** The government considers that having robust and effective regulation will boost innovation, by giving people and businesses the confidence they need to use new technologies safely. By making the UK a safe place for the use and development of these technologies, the UK can help attract investment, generate new jobs, benefit from tax revenues, and promote innovation in new products and services.

### **Permissioned (private) vs permissionless (public) blockchains**

**2.24** For the purpose of activities addressed in this Consultation, the government aims to create the right conditions for crypto and digital asset innovation – on both private and public blockchains – to flourish in a safe environment. These proposals allow for certain activities (phase 2 activities listed in Table 4A) to be conducted across all blockchains subject to certain controls and disclosures being put in place.<sup>13</sup> The government proposes to address the risks in a flexible manner through, for example, disclosure/ admission requirements and obligations on cryptoasset service providers. Regulators will continue to consider the risks of using these new technologies to appropriately mitigate the risks they pose.

**2.25** The detailed contents of disclosure / admission documents will be defined by cryptoasset trading venues, subject to FCA principles (see Chapter 5). However, this could include, for example, information about a token's underlying code and network infrastructure, known vulnerabilities, risks (including cybersecurity and governance risks) and dependencies (e.g. reliance on third party or decentralised blockchains or other infrastructure).

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<sup>13</sup> Note that certain regulatory authorities such as Basel Committee on Banking Supervision (BCBS) recommend a different approach for permissionless blockchains when they pertain to stablecoins issued by banks

**2.26** Furthermore, the authorisation and supervision of firms undertaking phase 2 regulated cryptoasset activities – which will be designed in more detail through FCA-led consultations and rulebooks – will consider operational risks (see Chapters 6, 7, 8 and 10). In line with International Organisation of Security Commissions (IOSCO) recommendations firms will be required to disclose material sources of operational and technological risks and have appropriate risk management frameworks in place to manage and mitigate such risks. Again, this would likely need to cover risks arising from dependencies on specific blockchains and networks.

# Chapter 3

## Overview of the current regulatory landscape for cryptoassets

### Recap on original proposals from the Consultation

**3.1** The Consultation set out the government's expectation that those categories of cryptoasset that already fall within the perimeter of an existing regulatory regime (e.g. those that already qualify as 'specified investments' or fall within the definition of a 'financial instrument' in Part 1 of Schedule 2 to the RAO or as e-Money) will continue to be regulated under those regimes, rather than under the future financial services regulatory regime for cryptoassets. In terms of the delineation between phases 1 and 2, the Consultation set out that phase 1 would cover the regulation of activities relating to fiat-backed stablecoins used for payment, while phase 2 would cover the broader cryptoasset regime.

**3.2** The Consultation also set out the expectation that once the cryptoasset regime is in place, firms undertaking regulated cryptoasset activities would likely need to adhere to the same financial crime standards and rules under FSMA that apply to equivalent or similar traditional financial services activities. Relatedly, the introduction of an authorisation regime under FSMA for persons carrying out certain activities involving cryptoassets means that crypto firms already registered with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs) and carrying out those activities will need to also seek authorisation from the FCA under the new FSMA-based regime. This is because businesses will need to be assessed against a wider range of measures than they were as part of the MLR registration process.

#### **Question 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?

**3.3** HM Treasury received 54 responses to this question. Several respondents made the point that it is important for the regime's credibility that it be seen to be robust, rather than light touch. Multiple respondents also praised the FCA's recent feedback statement on good and poor applications.<sup>14</sup> That notwithstanding, respondents offered a wide range of proposals to mitigate the burden of applying for FCA authorisation for firms that are already MLR-registered. Common suggestions included:

- transitional arrangements (e.g. a temporary permissions regime) to enable firms to continue undertaking business activities while their authorisation applications are processed
- avoiding the need for firms to re-submit information in their authorisation application that was previously submitted as part of their MLR registration application
- clear guidance from the FCA on timelines and expected content of applications, potentially including detailed checklists, worked examples, and Q&A documents
- a collaborative approach between applicants and the FCA (e.g. providing a facility to correct minor errors or omissions rather than requiring applications to be withdrawn, ongoing engagement with authorisation case officers, and an obligation for the FCA to provide a statement of reasons when it asks for an application to be withdrawn)
- a requirement for the FCA to anonymously publish metrics on the outcome of applications
- ensuring the FCA is adequately resourced to allow the timely processing of applications

**3.4** At least one respondent suggested the authorisation applications of firms registered under the MLRs could be prioritised, while another highlighted the need to avoid a 'first mover' advantage for firms who are authorised early by virtue of being the first reviewed.

**3.5** Finally, a small number of respondents proposed access to a streamlined 'variation of permission' route for firms already authorised for one or more existing activities. At least one respondent went further and proposed automatic transition to the new regime for firms that have an existing Part 4A authorisation and are also registered under the MLRs.

### **Question 5**

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

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<sup>14</sup> <https://www.fca.org.uk/firms/cryptoassets-aml-ctf-regime/cryptoasset-aml-ctf-regime-feedback-good-and-poor-quality-applications>

**3.6** HM Treasury received 50 responses to this question. 66% of responses agreed or generally agreed that the delineation and interaction between the regimes was clear, while 26% disagreed. 8% of respondents were either neutral on the point or their view was mixed.

**3.7** A common theme across the responses was that industry would appreciate greater clarity on the definitions of, and distinctions between, regulated stablecoins and cryptoassets more broadly. Likewise, many respondents were not clear on what was meant by stablecoins that are “used as a means of payment”. They highlighted that unbacked cryptoassets as well as so-called stablecoins are capable of being (and indeed are already) used for payments, as well as the fact that the way in which a particular stablecoin or cryptoasset is used can change over time and differ from user to user.

**3.8** There was also some uncertainty around whether firms who undergo an authorisation process for stablecoin custody activity as part of phase 1 would also be required to undertake a separate authorisation process for other stablecoin activities or wider cryptoasset activities once they come to be regulated as part of phase 2, with some suggesting this would be unduly burdensome. A small number of respondents also expressed concern that the phased approach to regulation would lead to confusion among consumers as to what categories of cryptoassets/stablecoins are and are not regulated at a given time.

#### **Question 6**

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

**3.9** HM Treasury received 54 responses to this question. 67% of respondents felt the phased approach would or could create potential challenges, while 20% disagreed. 13% of respondents were either neutral on the point or their view was mixed.

**3.10** Several respondents were concerned that the phased introduction of regulations would create uncertainty for the industry. In particular, and as noted above in respect of question 5, respondents observed that some firms undertake activities proposed to be regulated under both phase 1 and phase 2. If it is necessary to undertake separate authorisation processes in respect of these then this could be unduly burdensome. Additionally, some activities proposed to be regulated in different phases (e.g. stablecoin custody and exchange) are interdependent. At least one respondent asked what the phased approach would mean for firms undertaking both activities at the time when some parts of their business are regulated and others are not. This could also lead to negative outcomes for consumers who may form the impression that all a firm’s activities are regulated, when in fact only some are.

**3.11** Several respondents expressed more general concerns that the phased approach would lead to a drawn-out process, with multiple responses requesting greater clarity on the timescales for each phase. The delay between phases could also lead to unintended gaps and/or conflicting definitions. Several respondents noted that delays would have adverse consequences for UK competitiveness.

**3.12** Respondents also addressed prioritisation of particular activities within the phased approach. Different respondents sought different approaches. Some activities (e.g. staking) were broadly felt to merit a higher priority, while at least one respondent disagreed with the proposal to prioritise stablecoins within phase 1. Several respondents highlighted DeFi as one area where the government's proposed prioritisation was appropriate, with the approach allowing the understanding of the market and efforts at international cooperation to develop.

## Government response

### **FSMA authorisation process for regulated cryptoasset activities**

**3.13** Regarding the FSMA authorisation process, the new regime will be broader in scope than the current MLR registration regime and will include aspects of regulatory compliance that may not have previously been assessed. Authorisation will therefore not be automatically granted to MLR registered firms. However, the FCA will provide more detail on what the assessment will involve in due course and will also consider the regulatory histories of all applicant firms in those assessments. Similar to the current MLR registration regime, the FCA will seek to (i) provide feedback on good and poor-quality applications for the new regime as expeditiously as possible (ii) engage with the consultants and legal advisors supporting firms to contribute to the regulatory clarity that professional services are able to support applicant firms with, and (iii) provide data on the number of applications received and the outcomes of those applications.

**3.14** In line with the proposals previously set out, the expectation is for firms that have an existing authorisation under Part 4A of FSMA (for example those authorised to operate a Multilateral Trading Facility (MTF)) to apply for a Variation of Permission (VoP), rather than having automatic permissions or exemptions to enable them to undertake newly regulated cryptoasset activities. This is deemed important since regulatory regimes for cryptoasset activities will be tailored according to the specific risks and characteristics of cryptoasset markets. A 'pure lift and shift' approach and, by extension, automatic granting of permissions for firms undertaking similar – but not identical – activities relating to existing specified investments would not be appropriate. Such firms are however likely to benefit from their existing capabilities and supervisory history as they undertake the VoP process.

**3.15** The same would apply to a firm which had established FSMA authorised status for phase 1 regulated activities relating to fiat-backed

stablecoins. Such a firm would be expected to apply for a VoP if seeking to undertake additional regulated activities that fall under the scope of phase 2.

### **Delineation between phase 1 and phase 2 activities**

**3.16** On the delineation between phase 1 and phase 2 activities and the associated challenges, readers are pointed towards the separate Stablecoins Update for further clarity on this. By way of summary, the Stablecoins Update outlines the government's intention to prioritise (i) the creation of FCA regulated activities under the RAO for the issuance and custody of fiat-backed stablecoins which are issued in the UK and (ii) the regulation of payment services relating to certain fiat-backed stablecoins where used in a UK payment chain under the Payment Services Regulations 2017. This creates the framework for a subset of fiat-backed stablecoins to safely operate and grow in the UK under the payments regime, within a regulated environment. This approach also focuses on stablecoin payments, with custody for the majority of other cryptoassets and other core activities (e.g. operating an exchange) generally coming in phase 2. The government expects that this will provide a degree of optionality and flexibility for firms wishing to undertake phase 1 activities as early adopters as well as those with business models more focused on phase 2-only activities. The Stablecoins Update also gives further detail on the legislative approach on custody for all cryptoassets - since the government envisages that the same framework will likely be extended and expanded to the broader perimeter of cryptoassets under phase 2.

**3.17** Respondents who raised other challenges around the government's proposed prioritisation of activities (for example those that called for acceleration of certain activities in future phases) are pointed towards chapter 4, and also chapter 12 which provides updates on the government's approach towards staking activities, cryptoasset investment advice and mining, amongst other activities.

### **Timelines**

**3.18** In response to calls for further clarity on timelines, and to accelerate the overall implementation programme, the government's aim is for phase 2 secondary legislation to be laid in 2024, subject to Parliamentary time.

# Chapter 4

## Scope and sequencing of cryptoasset activities

### Recap on original proposals from the consultation

**4.1** The Consultation set out the government's intention to create a number of new regulated or designated activities tailored to the cryptoasset market where those activities mirror, or closely resemble, regulated activities performed in traditional financial services. The Consultation also set out a list of illustrative cryptoasset activities to bring into the regulatory perimeter and a proposed sequence for these activities across several phases. The Consultation noted the intention to capture cryptoasset activities provided in or to the United Kingdom and set out a number of challenges the government has identified in connection with different business models (namely those with a significant degree of vertical integration) and certain categories of cryptoassets (namely commodity-linked tokens, so-called algorithmic stablecoins and stablecoins backed by cryptoassets, NFTs, and utility tokens).

#### **Question 7**

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

**4.2** HM Treasury received 66 responses to this question. 67% of respondents agreed or generally agreed with the proposed territorial scope but 20% disagreed. 14% of responses were neutral or mixed.

**4.3** Those who broadly agreed with the proposal to capture activities both in and to the UK observed that many of the recent market failures have involved overseas firms. They saw the proposed territorial scope as necessary to protect consumers and ensure regulators have oversight of firms that are domiciled overseas while providing services to UK consumers.

**4.4** Some respondents – both those that generally agreed and disagreed with the proposed territorial scope of the regime - queried how the UK would in practice enforce regulations over firms in other jurisdictions conducting activities in the UK. They observed that doing so will require cooperation between national regulators.

4.5 Several of those respondents that disagreed with the proposal considered capturing activities *in or to* the UK represented a departure from the territorial scope of the regimes governing regulated activities involving traditional assets. There was some concern that capturing activities undertaken in jurisdictions other than the UK would risk causing confusion or subjecting businesses to conflicting regulations. At least one respondent was concerned that subjecting international firms to UK regulation might be seen as unduly onerous and that overseas firms may choose to simply ignore UK regulation while continuing to offer services to UK consumers.

4.6 A frequent theme across responses was the call for government to expand the scope of the OPE to cover regulated activities relating to cryptoassets as it does with regulated activities relating to certain traditional assets. Additionally, or in the alternative, many respondents were in favour of the future regime making provision for reverse solicitation and/or equivalence arrangements with other jurisdictions.

#### **Question 8**

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

4.7 HM Treasury received 61 responses to this question, of which 80% agreed or generally agreed with the list of activities. 7% of respondents disagreed, with 13% of responses being neutral or mixed.

4.8 Respondents supportive of the government's proposals noted with agreement that the government is proposing to regulate activities that are similar to those that exist in traditional financial services in a similar manner. There were, however, a number of activities that government did not propose to bring within the regulatory perimeter that respondents – including those who were generally supportive of the proposals – felt should be included. Many respondents requested that the regulatory treatment of staking should be clarified as a priority, rather than reserved for future phases of regulation. Additionally, some raised discretionary portfolio management services and the provision of investment advice as activities that could give rise to harms to consumers if undertaken improperly.

4.9 Both those respondents who were generally supportive and those who were generally critical of the proposals raised the need for greater clarity over the scope of certain activities. Respondents also highlighted how activities that might on the surface appear to be broadly analogous to traditional financial services activities would differ in the cryptoasset context.

4.10 Some respondents urged the government not to be unduly hasty about bringing DeFi activities within the regulatory perimeter. Their concern was to avoid misinterpreting or mis-categorising the

underlying nature of DeFi activities and thereby risk discouraging innovation in this rapidly evolving space.

**4.11** Some respondents felt strongly that certain activities should be permanently left outside the financial services regulatory perimeter. Mining and validation activities were frequently mentioned examples. Some respondents also disagreed with the proposals in the Consultation on the basis that banning cryptoasset activities would be a preferable approach to regulating them.

### **Question 9**

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

**4.12** 51 responses were submitted to this question. 69% agreed with the proposed phasing but 25% disagreed. 6% of responses were either neutral or mixed.

**4.13** The majority of responses to this question were broadly supportive of the government's proposals. That notwithstanding, alternative proposals for prioritisation did emerge as themes across multiple responses. As discussed in paragraph 4.8 above, several respondents were concerned at the proposal to omit or delay the regulation of portfolio management activities and the provision of investment advice in connection with cryptoassets.

**4.14** Likewise, a high number of respondents encouraged the government to prioritise providing clarity on the treatment of staking. Those who did so emphasised the importance of staking as part of the technology underpinning the sector, sought to distinguish it from the provision of a financial service, and highlighted the potential competitive advantage the UK could derive from being an early mover in this space.

**4.15** Smaller numbers of respondents felt that higher priority should be afforded to other activities, including custody of unbacked cryptoassets and the development of rules for the admission of new tokens (both currently slated for phase 2). A smaller group raised concerns with the proposed prioritisation on the basis that a ban would be preferable to regulation.

**4.16** Across a range of different responses, a key theme was the need for government to act quickly and minimise delay between phases. In general, respondents were clear that they would appreciate additional clarity on the government's plans around the timing of the different phases.

### Question 10

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

**4.17** 53 responses were received to this question. 74% of those agreed or generally agreed with the assessment. 6% disagreed and 21% were neutral or mixed. Responses to this question mostly agreed with the challenges and risks identified in the Consultation. That notwithstanding, responses did include a number of additional challenges and risks respondents felt the government ought to consider in connection with vertically integrated business models. In particular, respondents noted: (i) that platforms requiring the use of a native token could increase risks for consumers, (ii) that the predominance of a small number of vertically integrated firms' risks could have a negative effect on competition and innovation (as newer, smaller firms struggle to compete), and (iii) the potential for large-scale market disruption or the failure of a large firm to lead to systemic risk and contagion effects. Some respondents also queried how any requirements on vertically integrated firms would be applied to decentralised entities.

**4.18** While it is important to acknowledge the challenges and risks associated with vertically integrated firms, a significant number of respondents noted these risks and challenges are not unique to cryptoasset firms. Responses frequently noted the same or similar risks are present - and with appropriate governance and risk management can be effectively mitigated - in the traditional financial sector.

**4.19** Those responses that were more critical of the government's assessment of the challenges and risks expressed a preference for restrictions or bans on cryptoassets or noted that the recent failures of large cryptoasset exchanges appear to have been the result of fraudulent activity and the failure to safeguard client funds rather than risks specifically associated with vertically integrated business models.

### Question 11

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

**4.20** Relatively few responses (24) were submitted to this question. Among those, 50% of those responses supported the proposition that existing commodity linked tokens would either fall within scope of existing regulatory frameworks as they apply to the underlying commodity or could be adequately catered for through the broader cryptoasset regime. Only 17% of responses disagreed (with the

remaining 33% neutral, mixed or unsure). That notwithstanding, some responses recognised that the pace of development in this area means this will need to be kept under review with commodity-linked tokens considered on a case-by-case basis.

### Question 12

Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?

**4.21** 53 responses were received to this question. 71% of those agreed or generally agreed with the proposal. 13% disagreed and 15% were neutral or mixed. Responses to this question mostly agreed that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets. Those responses that supported the proposal tended to oppose any suggestion of equivalence between fiat-backed stablecoins and other types of tokens which seek to maintain a stable value. Supportive responses also commonly noted that regulating algorithmic stablecoins and crypto-backed tokens in the same way as unbacked cryptoassets was in line with the principle of “same risk, same regulatory outcome”.

**4.22** Responses that opposed the proposal observed that regulating algorithmic stablecoins and crypto-backed tokens as unbacked cryptoassets would risk divergence with the European Union’s approach under the Markets in Crypto-Assets Regulation (MiCA). Some responses also noted that it is not possible at present to say how algorithmic stablecoins can or might be used in future and bespoke category would therefore be appropriate. At least one response suggested it might be beneficial to determine the approach to regulation on a case-by-case basis, taking into account the unique characteristics, design and function of a token.

### Question 13

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

**4.23** HM Treasury received 62 responses to this question. 65% of respondents felt the proposed treatment was not clear, compared to 19% who thought it was entirely or generally clear. A further 16% of responses were mixed or neutral on the question.

**4.24** A significant proportion of respondents felt the definitions of NFT and utility token in the Consultation were not clear, either because they were factually incorrect or not sufficiently exhaustive. Likewise, many respondents objected to the statement that “[a]ll cryptoassets featured

*in Box 2.A – including NFTs and utility tokens – would have the potential to be included in the future regulatory perimeter if they were used in one of the activities in Table 4A”. Respondents submitted that some activities in Table 4A, such as custody, might be necessary for an NFT or utility token and thereby bring NFTs within the scope of the future regulatory regime without introducing a recognisable financial services activity.*

**4.25** Other respondents suggested a bespoke regime for NFTs would be necessary. Some also suggested that if government’s intention was generally not to capture NFTs, then it would need to publish regular guidance on the features that would differentiate an NFT from other categories of cryptoasset.

**4.26** Finally, some respondents noted that if NFTs were ultimately not captured within the financial services regulatory regime, it would be important to ensure they are subject to relevant anti-money laundering legislation to mitigate the money laundering risks NFTs share with similar non-financial services asset classes, such as artworks.

## Government response

### Scope of regulated cryptoasset activities

**4.27** By and large, the government intends to implement the territorial scope of the future regulatory regime as proposed in the Consultation. This means – subject to the token category exceptions discussed in more detail below – a person (whether legal or natural) will generally be required to be authorised by the FCA under Part 4A of FSMA if:

- they are undertaking one of the regulated activities;
- by way of business; and
- they are providing a service *in or to* the UK.

**Table 4.A Proposed scope of cryptoasset activities to be regulated under Phase 2**

Activity category	Phase 2 sub-activities (indicative, non-exhaustive)	Chapter
<b>Issuance activities</b>	Admitting a cryptoasset to a cryptoasset trading venue	Chapter 5
	Making a public offer of a cryptoasset	Chapter 5
<b>Exchange activities</b>	Operating a cryptoasset trading venue which supports: (i) the exchange of cryptoassets for other cryptoassets (ii) the exchange of cryptoassets for fiat currency (iii) the exchange of cryptoassets for other assets (e.g. commodities)	Chapter 6

Activity category	Phase 2 sub-activities (indicative, non-exhaustive)	Chapter
<b>Investment and risk management activities</b>	Dealing in cryptoassets as principal or agent	Chapter 7
	Arranging (bringing about) deals in cryptoassets	
	Making arrangements with a view to transactions in cryptoassets	
	Making arrangements with a view to transactions in cryptoassets	
<b>Lending, borrowing and leverage activities</b>	Operating a cryptoasset lending platform	Chapter 10
<b>Safeguarding and/or administration (custody) activities</b>	Safeguarding or safeguarding and administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset <sup>15</sup> (custody)	Chapter 8

**4.28** On the topic of market access, the government shares industry's view of the benefit of working towards deference/equivalence type arrangements and is committed to cooperating with international partners – including through the UK's ongoing work with standard setting bodies such as IOSCO and the Financial Stability Board (FSB) – to deliver a framework that can accommodate this.

**4.29** However, it is recognised that the conditions required for equivalence/deference are not currently in place. Given this, an approach is required that will facilitate access to global liquidity pools under specific circumstances (for example where the global liquidity pool is being operated in a jurisdiction which is meeting international recommendations and standards). This would apply on a time-limited basis for the interim period before appropriate equivalence/deference type arrangements are in place.

**4.30** Such an arrangement is important to ensure that UK consumers achieve satisfactory execution outcomes for their cryptoasset orders. A highly restrictive location and market access policy would be unlikely to achieve this due to limited order book depth (since a UK order would only be able to be matched against another UK order).

**4.31** A way of achieving this could be to permit UK firms who are operating a regulated cryptoasset trading venue in an overseas jurisdiction to be able to apply for authorisation for a UK branch extension of their overseas entity. The branch could be authorised to specifically handle trade matching and execution activity.

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<sup>15</sup> e.g. a wallet or cryptographic private key

4.32 The specifics of these requirements on physical location would be determined by the FCA (and informed by the FCA's framework for international firms) in line with existing practice in the UK.

4.33 For clarity, the government does not support expanding the OPE to cover cryptoassets. The cryptoasset industry is growing and developing rapidly, but the context of cryptoasset markets is not the same as those for traditional financial products to which the OPE already applies. The government's position is that firms dealing directly with UK retail consumers should be required to be authorised irrespective of where they are located.

### **Prioritisation of activities**

4.34 In general, the government intends to proceed on the basis of the priorities as set out in the Consultation. A significant number of respondents said the government should bring forward its work on staking (originally proposed for future phases) and that portfolio management and the provision of investment advice should be included as regulated activities. Both these issues are dealt with in Chapter 12. The government will bring forward its work on staking but does not agree that portfolio management and the provision of investment advice on cryptoassets should be brought within the regulatory perimeter at this stage. This latter position will be kept under review.

### **Vertically integrated business models**

4.35 The government intends to regulate vertically integrated business models as envisaged in the Consultation. At the most basic level, this means vertically integrated businesses should be required to follow the relevant regulatory rules for each regulated activity undertaken.

4.36 While there are risks to vertical integration it should be possible to mitigate said risks with appropriate governance, controls and risk management systems, as happens in the traditional financial sector.

4.37 As discussed in Chapter 6, the government does not intend to explicitly endorse or prohibit specific business models or corporate structures in legislation. Doing so at this point would limit the flexibility of a future regulatory regime at a stage when business models are still evolving at pace. It could also shape and influence market structures in unintended or suboptimal ways.

4.38 However, the government's expectation is that firms will be required to evidence that conflicts of interest and risks to market integrity are appropriately managed within their specific business models as they seek authorisation. In that regard, trading platforms that admit self-issued tokens or that intend to undertake proprietary trading against customer orders, will require particular scrutiny and ultimately the FCA may determine that some conflicts are impossible to manage. It should be noted that the FCA already has rules on conflicts of interest and will be considering and consulting on how these rules should apply to cryptoasset firms. Managing conflicts of

interest is also one of the FCA's Principles for Business to which all authorised persons are required to adhere.

**4.39** The government recognises that certain firms undertaking several regulated activities may present a higher risk to the wider ecosystem in the event of failure and the government and regulators will continue to consider whether and how such firms should be subject to proportionate prudential requirements. The requirements will be addressed in detailed FCA rules, but the issue is also being explored in the DSS and could be explored by further Financial Market Infrastructure (FMI) sandboxes – in particular the example of where a firm operates a MTF/organised trading facility (OTF) and simultaneously acts a central securities depository.

**4.40** Additionally, as proposed in the Consultation, trading venues will be required to keep and make available at all times accurate and comprehensive order book data for relating to trading on their exchanges to support effective market abuse and systemic risk monitoring.

#### **Activities relating to asset-referenced tokens**

**4.41** Very few respondents identified the need for a bespoke framework for these tokens, and the government notes this continues to be a small percentage of the market in terms of value and trading volumes. On that basis, as set out in the Consultation, to the extent these products do not meet the definition of an existing specified investment or collective investment scheme but do meet the relevant definition of cryptoasset, they will be regulated under the wider regime for unbacked cryptoassets, and other relevant legislation including the financial promotions regime. Where asset-referenced tokens do meet the definition of a specified investment or a collective investment scheme, they should be regulated under the relevant regulatory framework as applicable to that product.

**4.42** The government recognises the feedback regarding the speed of development in this space and will continue to monitor the development of the market for these tokens.

#### **Activities relating to so-called algorithmic or crypto-backed stablecoins**

**4.43** As with asset-referenced tokens, the government intends to regulate these products along the lines set out in the Consultation, as well as under the financial promotions regime. In general, this means so-called algorithmic or crypto-backed stablecoins will be regulated under the wider framework for unbacked cryptoassets. They will not fall within the scope of the forthcoming regulatory regime for fiat-backed stablecoins as they are not backed by fiat currency.

**4.44** This approach should not be taken to imply that so-called algorithmic or crypto-backed stablecoins behave in exactly the same ways as unbacked cryptoassets, but rather the broader framework the government intends to put in place for unbacked cryptoassets has the flexibility to accommodate all these varieties of token.

4.45 As with asset-referenced tokens, this category currently represents a small percentage of the market in terms of value and trading volumes, but the government will continue to monitor this situation.

### **Activities relating to NFTs and utility tokens**

4.46 Generally, the government's view is that NFTs of themselves are more akin to (for instance) digital collectibles or artwork than a financial services product. So, in the same way the sale of art is not regulated as a financial services activity, the government considers that in general activities in connection with NFTs are not appropriate for regulation as a financial service. That said, the government acknowledges that a range of tokens currently on the market are described as NFTs but perform other functions, and it is possible this may become more common in future. As such, when assessing whether a NFT falls within the future financial services regulatory regime, the government's focus will be on whether the token is used for one of the regulated activities in Table 4A of the Consultation within financial services markets or as a financial services instrument (in the general sense) or product, rather than how it describes itself.

4.47 By way of example, an in-game purchase (such as an object that can be used or displayed in-game) could be structured as an NFT. It is possible that this NFT might fall within the definition of a cryptoasset (either as defined in FSMA 2023 or in future, as more narrowly defined in secondary legislation). The sale of that in-game purchase (either within a specific game or on a marketplace external to the game) would not necessarily be subject to the financial services regulatory regime for dealing in cryptoassets, as the NFT is not being sold within financial services markets or as a financial services instrument (in the general sense) or product. Likewise, an exchange on which said NFT is traded is unlikely to be subject to the admission and disclosure obligations that would apply to a regulated financial services exchange admitting exchange tokens, or the regime governing the operation of a cryptoasset trading venue.<sup>16</sup> In this example, the closest real-world analogy might be to a collectible being sold on an auction site.

4.48 Conversely, something marketed as an NFT could fall within the future financial services regime for cryptoassets if it was in practice used as an exchange token. For example, a large class of NFTs technically unique but largely indistinguishable from each another could be minted. If buyers purchased these as a financial services instrument (in the general sense) or product without having a preference of one NFT over another (for example, if there was little or no price differentiation between the different tokens), this could be considered an exchange token for those purposes and exchanges trading in the token subject to the applicable financial services regulatory regime. The fact that a token is designed or marketed as an

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<sup>16</sup> Such an exchange could, of course, be subject to admission and disclosure obligations in respect of e.g. exchange tokens admitted to the platform.

NFT will not necessarily preclude the application of financial services regulation.

**4.49** The government expects utility tokens to be subject to a similar assessment as NFTs. Utility tokens are designed to (for example) provide digital access to a specific service or application and use technology such as DLT to support the recording and storage of data. Notwithstanding the purpose for which they were originally designed, a utility token could potentially be traded on cryptoasset trading venues for investment purposes. When assessing whether a utility token falls within the scope of the future financial services regulatory regime, the government's focus will be on how the token is used, rather on than a hypothetical application of the technology. For example, if a token could be used to access storage, but is also used for one of the regulated activities in Table 4A of the Consultation within financial services markets or as a financial services instrument (in the general sense) or product, it will likely be regarded as an exchange token for those purposes and the relevant activities subject to the appropriate provisions of the future regulatory regime.

**4.50** As is the case in traditional finance, cryptoasset firms will need to consider the relevant regulatory regime applicable to products they offer when designing them and introducing them to the market.

# Chapter 5

## Regulatory outcomes for cryptoasset issuance and disclosures

### Recap on original proposals from the Consultation

**5.1** The Consultation set out government's intention to establish an issuance and disclosures regime for cryptoassets grounded in the intended reform of the UK Prospectus Regime: the Public Offers and Admissions to Trading Regime (POATR) and tailored to the specific attributes of cryptoassets. Two regulatory trigger points were proposed: (1) admitting (or seeking the admission of) a cryptoasset to a cryptoasset trading venue, and (2) making a public offer of cryptoassets (including initial coin offerings (ICOs)). For admission of cryptoassets to a UK cryptoasset trading venue, the government proposed to adapt the MTF model from the POATR. Under this framework, venues would write detailed requirements for disclosure documents required for admission, in accordance with principles established in the FCA's rulebook. For public offers, the current Prospectus Regime applies to offers of cryptoassets where those cryptoassets fall within the definition of securities in scope of the regime. This will continue to be the case under the new POATR, once implemented. For public offers of other cryptoassets the government is considering an alternative route (e.g. using the DAR). All admission and disclosure documents would be stored on the National Storage Mechanism (NSM) maintained by the FCA. Venues would be required to search the NSM before new admissions and ensure information is consistent with other documents lodged.

#### **Question 14**

Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

**5.2** HM Treasury received 54 responses to this question. 94% of those responses agreed or generally agreed with the proposed regulatory trigger points, with 4% disagreeing and 2% of responses being neutral or mixed. Amongst those who fully supported the proposal it was

argued that this should help bring about an appropriate level of due diligence as well as increased transparency and trust to tokens that are made available to the UK public. Others noted that the proposed trigger points would also provide room for innovation given that they would not apply to newly minted tokens which are not yet made available to the general public. Many responses also felt that the alignment to the issuance regime for transferable securities was logical.

**5.3** Of those who were generally in favour of the proposals, many requested further clarity on the definition of ‘issuance’, ‘offers’ and other key terms and concepts. At least five responses called for exemptions or transitional arrangements<sup>17</sup> for cryptoassets already in circulation (especially those that are relatively well-established) – arguing that these tokens benefit from increased transparency and trust given their trading history. Some responses suggested that the government should clarify the treatment of launchpads, airdrops and decentralised exchanges,<sup>18</sup> while others sought greater clarity on issuance obligations for specific token types – e.g. NFTs, fan tokens, governance tokens and other types of utility tokens.<sup>19</sup> Some industry associations recommended that currently regulated UK platforms (including currently designated MTFs and OTFs) – in addition to future authorised cryptoasset trading platforms - should be able to undertake primary issuance activities of cryptoassets. Finally, a number of responses cautioned against a ‘lift and drop’ approach based too heavily on the framework for transferable securities.

**5.4** A small number of responses disagreed with the proposed trigger points. At least one of these disagreed with the extra territorial scope, arguing that overseas firms making offers of tokens which may be available to UK customers should not be caught as long as those firms are not directly marketing to UK customers.

### **Question 15**

Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

**5.5** Treasury received 54 responses to this question. 72% of those responses agreed or generally agreed with the proposal – but a significant minority (26%) disagreed. Those that fully supported the proposal generally felt that centralised venues were the most appropriate market participants to take on oversight and responsibility for setting content requirements given their central role within the

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<sup>17</sup> Sometimes referred to as “grandfathering” in the feedback received

<sup>18</sup> Readers should refer to Chapter 11 (on Decentralised Finance) for further clarity on this

<sup>19</sup> Readers should refer to Chapter 4 (on activities relating to NFTs and utility tokens) for further information

ecosystem, and the fact that information provided by venues is often the primary source of information for investors. Some responses pointed out that the government's proposal was preferable to an alternative model whereby a regulator determines a list of 'approved' or 'accepted' cryptoassets – as is the case in some jurisdictions – since such a model would not be sufficiently scalable or dynamic and would put an excessive burden on the regulator.

**5.6** Amongst those who generally supported the proposal, the most commonly mentioned caveat was the potential for lack of consistency. The concern here was that giving responsibility for admission requirements to trading venues could lead to inconsistent and heterogeneous disclosure documents, raising costs for the industry and making disclosure documents harder to navigate and interpret for investors. Related to this, some responses warned of venue acceptance arbitrage risks arising from different disclosure standards, a potential race to the bottom, and concentration risks driven by the ability of the largest venues to outcompete smaller players. At least 10 responses suggested that the FCA should play a more prominent role in defining detailed content requirements – for example by developing a template, or through establishing or endorsing some sort of central body to do so. One response also highlighted potential conflicts of interest for trading venues admitting self-issued tokens. Some responses called for further clarity on certain aspects of the proposals – e.g. ongoing disclosure requirements, the obligation for venues to investigate the potential for investor detriment, how requirements would apply to venues only catering only for wholesale or sophisticated investors, and the application of requirements for tokens distributed via decentralised networks.

**5.7** 26% of responses disagreed with the government's proposal. This included those that disagreed with the overall premise of regulating cryptoassets as financial services, as well as those who felt that the proposals put excessive burdens on firms. Within the latter population, some responses felt that the proposals went beyond the EU's equivalent framework (MiCA) in particular due to the potential disclosure responsibilities on venues admitting assets with no identifiable issuer. Some felt very strongly that the FCA (or even HM Treasury) should play this role instead of cryptoasset trading venues. One respondent suggested that the regulator should instead oversee a register of approvers to enable other market participants – not just cryptoasset trading venues – to approve disclosure documents.

#### **Question 16**

Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?

**5.8** 47 responses were received to this question. 64% of responses agreed or generally agreed with the proposed options but a significant minority (34%) objected to the approach on liability. Those in favour of

the proposals felt that some form of liability would be necessary to make the disclosures regime meaningful and effective. It was also pointed out that the proposed approach would align to the disclosures regime for transferable securities.

**5.9** Some respondents were generally supportive of the approach towards liability but pointed out that costs arising from the use of law firms and other third parties could be transferred to investors. Others cautioned that the approach could favour more established cryptoassets and called for early-stage exemptions or minimum thresholds to help foster innovation in newer tokens. On a related note, some responses warned that prudential requirements could favour larger, more established exchanges and issuers.

**5.10** Several responses argued that preparers of disclosure /admission documents should be permitted to use public information sources and provide information on a 'reasonable endeavours' basis – especially for more decentralised tokens. A number of cryptoasset exchanges pointed out that they would be extremely reluctant to take on liability for information that relates to the underlying token and network / protocol which is fully outside of their control (for example information concerning the token supply schedule, the vesting schedule, and the operation of the underlying consensus mechanism). Their view was the authorities should therefore consider the degrees of separation between the information and the organisation which produces the admission disclosure document.

**5.11** Responses which disagreed with the government's proposed approach generally took stronger positions on the arguments outlined above. Several strongly objected to the suggestion that venues should take any form of liability for tokens they admit for trading where there is no clearly identifiable issuer. Some warned of the potential for a major 'chilling effect', limiting the availability of tokens and the depth of information in disclosure documents. A few responses suggested that the current proposals would push venues to locate elsewhere.

### **Question 17**

Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?

**5.12** HM Treasury received 53 responses to this question, with 92% agreeing or generally agreeing and 6% disagreeing. Most respondents felt that this was a sensible basis or starting point - though there were various suggestions to include additional information including:

- Further information relating to the issuer or person controlling the project – e.g. relevant financial information, their location / domicile, previous cryptoasset products and services and ICOs

- Information relating to the token economics – e.g. token supply, distribution, inflation, reward mechanism
- Information relating to the token’s governance – e.g. distribution of voting rights, governance processes for code changes, use of time locks, review periods
- Information around potential conflicts of interest as well as available redress mechanisms or compensation arrangements (or lack thereof)

**5.13** Extensive feedback was received on the proposals to include risk information. Many responses pointed out that risk information should be focused, specific and useful – and that care should be taken to avoid a framework which results in forward-looking risk disclosures which are excessively long, unhelpfully exhaustive about every conceivable risk type, generic, and unlikely to be read by the typical investor. Others pointed out that risks are difficult to measure objectively for unbacked cryptoassets.

**5.14** In terms of style, many responses suggested that disclosures should be required to be made in simple, understandable language – and should feature standardised, easily comparable information. A few respondents recommended that the necessary information test is kept flexible and not overly prescriptive. However, others noted that accompanying guidance would be helpful or necessary to assist firms in meeting the necessary information test.

### **Question 18**

Do you consider that the intended reform of the Prospectus Regime in the Public Offers and Admission to Trading Regime (POATR) would be sufficient and capable of accommodating public offers of cryptoassets?

**5.15** HM Treasury received 39 responses to this question, with 90% agreeing or generally agreeing and 8% disagreeing. Many responses again recommended caution in mirroring the POATR too closely, without sufficient regard to the specific risks and characteristics of cryptoasset markets. Another common theme was proportionality and international competitiveness, with many stressing the need to avoid excessive barriers to entry, such that innovation from smaller players can be encouraged and accommodated.

## **Government response**

### **Disclosure requirements for well-established tokens and tokens without identifiable issuers**

**5.16** In general, the government intends to take forward the proposed approach, including the basis for the regime and trigger points. The government’s view is there should be disclosure documents in place for *all* cryptoassets which are made available for trading on a UK

cryptoasset trading venue. This would include all well-established tokens (i.e. those characterised by relatively high levels of liquidity and at least several years of trading history) as well as those which do not have a clearly identifiable issuer - e.g. Bitcoin. The key purpose of this regime is to make available consistent, minimum standards of information to consumers for all tokens used for activities within the regulatory perimeter. From this perspective it does not make sense to have a two-tier regime which differentiates between well-established tokens and more recently launched tokens. Indeed, these well-established tokens are likely to continue to be the most important tokens in terms of market share and consumer exposure for the foreseeable future, making them even more important from a consumer information perspective.

**5.17** To reduce the risks and impacts of ‘cliff edges’ and avoidable removals from trading<sup>20</sup> relating to the back book of tokens already in circulation, there will need to be sufficient transitional arrangements for bringing activities into the regulatory regime – i.e. sufficient time periods between laying the legislation and the regulatory regime becoming effective.

**5.18** In addition, the government agrees that those preparing documents could make use of publicly available information when preparing relevant sections of their disclosure / admission documents, but they would need to be clear where this information originated and the level of due diligence they had done over it. This would be consistent with the approach under the UK’s POATR. Venues could also work together to jointly gather disclosure information, make use of third parties, or distribute the administrative burden in other ways that are mutually agreeable.

**5.19** The government agrees with responses which suggested that *some* degree of token withdrawals from platforms *may* be beneficial through identifying and removing cryptoassets which no party is willing to stand behind (or where the necessary information simply cannot be reliably gathered and assessed) from the public sphere. This could increase trust and confidence levels in the remaining population of tokens which are publicly accessible.

**5.20** For cryptoassets which are issued after the regime becomes effective, the government’s position – based on the current and historical situation – is that the quantum or flow of these newly issued tokens which do not have an identifiable issuer is likely to be limited. It is a proportionate requirement for cryptoasset trading venues – which are seeking admission of such assets for commercial purposes – to prepare disclosure documents for these tokens. Given that most major

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<sup>20</sup> Historical examples show that the admission of a token to a venue (especially a relatively illiquid token to a major cryptoasset exchange) can have a significant effect on the market valuation of the cryptoasset – driven by perception of greater trust, credibility and the anticipation of increased adoption and demand. Conversely, a removal from trading could significantly undermine the market capitalisation of a cryptoasset, thereby impacting the cryptoasset portfolios of individual investors.

crypto exchanges already have extensive coin admission policies it is anticipated that this should not be a major lift beyond existing policies and procedures.

### **Responsibilities for defining detailed content requirements**

**5.21** The government also intends to take forward the proposal for venues to define detailed content requirements for admission disclosure documents. However, the government acknowledges the appetite from industry for more prescriptive rules on content requirements; the government is supportive in principle of the idea of a centralised coordinating body (e.g. industry association) to coordinate this effort – with FCA oversight. This should help address concerns raised about heterogeneity or inconsistency of disclosures.

### **Wholesale versus retail**

**5.22** The government notes the call for clearer differentiation between venues which cater to retail consumers versus those which only admit institutional investors. While these sorts of details would typically be covered in firm-facing rules defined by the FCA, the government agrees, in principle, with the idea that disclosure requirements would differ – and be less prescriptive – for venues which only admit institutional investors (on the basis of “same risk, same regulatory outcome”). The benefit of allowing trading venues to define the detailed content requirements for admission and disclosure documents is that this kind of differentiation would be within their remit, and as much or as little differentiation as needed would be possible.

### **Public offers (including ICOs), airdrops and tokens earned via reward mechanisms**

**5.23** For tokens made available through a public offer (e.g. ICO or other similar issuances) rather than admitted to trading via a regulated platform, disclosure requirements and exemptions will likely be similar to those proposed in the new draft POATR.<sup>21</sup> Such exemptions would therefore be expected to include offers of free cryptoassets (e.g. via an airdrop or similar distribution mechanism) or offers made only to professional / sophisticated investors. Value thresholds may need to be calibrated differently due to the typical size of an ICO and specific risks.

**5.24** For tokens earned via a reward mechanism, this is unlikely to constitute a public offer as these tokens would be awarded in return for a service (staking and validation, mining, or providing liquidity in cryptoassets to receive new tokens in the case of ‘liquidity mining’). The government will keep this matter under review since it is important that any such determination is not used to game the system to avoid appropriate disclosure obligations.

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<sup>21</sup> <https://www.gov.uk/government/publications/public-offers-and-admissions-to-trading-regulations-2023-draft-si-and-policy-note>

**5.25** Notwithstanding the above, firms will still need to consider obligations around cryptoasset financial promotions for tokens which are exempted from, or out of scope of, the cryptoasset issuance regime.

### **Liability arrangements (including for tokens without identifiable issuers)**

**5.26** Regarding liability, the government maintains the position that all firms required to publish cryptoasset disclosure documents should be liable for their accuracy. However, the government agrees that cryptoasset exchanges – which choose to take responsibility for the disclosure documents – should not be held liable for all types of consumer losses arising from events relating to that token, provided that they have taken reasonable care to identify and describe the risks. For example, where a loss is caused by a failure of the underlying protocol or network that is not controlled or operated by the trading venue, this would be unlikely to constitute a liability event providing, for example, that the trading venue had (i) performed a reasonable degree of due diligence on the token and the underlying network, (ii) made very clear to consumers their findings and (iii) avoided misleading statements guaranteeing the performance and resilience of the network.

**5.27** This is similar to the envisaged approach to liability under the POATR, for statements believed to be true based on reasonable enquiries. In contrast, under a strict liability regime – as proposed in some other jurisdictions – reasonable steps may not be a defence. Trading venues can therefore manage their liability if they make reasonable enquiries in preparing disclosure documents (which would be within their control).

**5.28** In addition, certain types of protected forward looking statements (e.g. relating to the project, and future use cases of the token) should be held to a different liability standard than historical, factual statements (e.g. relating to code audits which have been conducted in the past and vulnerabilities which have been identified through these). The former would generally be subject to recklessness/dishonesty standards<sup>22</sup> whilst the latter would be subject to negligence standards.<sup>23</sup> This is consistent with the proposed approach underpinning the POATR and should encourage issuers to include helpful and relevant forward-looking information to the market, without undue fear of a deluge of liability claims. This is a more flexible and proportionate approach than a regime with strict liability standards and should mitigate the “chilling effect” that some responses warned of.

### **Necessary information test**

**5.29** Regarding the proposed high-level necessary information test, the government intends to use this as a starting point but will consider

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<sup>22</sup> See s 90A and Schedule 10A of FSMA.

<sup>23</sup> See s 90 and Schedule 10 of FSMA.

suggestions for additional categories of information. A necessary information test will ensure that an overall standard of preparation for disclosure / admission documents remains in statute whilst providing flexibility. However, the government expects that many of the more specific categories of information suggested by respondents would, in practice, be captured by the test. For example, it would be difficult to demonstrate that the necessary information test would be met if information about conflicts of interest and the availability (or not) of redress mechanisms was absent. The government agrees with the suggestions for HM Treasury, the FCA, industry and other stakeholders to work together to further shape disclosure requirements and the associated necessary information test. Some of this external engagement has already commenced for example through roundtables with industry participants.

### **Mitigating barriers to entry**

**5.30** Several respondents noted that onerous disclosure / admission requirements can act as a barrier to entry, deterring participation from SMEs and stifling innovation. The government is cognisant of this and therefore views the following features of the proposed regime as important:

- Disclosure / admission requirements will apply only to tokens that are made available to the UK public (i.e. not to all newly created tokens)
- Certain exceptions will apply – for example offers made for no consideration or where the value of consideration is below a certain threshold, offers made to a limited number of persons or only to professional investors, and tokens acquired solely through a consensus protocol reward mechanism
- Disclosure / admission documents will need to be focused and fit-for-purpose and would likely not take the same shape or form as long equity prospectus-like documents
- For any prudential requirements on issuers, professional indemnity arrangements - as an alternative to own financial resources - will be considered – subject to regulator rules

# Chapter 6

## Regulatory outcomes for operating a cryptoasset trading venue

### Recap on original proposals from the Consultation

**6.1** The Consultation set out government's proposals to establish a regulatory framework for persons operating a cryptoasset trading venue which would be based on existing RAO activities of regulated trading venues – including the operation of an MTF. Accordingly, persons carrying out these activities would be subject to prudential rules and various other requirements including consumer protection, operational resilience, and data reporting.

#### **Question 19**

Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

**6.2** HM Treasury received 48 responses to this question, with 85% agreeing or generally agreeing and 8% disagreeing. A large number of responses suggested that the existing Markets in Financial Instruments Directive (MiFID) and FSMA frameworks were largely adequate – or at least served as a good starting point. Many also noted that the proposed approach would bring beneficial consistency and familiarity and could encourage firms that operate already-regulated platforms to participate in the cryptoasset sector.

**6.3** Of those who generally agreed with the approach, a common theme of concern was proportionality and international competitiveness. In particular, many responses warned that excessively stringent prudential requirements and onerous reporting requirements could result in crypto trading venues choosing to locate elsewhere. Several responses pointed out differences between cryptoasset trading venues (as they typically operate today) and MTFs which would need to be carefully considered. Specifically, the current prevalence of matched principal execution protocols in crypto trading venues arguably makes them more akin to OTFs rather than MTFs. In addition, most crypto

trading venues permit direct retail access, whereas MTFs admit only institutional investors. One response also highlighted that, unlike crypto trading venues, MTFs do not take custody of participant funds, issue their own securities, extend credit to members, or act (in effect) as a central clearing counterparty.

**6.4** Amongst those that disagreed, there were some suggestions to use different existing regimes as a basis – for example regulations for Recognised Investment Exchanges (RIEs), the regulated activity of ‘arranging deals’ or that of operating a peer-to-peer lending platform. Some felt that the proposed approach would push cryptoasset matching activity to other jurisdictions (or decentralised protocols), especially if similar prudential and data reporting requirements were adopted, together with the obligation to subsidiarise in the UK.

### **Question 20**

Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience, and reporting requirements?

**6.5** The government received 59 responses to this question. Again, a common theme in the feedback was international competitiveness and avoiding excessive barriers to entry for example, by permitting firms to make use of professional indemnity insurance arrangements as an alternative to own funds – in order to meet prudential requirements.

**6.6** The proposals on data reporting also generated significant feedback with some arguing that order book reporting requirements would be disproportionate since they would require the sharing of sensitive and proprietary information. Some responses suggested that order book reporting should be limited to off-chain transactions only, or that reporting requirements should be introduced when the industry has matured further. However, others argued that the authorities should go further suggesting, for example, that real time reporting should be required.

**6.7** Another area where many responses suggested that the requirements should go further was operational resilience, with recommendations relating to contingency planning, testing, third party audits, proof of solvency, proof of reserves and proof of liability. Various responses highlighted the need to address risks – including supplier failure, service deterioration, concentration risk, political risks and transfer of ownership – through appropriate business continuity and recovery and resolution plans.

**6.8** Proposed location requirements were a contentious theme. Many were in support of the indication that firms operating cryptoasset trading venues would likely require subsidiarisation in the UK. But there were also strong objections to this on the basis that it would increase costs and regulatory burdens and fragment liquidity pools. Some also argued that this position would represent a departure from similar

activities in traditional finance (where, for example, MTFs and OTFs can make use of the OPE under specific circumstances).

**6.9** Other common themes of feedback have been briefly summarised below, noting that most of these detailed firm-facing rules will be addressed through subsequent FCA consultations and rulebooks:

- Fee structures: some responses highlighted issues with current fee structures on some crypto exchanges and called for measures to ensure fair and transparent fees as well as rules to ensure that investors do not become unfairly 'locked in' to exchanges
- Outsourcing: a large number of firms highlighted the importance of being able to procure support services from third parties (including overseas service providers and overseas entities within the same parent group)
- Resolution and insolvency: a few responses suggested that Part 24 of FSMA may not be fit for purpose in the context of crypto asset business activities, and has not yet been properly tested on complex FinTech business models
- Execution protocols: several respondents again underlined the need for a regime to accommodate matched principal trading as well as central limit order book matching
- Business model segmentation: many responses talked of the need to distinguish between venues only admitting wholesale market participants versus those which also admit retail consumers. Another suggestion was for clear distinctions between venues which undertake primary issuance activity versus those that only offer secondary market trading.

## Government response

### **Basis for the regime and consideration of specific trading models and execution protocols**

**6.10** The government intends to take forward the proposed approach, including the basis for the regime - but reiterates the need to take into consideration specific characteristics and risks of cryptoasset trading activities. The consultation process has helpfully highlighted specific examples of this. In response to the questions about certain execution protocols and trading models (e.g. OTFs / matched principal trading and proprietary trading), the government does not intend to explicitly endorse or prohibit specific business models or execution protocols in legislation. Doing so at this point would limit the flexibility of a future regulatory regime at a stage when business models are still evolving at pace. It could also shape and influence market structures in unintended or suboptimal ways. However the expectation is for firms to be able to

evidence that conflicts of interest and risks to market integrity are appropriately managed within their specific business models as they seek authorisation. Separately, the government notes that some requirements applicable to MTFs and OTFs will be reviewed more broadly as part of the government and FCA's implementation of the Wholesale Market Review reforms.

### **Location requirements**

**6.11** Location policy and overseas market access is addressed in further detail in chapter 4.

### **Retail versus wholesale**

**6.12** Regarding the feedback on customer segmentation, the government agrees, in principle, with the idea that certain requirements (e.g. disclosures) would differ – and be more appropriate – for venues which only admit institutional investors (on the basis of “same risk, same regulatory outcome”). The benefit of allowing trading venues to define detailed content requirements for admission and disclosure documents is that this kind of differentiation would be within their remit, and as much or as little differentiation as needed would be possible.

### **Primary versus secondary markets activities**

**6.13** In response to calls for distinctions between cryptoasset trading venues which undertake “primary issuance” activity versus those which only support secondary market trading, the government intends to take an activities-based approach to regulation, as articulated in the original proposals. This would have the flexibility to accommodate different business models. Firms which intend to operate a cryptoasset trading venue will be required to obtain FSMA authorisation for that activity (Chapter 6). They will provide a crucial function in terms of admitting cryptoassets to their venues and conducting due diligence over the cryptoassets (Chapter 5). Other firms may choose to seek FSMA authorisation under one of the other activities outlined in the Consultation where they are acting as intermediaries (Chapter 7). Further regulatory obligations will apply whereby those firms would need to ensure that appropriate admission disclosure documents are in place for any cryptoassets in connection with which they offer services (Chapter 7). They will be reliant upon trading venues to admit the cryptoassets rather than perform this function themselves, so, to some degree will function in a similar way to secondary market trading venues.

**6.14** Additionally, for those firms which are seeking to introduce an asset to the UK, further regulatory obligations will apply whereby those firms would need to ensure that appropriate disclosure / admission documents are in place for any cryptoassets admitted for trading (see Chapter 5).

## **Insolvency and restructuring**

**6.15** The government intends to apply the insolvency provisions in Part 24 FSMA as these provisions provide the FCA with the same rights to protect consumers of crypto firms, and itself participate, in standard insolvency procedures (e.g. administration and liquidation) as it has for FSMA authorised firms and payment/e-money firms.

## **Other considerations**

**6.16** Chapter 11 covers the government's response on decentralised exchanges and other DeFi protocols. Chapter 4 (on the perimeter of cryptoasset activities) provides further clarity on considerations around vertically integrated business models. Most of the other feedback related to aspects of the regime which will need to be tackled through detailed regulator consultations and rulebooks (e.g. specific data reporting and operational resilience requirements). This feedback has been shared with the regulators and will be considered through future regulator consultations and firm-facing rules. The FCA has statutory obligations to consult and conduct cost benefit analyses for the measures they introduce. Furthermore, the FCA's Regulatory Initiatives Grid will give industry a forward plan of the various planned consultations.

# Chapter 7

## Regulatory outcomes for cryptoasset intermediation activities

### Recap on original proposals from the Consultation

**7.1** The Consultation proposed that requirements applying to analogous regulated activities – such as ‘dealing in investments as agent’ and ‘dealing in investments as principal’ set out in Article 25 of the RAO – would be used and adapted for cryptoasset market intermediation activities. The potential need for additional rules or guidance to address specific risks and characteristics of cryptoasset market intermediation activities was noted.

#### **Question 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?

**7.2** HM Treasury received 49 responses to this question, with 86% agreeing or generally agreeing and 10% disagreeing. Those that supported the proposal felt that it was well aligned to the principle of “same risk, same regulatory outcome”, and that existing regimes for market intermediation provided an appropriate and familiar framework to address most of the key risks. Some of the more specific proposals received explicit support – for example the focus on ‘best interest’ as opposed to ‘best execution’ since the former concept is more appropriate and proportionate. Several respondents who were in favour of the proposals did however note that ongoing assessment would likely be required as the industry matures.

**7.3** The majority of the responses were generally supportive but caveated. Some called for more clarity around the definition and scope of these intermediation activities. For example, one response pointed out that the term ‘making arrangements’ is used in both the RAO and MLRs but the application is different, with exemptions applied to the RAO but not the MLRs. Another response suggested that specific activities or business models should not fall within scope – for example

DeFi technology providers which create software used for the intermediation of cryptoassets, or e-money providers that arrange funds for payment for a customer that wants to trade in cryptoassets.

**7.4** Several respondents pointed towards specific aspects of cryptoasset markets which are unique and therefore require special consideration. A prominent example was the concept of acting in accordance with the best interests of clients which many suggested was hard to demonstrate in cryptoasset markets due to the fragmentation of liquidity across a large number of venues globally and more limited transparency around price formation versus traditional exchanges.

**7.5** Amongst those that disagreed with the proposals most argued for a bespoke approach, but these responses typically contained limited detail on alternative proposals. One response did point towards the global code of conduct for spot foreign exchange as an alternative basis.

### **Question 22**

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

**7.6** The government received 46 responses to this question. Proportionality and international competitiveness were frequently mentioned – with similar warnings to those highlighted in the feedback to Chapter 6. In particular, several responses recommended that firms should be able to make use of professional indemnity insurance arrangements as an alternative to own funds in order to meet prudential requirements. Some also noted that the Prudential sourcebook for MiFID Investment Firms (MiFIDPRU) presents challenges for venture capital-funded enterprises.

**7.7** Client segmentation was also a common theme in the feedback. Some responses stated that the requirements to assess appropriateness and make certain disclosures should not apply when carrying out services for institutional counterparties. Some responses called for exemptions or clarifications for specific market participants – for example, those administering trusts and estates on a professional basis.

**7.8** More specifically, many responses noted that concepts of ‘best execution’ or ‘best possible result’ are difficult to define and apply in cryptoassets due to the globalised and fragmented nature of execution venues and specific features of cryptoasset transactions such as slippage in liquidity pools.

**7.9** The other two most common themes in the feedback were location requirements and operational resilience. On location requirements firms again raised concerns around the potential

fragmentation of liquidity and higher costs for firms which could be passed on to investors. A more specific point for clarification posed by several firms was on the treatment of UK authorised intermediaries that intended to route UK customer orders to cryptoasset trading platforms operated by overseas group entities. On operational resilience, similar risks to those summarised in Chapter 6 were described.

## Government response

### Basis for the regime

**7.10** In general, the government intends to take forward the proposed approach, including the basis for the regime. Specifically, the government intends to define a set of new regulated activities relating to the intermediation of cryptoassets, drawing from analogous activities in the existing regulatory perimeter.<sup>24</sup> As previously set out, the legislative approach, and subsequent rules set by the FCA, will need to carefully consider specific aspects of crypto markets and implications for concepts which may not map across well from the traditional financial services sector. An important example of this would be the appropriate methods for defining and evaluating whether an intermediary has acted in accordance with the 'best interests' of a client.

### Location requirements

**7.11** Location policy and overseas market access is addressed in further detail in Chapter 4.

**7.12** If all international cryptoasset exchanges were to seek authorisation in the UK as cryptoasset intermediaries (and not as cryptoasset trading venues), this would be problematic since the proposed issuance and market abuse regimes 'hang off' regulatory trigger points that are controlled by authorised cryptoasset trading venues.<sup>25</sup> To ensure that issuance and market abuse regimes are 'activated' for tokens bought and sold by UK investors, the government intends to require a disclosure / admission document to be lodged on the NSM by a trading venue, prior to any intermediary being able to deal or arrange deals in a given token (similar to the requirement for a trading venue to search the NSM before a new admission to ensure disclosure / admission documents are in place).

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<sup>24</sup> For analogous activities in the existing regulatory perimeter, readers should refer to i) Article 14 of the RAO ("Buying, selling, subscribing for or underwriting...as principal"); ii) Article 21 of the RAO ("Buying, selling, subscribing for or underwriting...as agent"); iii) Article 25(1) of the RAO ("Making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite..."); and iv) Article 25 (2) of the RAO ("Making arrangements with a view to a person who participates in the arrangements buying, selling, subscribing for or underwriting...(whether as principal or agent)..." )

<sup>25</sup> For issuance: Admitting (or seeking admission of) a cryptoasset to a UK cryptoasset trading venue or making a public offer of a cryptoasset (including ICOs), which would need to be done via a UK regulated platform; for market abuse: Admitting (or seeking the admission of) a cryptoasset to a UK cryptoasset trading venue

## **Retail versus wholesale**

**7.13** Regarding the feedback on customer segmentation, the government agrees, in principle, with the idea that certain requirements (e.g. disclosures, appropriateness checks) would differ for intermediaries when dealing with eligible counterparties since this would mirror existing conduct regimes and meet the core design principle of “same risk, same regulatory outcome”.

## **Other considerations**

**7.14** Most of the other feedback related to aspects of the regime which will need to be tackled through detailed regulator consultations and rulebooks (e.g. specific conduct, prudential and operational resilience requirements). This feedback has been shared with the regulators and will be considered through future regulator consultations and firm-facing rules. The FCA has statutory obligations to consult and conduct cost benefit analyses for the measures they introduce. Furthermore, the FCA’s Regulatory Initiatives Grid will give industry a forward plan of the various planned consultations.

# Chapter 8

## Regulatory outcomes for cryptoasset custody

### Recap on original proposals from the Consultation

**8.1** The Consultation proposed to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities, making suitable modifications to accommodate unique cryptoasset features, or putting in place new provisions where appropriate.

#### **Question 23**

Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

**8.2** 53 responses were submitted to this question. 79% agreed or generally agreed with the proposal. 15% disagreed and 6% of responses were neutral or mixed. Those that agreed felt that the Consultation appropriately acknowledged the conceptual similarities to traditional finance custody, as well as key differences – for example the various technology solutions which are used to secure the asset and safely manage private keys. These respondents agreed with the basis for the regime as long as the specific characteristics and risks associated with cryptoasset custody are considered and accommodated. Others noted that this approach would help deliver a level playing field and generate trust and confidence in the system, with cryptoasset custody regulated on a par with traditional financial asset custody. Several responses stated that forthcoming regulation should be 'technologically agnostic' to allow for scope to be future proofed as the technology in this market develops.

**8.3** Amongst those that generally agreed with the approach, a common reservation was uncertainty around the scope and definition of the regulated activity of custodying assets.<sup>26</sup> In particular, further

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<sup>26</sup> "Safeguarding, or safeguarding and administering (or arranging the safeguarding or safeguarding and administering) of a cryptoasset other than a fiat backed stablecoin and / or means of access to a cryptoasset (e.g. a wallet or cryptographic private key)"

clarity was requested around concepts like ‘arranging’ custody, use of third parties (including sub-custody and outsourcing arrangements), custody software and hardware providers and use of self-hosted wallets (also known as unhosted wallets or non-custodial wallets). A number of respondents took the position that software developers or providers of self-hosted wallet infrastructure, whose functions are limited to the development and/or sale of the software/hardware for self-hosted wallets, should be excluded from the scope. Several responses also highlighted the importance of the UK’s underlying legal framework and the need for clarity around issues such as bankruptcy remoteness of customer assets.

**8.4** A few responses disagreed with the proposal to apply and adapt existing frameworks for traditional finance custodians. One respondent suggested that modern technology (in particular modern cryptographic tools) could provide the opportunity to replace legacy frameworks with a distinct and cleaner alternative cryptographic custody regime under which owners would never have to relinquish control of their assets.

**8.5** Some responses felt that the differences in cryptoasset were so fundamental that a bespoke framework was necessary as the risks were significantly higher with crypto such that the current framework wouldn’t suffice. Examples of these differences included (1) the various novel technology solutions (e.g. hot versus cold storage, multi-signature verification, multi-party computation and the use of smart contracts to hold private keys), (2) the conceptual differences around ‘control’ of the asset and (3) scenarios which are unique to cryptoassets (e.g. the custody of tokens distributed via smart contracts or airdrops). One response noted that lack of recoverability (if the private key is lost, the owner cannot retrieve their cryptoassets) is unique to cryptoassets. Another response suggested that certain types of tokens may require a separate custody framework. For example, commodity-backed tokens may not be suitable for a regime based on the Client Asset Sourcebook (CASS) – since product and service providers typically outsource physical custody to secure asset storage companies rather than traditional finance custodians.

#### **Question 24**

Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

**8.6** 55 responses were submitted to this question. There was a significant degree of overlap in the content discussed in response to this question with that of question 23 – in particular on the need to further clarify the scope of the regulated activity and how it would apply to different business models, as well as the importance of the legal construct under which custody can be delivered under English and Welsh law.

**8.7** The topic of liability generated significant interest. For the most part, there was strong support for the government's proposal to pursue a proportionate approach which would not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control. One response helpfully pointed out the difficulties in drafting legal text that creates a clear distinction between events that are within the control of the custodian, and those that are not – based partly on experiences from the EU's equivalent process. This response suggested ways to address or mitigate some of these challenges including: (i) developing an agreed analytical and terminological framework for the custody of cryptoassets; (ii) allowing custodians and their clients the ability to agree bilaterally in their custody contracts an appropriate set of liability arrangements and (iii) setting out an appropriate liability standard for custodians linked to the concept of control. Also on the topic of liability, some respondents did not agree with applying the same (strict) standards as for depositaries under the Alternative Investment Fund Managers Regulation to custodians of cryptoassets.

**8.8** Storage solutions and wallet structures were a recurrent theme in the feedback received. Some responses argued that regulatory rules should require segregation of individual client cryptoasset wallets while others argued that omnibus accounts should be permitted. However, there was overwhelming support for the proposal that a firm's own assets should be segregated from their clients' assets. Cold storage requirements were another area where there was no clear consensus. Some responses suggested that regulated custody providers should be required to keep a minimum proportion of customer assets in cold storage in line with certain other jurisdictions. Others argued for a more flexible, outcomes-based approach – especially while the industry is still in its more formative stages.

**8.9** A number of responses had views on the Financial Services Compensation Scheme (FSCS). Some responses felt that cryptoasset custodian failures should be covered, pointing out that this would be consistent with the traditional finance custody regime. Others called for clarification as to how this might work – e.g. regarding levy structures and treatment of vertically integrated businesses.

**8.10** The government also received many suggestions on operational resilience requirements for cryptoasset custody providers – including recommendations on regular reconciliations, third party audits, cybersecurity practices and controls, recoverability of critical IT systems, and business continuity planning.

## Government response

### **Basis for the regime**

**8.11** The government intends to take forward the previously proposed approach, including the basis for the regime. Specifically, the government will legislate to define a new regulated activity for custody covering the (i) safeguarding, (ii) safeguarding and administration, or

(iii) the arranging of safeguarding or safeguarding and administration, of a cryptoasset. Existing frameworks for traditional finance custodians under Article 40 of the RAO will be used as a basis for the regime. However, the government reiterates the importance of making suitable modifications to accommodate unique cryptoasset features or putting in place new provisions where appropriate. The novel and unique scenarios, risks and technology solutions that were raised in the feedback will be taken onboard as the UK authorities proceed with secondary legislation, detailed consultations, and rulemaking processes.

**8.12** The Law Commission published its Final Report on Digital Assets on 28 June 2023, recommending selective reform and development of the private law on digital assets to secure UK's position as a global financial hub.<sup>27</sup> This important piece of work provides further clarity on foundational legal concepts, as well as specific recommendations and next steps to further clarify the concept of 'control'. HM Treasury and the FCA will also consider this carefully in forthcoming work on custody.

### **Self-hosted wallets**

**8.13** On the use of self-hosted wallets, generally speaking, the activity of providing self-hosted wallet technology to a consumer is, in itself, not expected to fall under the definition of 'safeguarding' or 'safeguarding and administering' (i.e. the new regulated activity for custody). However, regulators will continue to keep this under review and assess how and if certain custody requirements might apply to self-hosted wallets including whether aspects of these products and services – in particular relating to operational resilience – could be addressed through the FCA's outsourcing and third parties rules and guidance.

### **Use of third parties**

**8.14** Regarding arrangements with third parties – either to provide the custody or some of the underlying technology or infrastructure – the scope of regulation for these arrangements will be considered in the new regulated activity for custody. The FCA will also consider detailed rules for third party arrangements, including whether to apply similar rules to those which apply to traditional finance custodians. Where firms outsource physical custody to secure asset storage companies, the government expects that such arrangements could be captured by the 'arranging' limb of the custody regulated activity depending on the terms of the contract between the firm and secure asset storage company.

### **Custody liability**

**8.15** On the topic of liability, the government confirms the intention to take forward a proportionate approach which would not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control. This was broadly

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<sup>27</sup> See the June 2023 Law Commission report (Digital assets: Final report), in particular: Chapter 5

supported by most (though not all) respondents – and would be in line with the approach for traditional finance custody.

### **Custody of security tokens**

**8.16** The government expects that security tokens which meet the definition of an existing specified investment - will, for the most part, continue to be regulated in line with existing rules and regulations (e.g. issuance, reporting and prudential rules). However, *custody* of security tokens will no longer be regulated in the same way as other specified investments and will instead be specified by a new regulated activity to address fundamental differences in the way that cryptoasset custody operates versus traditional custody arrangements (e.g., firms that solely safeguard cryptographic private keys which provide access to cryptoassets). The government intends that this will achieve the same regulatory outcome as is in place currently.

**8.17** The Stablecoins Update and subsequent phase 1 legislation will provide clarity on the custody regime for UK-issued fiat-backed stablecoins and security tokens. This regime for cryptoasset custody will be expanded to cover a broader set of cryptoassets in the future as they come into the regulatory perimeter. Overall, this approach will ensure that there is not duplicative or overlapping regimes applied to security tokens.

### **Other considerations**

**8.18** Detailed rules (e.g. regarding safeguarding clients' ownership rights, record-keeping and controls and governance) will also be addressed through FCA consultations and regulatory regime, taking into account existing frameworks as well as the Law Commission's recommendations on what constitutes 'factual control', including the Law Commission's view that factual control might work in different ways across different assets and products. Regarding FSCS protections, while some responses felt that the government should legislate for this, this will be determined by the regulator as part of its usual public consultation and rulemaking governance.

# Chapter 9

## Regulatory outcomes for market abuse

### Recap on original proposals from the Consultation

**9.1** The Consultation proposed to introduce a cryptoassets market abuse regime based on elements of the Market Abuse Regulation (MAR) regime for financial instruments. The market abuse offences would apply to all persons committing market abuse on a cryptoasset that is admitted (or requested to be admitted) to trading on a UK cryptoasset trading venue. This would apply regardless of where the person is based or where the trading takes place. The proposed regime would entail obligations for certain market participants, for example cryptoasset trading venues (who would be expected to detect and disrupt market abuse behaviours) and cryptoasset market intermediaries (who would have obligations placed on them, in particular those around the handling of inside information).

#### **Question 25**

Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?

**9.2** 50 responses were received on this question. 88% agreed or generally agreed with HM Treasury's assessment of the challenges. 12% of responses were neutral or mixed and 0% disagreed. The vast majority of responses were supportive of HM Treasury's effort to introduce standards to manage and mitigate the identified risks of market abuse. Most of these agreed that the assessment of risks was accurate, with many also noting that the ambition levels were sensible and realistic.

**9.3** The bulk of the feedback was focused on distinctive aspects of cryptoasset markets (in addition to those already identified in the Consultation) which do not clearly map across from traditional asset classes and therefore require specific attention. Some of these unique issues arise from the nature of the underlying consensus mechanisms. For example, with proof-of-stake (PoS) and proof-of-work (PoW) mechanisms, pending transactions may be queued in a publicly visible waiting area called a 'mempool', until a miner or validator selects them to be incorporated into a transaction block. Miners and validators have

found ways to profit from this called Maximal Extractable Value (MEV) strategies which may involve excluding, or reprioritising transactions from the mempool. This can result in sub-optimal outcomes for investors and may create opportunities for frontrunning or at least frontrunning-like behaviour.<sup>28</sup> Another challenge may be around liquidity incentive schemes, where a protocol issues reward tokens to those that provide liquidity. This can induce users into providing exit liquidity for the token's creators or other insiders.

**9.4** Other responses identified specific risks arising from limitations in market data since cryptoasset trading data is often fragmented and incomplete, making it difficult to gain a comprehensive view of market activity. In addition, many cryptoasset exchanges do not currently provide the same level of transparency as traditional exchanges. Another specific issue which was frequently raised was the prevalent use of social media and prominent media figures to influence the market. Although this is not unique to cryptoassets it is more prevalent in cryptoassets in part due to the more retail-driven nature of the market and the more speculative nature of valuations associated with certain tokens. Other specific risks raised included regulatory coverage gaps given the UK's proposed phased approach and the potential for a single cryptoasset to be traded across both Centralised Finance (CeFi) and DeFi market structures.

**9.5** Some responses mentioned other novel risks such as those arising from the hoarding of computational capacity to manipulate the ledger, and the use of large language models to carry out market abuse. Risks associated with governance exploits, exploits of coding errors and technical flaws (e.g. Sybil attacks<sup>29</sup>) were also mentioned, as well as risks arising from the use of crypto specific products and services like flash loans and tumblers / mixing services.

**9.6** Several responses highlighted that the cryptoasset sector offers major potential improvements as well as challenges when it comes to market abuse. For example, the increased transparency around wallet information and on-chain transactions could be a major advantage. However, several responses noted the difference between on-chain and off-chain transactions, noting that off-chain data is relatively opaque and harder to track. More mature Regulatory Technology (RegTech) solutions will also be required to fully capitalise on the potential associated with cryptoasset technologies.

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<sup>28</sup> Frontrunning occurs when a trader obtains inside knowledge about a forthcoming order that could move the market price of the asset and uses this to buy or sell ahead of the corresponding transaction in order to make a profit from the price differential. Note, however, that information obtained from a mempool would not generally be regarded as inside information since mempools are typically publicly accessible – with the requisite technology and know-how

<sup>29</sup> A type of attack on a computer network where the attacker subverts the service's reputation system by creating a large number of pseudonymous identities and uses them to gain a disproportionately large influence

### Question 26

Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?

**9.7** 49 responses were received on this question. 86% agreed or generally agreed with the proposed scope of the regime and 14% of responses disagreed. Those that fully agreed with the proposal felt that the extra territorial scope (regardless of where the trading activity takes place) was important due to the globalised nature of cryptoasset trading and the fact that it is not typically linked to specific jurisdictions. Others also suggested that the proposed scope would ensure some level of consistency with the wider market abuse regime.

**9.8** Of those who generally agreed with the proposal, one common reservation was around the ability of the regulator to take enforcement action against offshore market participants. There were concerns that this could be impractical and prohibitively costly, thus undermining the prospect of achieving a level playing field for all market participants. Another concern raised was the potential for prices to be impacted by market abuse behaviour conducted on decentralised exchanges or lending platforms – and the associated cross-platform arbitrage opportunities that could arise from that. Some responses specifically challenged the ‘requesting’ or ‘seeking’ component of the proposed scope, arguing that this that the obligations in respect of pre-admission cryptoassets may be excessively broad.

**9.9** Other responses suggested broadening the scope of the regime. One response argued that the scope should be broadened to also include private coin offerings which can also be impacted by market abuse behaviour. Another response suggested inclusion of cryptoassets that are available via lending platforms and over the counter (OTC) desks.

**9.10** Responses which disagreed with the proposals mostly argued that the scope was excessively broad – especially while approaches towards international coordination are still being developed. Some of these respondents felt that the market abuse regime should not (at any stage) extend beyond transactions where there is no clear UK nexus (e.g. activities taken by UK residents, or in relation to UK venues). These responses noted that cryptoassets admitted to a UK venue will likely be available on hundreds of other venues around the world, and that the suggested approach would therefore introduce an unduly broad perimeter. The design principle of proportional and focused regulation may therefore not be met since trading venues would have to devote

significant resources to identifying bad actors in other jurisdictions and then taking the appropriate actions.

### Question 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?

**9.11** 47 responses were received on this question. 98% agreed or generally agreed with the proposal on prohibitions. 2% of responses were neutral or mixed. Many responses strongly supported the proposal, noting the benefits from consistency with the wider financial system and potential to encourage more institutional participation in crypto markets. Some cryptoasset exchanges noted that MAR is already used as the basis for alerting surveillance logic that is already deployed on cryptoasset venues (in addition to unique surveillance measures which are tailored to crypto markets).

**9.12** Some of the feedback again mentioned novel and distinct types of market abuse in cryptoassets (see also the summary of question 25 feedback) – but generally noted that these were compatible with the high-level categories of prohibitions under MAR. A handful of responses pointed out that, whilst the categories of prohibitions under MAR were suitable, the relative importance of market manipulation is likely to be greater because individuals can more easily influence the price of individual cryptoassets since their valuations are not driven by fundamental factors. For the same reason insider trading is likely to be relatively less important since value of most cryptoassets is generally not based on fundamental attributes of a business (such as earnings or mergers and acquisitions) which are knowable by insiders. On a related note, some respondents felt that the MAR definition of inside information is largely incompatible with the cryptoasset market and that it should only apply to a subset of cryptoassets – e.g. stablecoins.<sup>30</sup>

**9.13** Other responses pointed out that ways in which market abuse is carried out – and the shape and structure of the cryptoasset market more generally – are not static; prohibitions would therefore need to be reviewed periodically as trading strategies evolve. There were also calls for additional guidance – for example a non-exhaustive list of specific market abuse practices (as exists for MAR). One response suggested that the government considers the REMIT market abuse framework<sup>31</sup> as an alternative basis to MAR. The REMIT market abuse framework –

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<sup>30</sup> Presumably because the role and characteristics of an issuer are very different for most cryptoassets versus an issuer of a security – though more comparable for some cryptoassets such as fiat-backed stablecoins with clearly identifiable issuers that stand behind the token and hold reserves to enable their redemption for fiat currency.

<sup>31</sup> Regulation (EU) No 1227/2011 of the European Parliament and of the Council on wholesale energy market integrity and transparency

used to promote wholesale energy market integrity - adopts a similar definition of market abuse to MAR but is regarded by some as a simpler framework from a compliance perspective.

**9.14** One response took the view that banning access to cryptoasset markets for retail investors was a more appropriate approach than implementing a market abuse regime.

### **Question 28**

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

**9.15** 52 responses were received on this question. 46% of responses received felt that the proposals put a proportionate burden of responsibility on crypto trading venues, with 46% disagreeing and 8% neutral or mixed.

**9.16** A significant number of responses took the view that the proposed level of responsibility on trading venues was appropriate. In many cases, these respondents argued that cryptoasset trading venues play a critical, central role in the cryptoasset ecosystem and are the only entities that have full access to all the data necessary to conduct market surveillance in a meaningful way. Some of these responses did however suggest that the size, complexity, and risk profile of different venues should be considered when establishing regulatory requirements and that obligations should be reviewed periodically. There were also calls for detailed guidance and technical standards to bring clarity on how exact responsibilities would be expected to be discharged.

**9.17** Of the 45% of responses who disagreed with the proposed level of obligations on cryptoasset trading venues, a common line of argument was that it is unreasonable to expect the surveillance responsibilities of cryptoasset trading venues to extend beyond their own venues or beyond trades without a clear UK nexus. Most of these responses argued that the FCA should instead play the centralised surveillance role in line with the securities market framework, or that authorities should design and implement a 'dual competency' for the development and monitoring of market abuse practices involving both crypto trading venues and the FCA. One respondent noted that securities market supervision was transferred from exchanges to the regulator in 2000 because individual market operators were unable to look across the entire market. Another line of argument suggested that other private sector market participants – e.g. issuers and brokers – should also play an important role in terms of managing inside information and conducting appropriate market surveillance, rather than focusing obligations so heavily on cryptoasset trading venues.

**9.18** In particular, the suggestion that trading venues establish systems, controls and methods of disruption which could indicatively include cross-venue information sharing arrangements and public warning lists / deny lists received a high degree of opposition. Firms and industry associations pointed out that data sharing requirements would be complex and resource intensive and would generate liability risks due to data protection laws in the UK, and other jurisdictions (including the EU's General Data Protection Regulation (GDPR)). There were also concerns that this could necessitate the sharing of proprietary, commercially sensitive data with competitor firms – depending on the nature of the information that was required to be shared. Regarding public warning lists / deny lists, firms also raised concerns relating to data protection challenges as well as due process risks if required to add a natural person to such a list.

**9.19** One counterproposal was to have a phased approach towards implementation. Under the first phase, venues would be responsible for activity on their own venues and may have more limited information sharing arrangements (e.g. trades with a clear UK nexus – where at least one counterparty is UK-based).<sup>32</sup> Under the second phase, information sharing capabilities could be enhanced with broader participation and/or additional data fields. Under the third phase there could be a more comprehensive information sharing and surveillance mechanism across venues and across jurisdictions. The government received various permutations of this counterproposal, some of which involved a more prominent coordination role played by the FCA.

### **Question 29**

What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?

**9.20** 45 responses were received on this question. Many emphasised the need for legal and regulatory clarity through the continued (or accelerated) programme of work to deliver legislation and regulatory rules and guidance – at both domestic and international levels. Several respondents suggested that the government should also support initiatives that promote international standardisation of cryptoasset activities. This would include, for example, the use of standardised product or token codes, legal entity and natural person identifiers, and the adoption of common lexicons such as financial crime taxonomies.

**9.21** Many responses also highlighted the importance of supporting and promoting regulatory sandbox initiatives and digital innovation pathways. Some respondents recommended that the government take steps to protect intellectual property (IP) to promote the development of RegTech products and services – for example

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<sup>32</sup> Cryptoasset trading venues could potentially use the same data fields and capabilities developed for compliance with the Travel Rule for cryptoassets to identify such trades

automated surveillance tools and solutions which make use of artificial intelligence and machine learning. Finally, some responses suggested that the government should proactively promote specific, novel technologies such as anti-market abuse measures or controls which can be coded into the cryptoassets themselves.

### Question 30

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

**9.22** 49 responses were received on this question. 76% of those agreed or generally agreed on the proposal but 22% disagreed (2% were neutral or mixed). Some responses argued strongly in favour of the proposal, stating that this was an essential measure to build trust in the system. Some of these responses highlighted major concerns relating to insider trading in cryptoasset markets today, noting the ability for insiders to benefit significantly from their inside knowledge of, for instance, future token admissions by an exchange. Another point made here was that responsibilities for managing inside information should not rest solely on issuers and/or crypto trading venues, but rather a broad set of actors in the ecosystem given that inside information is not exclusively (or perhaps even primarily) a challenge for trading venues.

**9.23** Those that generally agreed with the proposal, typically stressed the importance of providing much more detailed guidance and concrete examples of what constitutes inside information – and how it should be managed - given the different characteristics of cryptoasset markets compared to traditional ones. Others called for a 'reasonable endeavours' test and an approach which is based on information and analysis that is reasonably available to the regulated firm. One response highlighted a specific challenge arising from the fact that the industry employs various non-standard communication channels that may be technically complex to monitor – e.g. social media platforms, peer-to-peer networks, decentralised applications ('dApps') and dark web forums. Another response suggested that certain industry participants including miners, validators, and oracles should not be subject to inside information requirements since they generally handle only public data. Their activities would perhaps be more analogous to high frequency trading actors that benefit from performing an activity.

**9.24** Amongst those that disagreed with the proposals, a few noted that the approach would represent a significant departure from MAR (under which only issuers - and persons acting on their behalf or on their account - have such obligations to manage inside information). A significant number of responses were concerned that this approach would put excessive burdens on regulated firms with limited upside. Some argued that such a regime would be administratively unworkable in practice, particularly for larger firms that have major international

operations, and that crypto-native employees of regulated firms may hold inside information on new crypto projects without the knowledge of the firm.

**9.25** Counterproposals suggested applying these obligations only to issuers, or only to cryptoasset exchanges (or both) rather than all regulated firms. Another suggestion was to have an industry-led solution that was more appropriately tailored to the cryptoasset sector – rather than something based on MAR and extended beyond issuers to all regulated firms.

## Government response

### **Basis for the regime, and scope**

**9.26** The government intends to take forward most aspects of the proposed approach set out previously, including the suggested scope of the regime, the regulatory trigger points, and the use of MAR as the basis for the regime including the prohibitions (covering insider dealing, market manipulation and unlawful disclosure of inside information). Obligations will apply to cryptoasset trading venues and other regulated market participants.

**9.27** The government disagrees with the position that the overall scope of the regime should be more narrowly defined (e.g. with respect to UK venues only) since this would not deliver adequate protection to UK consumers for reasons previously described. Furthermore, some of the responses argued that the proposed geographic scope was not feasible or practicable. The government also disagrees with this position noting that UK financial services regulation already affects firms based overseas in many areas such as consumer credit, market abuse and financial promotions. The government will discuss this challenge with the FCA to devise ways to mitigate the risks posed by overseas firms in this context. This is not an unprecedented challenge and the regulator may be able to address it using established approaches. Where a breach meets the FCA's threshold for action there are a variety of tools that can be used to mitigate harm such as engaging with other authorities or stakeholders including foreign regulators and opening an enforcement investigation.

**9.28** It is also important to retain the 'requesting admission' or 'seeking admission' element in scope. As highlighted by other respondents, insider dealing can and does occur prior to the point of token admission to a cryptoasset trading venue.

### **Surveillance and information sharing**

**9.29** Regarding suggestions relating to information sharing, the government acknowledges the challenges presented around technical complexity, data privacy, and the protection of confidential IP - and therefore the need for a staggered implementation for cross-venue data sharing obligations. This will be factored into the approach as the government legislates. The government stresses that lighter touch arrangements on information sharing – which do not fully meet the

regulatory objectives set out in the Consultation – should only be available on a time-limited basis. The government maintains that cryptoasset market participants should ultimately be able to trade in a fair and orderly environment. Furthermore, through extensive consideration of the challenges raised by industry through written submissions and in-person engagement, the government does not believe these to be insurmountable – but agrees that they are relatively complex and will necessarily take time to implement.<sup>33</sup>

**9.30** In response to the many suggestions for a central organisation to coordinate and harmonise information sharing, the government agrees and is supportive in principle of the idea of a centralised coordinating body (e.g. an industry association) to coordinate this effort – with FCA oversight. This should be an industry-led solution, leveraging the expertise of cryptoasset exchanges and their proximity to the various products and customers. Such an approach would also benefit from greater flexibility and adoption of innovative RegTech solutions. HM Treasury will continue to work closely with the FCA, industry and other external stakeholders to help shape the structure and function of an industry-led market abuse information sharing platform.

### **Obligations to manage inside information**

**9.31** In terms of obligations to manage inside information, the government will take forward proposals to require regulated cryptoasset firms - such as operators of cryptoasset trading venues and cryptoasset intermediaries - to appropriately manage price sensitive information in relation to cryptoassets.<sup>34</sup> Regulated firms will be expected to have policies and procedures in place to identify price sensitive information and put controls around this (which may include insider lists for example), and to release that information to the public domain as soon as possible for example via primary information providers.<sup>35</sup> This is expected to extend beyond cryptoasset trading platforms as other market participants in the ecosystem – such as cryptoasset intermediaries - have an important role to play in managing inside information.

### **Other considerations**

**9.32** Where respondents have raised features and risks which are unique to cryptoassets, the government considers that the framework proposed will be flexible enough to address them. In some cases this may be achieved by the regulator setting firm-facing rules or guidance. On the point around celebrity endorsements and pump and dump

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<sup>33</sup> It should also be noted that market abuse regimes and supporting infrastructures for traditional financial services asset classes – e.g. financial instruments – were developed over many decades. Expecting the same level of sophistication and coordination on day 1 of the broader cryptoasset regime is unrealistic, especially for an industry which is currently characterised by a high degree of fragmentation across venues and jurisdictions

<sup>34</sup> Regarding the scope of regulated firms, readers are pointed towards chapter 12 which provides an update on the government's approach regarding mining and validation; this chapter clarifies that the government considers that the specific process of mining and operating a validator node using on-chain staked cryptoassets would generally constitute a technical function and not a financial services activity

<sup>35</sup> <https://www.handbook.fca.org.uk/handbook/DTR/8.pdf>

schemes perpetrated through social media, the government draws attention to the recent Financial Promotions SI (with the corresponding regulatory regime going live in October 2023) which will apply to cryptoasset financial promotions capable of having an effect in the UK, regardless of where in the world the promotion originates and the medium it takes (i.e. social media will be captured). The FCA has also published two guidance consultations on financial promotions for cryptoassets and social media respectively.<sup>36</sup> Finally, the government is supportive in principle of two other broad points that came up frequently in the feedback. Firstly, the government agrees that additional guidance should be made available by the regulator to provide clarity on what constitutes market abusive behaviour (including a non-exhaustive list of examples). The government also agrees that key aspects of the regime will need to be periodically reviewed and assessed given the dynamic nature of the industry.

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<sup>36</sup> GC23/1 & GC23/2

# Chapter 10

## Regulatory outcomes for operating a cryptoasset lending platform

### Recap on original proposals from the Consultation

**10.1** In the Consultation, the government highlighted that firms offering cryptoasset credit and borrowing services were likely to be captured by requirements proposed within the cryptoasset intermediation and custody regimes. In addition, for cryptoasset lending firms, the Consultation proposed a bespoke set of rules and ongoing monitoring arrangements and the creation of a newly defined regulated activity – ‘operating a cryptoasset lending platform’. Through this, the government proposed that lending platforms would have requirements to put in place adequate risk warnings, adequate financial resourcing and clear contractual terms of ownership.

#### **Question 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?

**10.2** HM Treasury received a total of 41 responses to this question with 83% agreeing or generally agreeing that the assessment of challenges was correct. Several responses did however note that HM Treasury should consider additional challenges. Of these, the most common themes were the need for distinction between retail and wholesale lending activities, and the need for alignment with broader financial services regulation. Some respondents also noted that staking activity should not be subject to the same regulation as lending or borrowing activities. Others recommended that HM Treasury gave further consideration to the challenges faced by borrowers/consumers, with one response suggesting an amendment to the Consumer Credit Act 1974 to achieve adequate protection for retail borrowers. DeFi lending was also mentioned as an additional challenge with some respondents adding that DeFi lending regulation should be addressed in parallel to centralised cryptoassets lending. Of those disagreeing with the approach, respondents noted that regulation of this activity would be

inconsistent with the way securities lending transactions are treated and thus the government should not take forward a blanket approach.

### **Question 32**

What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?

**10.3** HM Treasury received 32 responses to this question. Several respondents noted that adequate prudential requirements in the form of capital and liquidity safeguards, reserve requirements, ring-fencing of retail funds,<sup>37</sup> stress testing and leverage limits could have prevented such a collapse. Other respondents discussed the need for adequate disclosures to consumers, including adequate risk warnings, clarity on legal ownership, compensation agreements and information on insolvency procedures. At least one respondent suggested that all such information should be clearly presented in the customer-facing terms and conditions, so that all investors are informed of the risks associated with using a cryptoassets lending platform. A significant number of respondents also noted that stricter custody arrangements, appropriate segregation of client assets and limitations on rehypothecation could have also been helpful. Other responses discussed the inappropriate governance structures in place for lending platform business models and added that any regulation should cover appropriate governance, transparency and accounting standards.

### **Question 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?

**10.4** HM Treasury received 40 responses to this question with the majority of respondents (83%) agreeing or generally agreeing with the proposal. At least one respondent outlined several transferable elements from traditional lending that could be extended to cryptoassets lending including risk warnings, capital requirements and collateral reporting. Several responses noted that FSCS protections should be extended to cryptoasset lending for consumer protection reasons. A significant portion of responses asked HM Treasury to differentiate between cryptoasset retail lending and wholesale lending. More specifically, some responses suggested that firms lending solely to institutional counterparties should be permitted to engage in certain

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<sup>37</sup> though other responses suggested that retail participation should be wholly prohibited

activities without the same authorisations that would be required to lend to retail customers. Of those disagreeing – several respondents felt that securities lending regulation should be the basis for a cryptoassets lending regime.

**10.5** Most respondents agreed that a bespoke regime would be most appropriate for cryptoassets lending with this regime focusing on credit risk, disclosure requirements, collateral, and margin calls. Among other traditional lending regimes that HM Treasury could consider, respondents mentioned the Consumer Credit Act in the UK and the Capital Requirements Regulation (CRR) and the Mortgage Credit Directive (MCD) in the EU.

#### **Question 34**

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

**10.6** HM Treasury received 36 responses to this question, with an overwhelming majority (89%) agreeing or generally agreeing with the proposal. However, a number of responses qualified this view by asserting that the reporting requirements for these firms should not be as stringent as those applying to traditional lending. Other respondents suggested that regular audits would attract investors to these platforms and so should be welcomed. A few responses questioned whether the availability of cryptoasset lending to retail participants should be allowed. Others suggested that a warning requiring express consent should be displayed before retail customers pledge their assets. Of those disagreeing with the proposals, respondents highlighted that the suggested option would be too burdensome for firms and not likely to benefit retail clients. Instead, one respondent suggested that prescriptive ratios should be defined with regards to collateral, liquidity and rehypothecation, with a bespoke risk management framework rather than a regime focused on transparency.

#### **Question 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)?

**10.7** HM Treasury received 44 responses to this question with 89% of those agreeing or generally agreeing with differentiating between these activities for regulatory purposes. The majority of these responses were of the view that lending (where there is transfer of legal title) presented a higher degree of risk than staking due to potential harms arising from rehypothecation, counterparty default, and greater information asymmetries. Other respondents asked HM Treasury to clarify the difference between staking and lending through clear

definitions (with these responses generally recommending that a transfer of legal or beneficial title should be the key distinction). Some respondents also noted that staking in itself was a technological process that should not be covered by financial services regulation. Others suggested that a carve out from Collective Investment Scheme (CIS) regime would be appropriate for the regulation of staking activities.

## Government response

### **Basis for the regime, and scope**

**10.8** The government intends to take forward the approach outlined in the Consultation, including the proposal to establish a newly defined regulated activity of ‘operating a cryptoasset lending platform’, in line with broad support from both industry and consumer groups.

**10.9** The Consultation feedback correctly noted that there are many different types of cryptoasset borrowing and lending arrangements, involving different business models, market participants and risks. As such, it would not make sense to regulate all borrowing and lending activities in the same way or adopt a single model of traditional lending regulation for all cryptoasset lending arrangements.

### **Retail versus wholesale**

**10.10** The government agrees on the need for a clear differentiation between lending to retail consumers and lending between wholesale counterparties and will therefore consider additional requirements for retail lending arrangements. For clarity, the framework set out in Chapter 10 of the Consultation was designed primarily with retail consumers in mind (taking into account learnings from the failure of platforms like Celsius) rather than wholesale bilateral lending arrangements. The intention is to prioritise regulation of these types of lending business models (i.e. centralised platforms) given concerns around retail consumer risks.

**10.11** With this in mind, the government agrees, in principle, that wholesale bilateral cryptoasset lending arrangements would not be subject to the same types of regulatory requirements. However, as previously set out, there are some similarities between wholesale cryptoasset lending and securities lending that could result in the build-up of systemic risk. The government, therefore, maintains that some requirements similar to those found in the UK Securities Financing Transactions Regulation (SFTR) (e.g. requirements relating to counterparty and transactions details, collateral composition, rehypothecation, substitution of collateral at the end of the day and haircuts) could help improve transparency associated with cryptoassets financing activities. These may be considered in future phases of regulation.

### **Lending versus staking**

**10.12** The government agrees with the feedback recommending differentiated regulatory treatment between cryptoasset lending and

cryptoasset staking (where the latter does not involve transfer of legal title of the asset). Readers are pointed towards chapter 12 for further detail on this.

# Chapter 11

## Call for evidence: Decentralised Finance (DeFi)

### Recap on original proposals from the Consultation

**11.1** In the Consultation, the government noted that Decentralised Finance (DeFi) was a nascent, complex area carrying unique challenges. As such, the Consultation requested further evidence from respondents before setting out any prescriptive frameworks. The government noted that the work of international organisations was pertinent, and that the government was not seeking to front run this by developing a prescriptive framework for the UK that would need to be fundamentally re-shaped once international approaches and standards crystallise. There was recognition that work was already being undertaken at various international organisations to address risks emanating from DeFi.

**11.2** The government also outlined that the regulatory outcomes and objectives described in the preceding chapters should apply to cryptoasset activities regardless of the underlying technology, infrastructure, or governance mechanisms. However, due to the challenges specific to DeFi, this would take longer to clarify. The consultation noted that one way of achieving this would be to regulate DeFi through a set of DeFi-specific activities.

**11.3** Overall, HM Treasury sought a proportionate approach which recognised the opportunities offered by DeFi new business models and encouraged a thriving and well-regulated UK DeFi industry, whilst delivering similar regulatory outcomes across centralised financial services activities and their DeFi equivalents, thereby preventing risks of regulatory arbitrage.

#### **Question 36**

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

**11.4** HM Treasury received a total of 55 responses to this question with 80% of respondents agreeing or generally agreeing that the

assessment of the challenges of regulating DeFi was appropriate. At least five responses supported HM Treasury's view that it would be unwise to front-run international work on DeFi, especially with regards to coordination and alignment on taxonomy. Other respondents asked HM Treasury to clearly define what activities fall in the scope of DeFi.

**11.5** Respondents noted that DeFi projects often involved complex financial products and protocols that would be difficult for consumers to understand. Many of the respondents highlighted that DeFi business models should be identified on a spectrum of centralisation rather than a binary delineation between centralised and decentralised, with some business models shifting over time from decentralised to centralised (though the shift could also occur in the other direction). One respondent argued that HM Treasury should determine what degree of centralisation merits regulation, noting that fully decentralised solutions cannot and should not be regulated. Another respondent noted that as many DeFi firms were on a journey to decentralisation, regulating the action of establishing or operating a protocol could cripple the DeFi sector.

**11.6** Respondents agreed that a DeFi framework should focus on the entity managing access to a protocol rather than the software providers or developers of the protocols. At least two respondents noted that any DeFi regulatory framework should recognise and facilitate the unique features of DeFi (particularly decentralisation and disintermediation). Another respondent noted a more prescriptive framework whereby FSMA should apply either to grant authorisation or to bring relevant enforcement actions would be key. The challenge of enforcement was also recognised by other respondents.

**11.7** Of those disagreeing with HM Treasury's assessment of challenges, one respondent noted that existing regulatory frameworks were not fit for purpose to address DeFi's unique risks. Specifically, the respondent highlighted challenges associated with the lack of oversight of Decentralised Exchanges (DeXs), lack of specified guidance on regulating initial DeX offerings, lack of custody and insurance, and challenges associated with cross-border transactions.

### **Question 37**

How can the size of the "UK market" for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?

**11.8** HM Treasury received a total of 26 responses to this question. Respondents highlighted several metrics that could be used to evaluate the size of the UK's DeFi market. This list included data on

Total Value Locked (TVL)<sup>38</sup>, active users, volume, liquidity, fees, token price, governance participation, market share and smart contract audit. One respondent noted that this information could be obtained from regulated Know Your Customer (KYC) compliant exchanges on DeFi-specific token transfers which could be augmented with further tax data – though the respondent noted that this would be an underestimation as this would only focus on on-chain activity.

**11.9** A few respondents noted the difficulty of obtaining such information given the borderless nature of DeFi transactions. This could be addressed by crowd-sourcing information from market participants although achieving extensive compliance could be difficult. Alternatively, several respondents noted that existing data could be sourced from DeFi Llama and Chainalysis' DeFi adoption rates.

**11.10** One respondent put forward an estimate of approximately 1.38 million UK DeFi users in 2022 and 0.64 million UK individuals participating in yield farming. Estimates varied on TVL in DeFi. At least three respondents put the global estimate at ~\$50 billion, with estimates of the UK "market share" comprising varying from around 5% to 20% (\$2.5 to \$10 billion).

### **Question 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?

**11.11** HM Treasury received a total of 54 responses with 81% of respondents agreed or generally agreed with the proposed approach. One respondent suggested that although DeFi involves new technologies and approaches to governance, the activities occurring on a DeFi protocol (trading, lending, hedging) were analogous to those that exist in traditional finance. The goal for the regulators should thus be the prevention of regulatory arbitrage between DeFi and CeFi infrastructure.

**11.12** A significant number of respondents agreed that DeFi regulation should be implemented according to a longer timeline to enable a more internationally coordinated approach as the market was relatively small and at an early stage of development. One respondent further raised the anonymity of transactions being a significant obstacle to achieve the same regulatory outcome across DeFi and CeFi activities.

**11.13** Of those disagreeing, respondents argued that DeFi was fundamentally different to traditional financial services which are heavily centralised and intermediated financial services activities. These

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<sup>38</sup> TVL represents the amount of assets deposited by the liquidity providers in the different protocols developed in the DeFi space

responses further set out the importance of maintaining the user's freedom of choice to use DeFi services as long as they maintain control of their own assets and funds and the protocols are automated, self-executing and based on open-sourced code. Another respondent agreed that prescribing uniformity between CeFi and DeFi should not be the only ambition as this could stifle innovation within the DeFi space. Given the complexity of financial products involved in DeFi, one respondent noted that an educational approach was more appropriate than imposing a specific, potentially restrictive regulatory regime.

**11.14** Collectively, respondents noted that DeFi had five main features which separated it from CeFi. First, self-custody – whereby only the owner has possession of the private key to access their private keys. Second, autonomous nature – DeFi is reliant only on the execution of transactions through smart contracts. Third, transparency – DeFi activity is recorded on a public blockchain and based on open sourced code. Fourth – composability allowing interoperability of DeFi protocols and dApps. Lastly, DeFi by its nature is decentralised and controlled by a network of users; CeFi is controlled by a single person/small, centralised group. As such, one response argued that the regulatory tools used to regulate DeFi would have to be separate to those used in CeFi. Other respondents highlighted that defining standards could be used to address DeFi-specific risks. This could include conducting regular, independent code audits and IT security tests, in addition to standards around information disclosures about the services provided and their associated risks.

#### **Question 39**

What indicators should be used to measure and verify “decentralisation” (e.g. the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?

**11.15** HM Treasury received a total of 38 responses. Most respondents agreed that decentralisation should be seen as a process/spectrum rather than a static choice between centralisation and decentralisation. A significant number of respondents also noted that most ‘centralised’ DeFi firms were on a path to decentralisation (‘progressive decentralisation’) and as such a prescriptive DeFi framework that only applies to fully decentralised firms would be unhelpful.

**11.16** Voting rights/governance token distribution was raised by nearly all respondents as a metric that could be used to measure decentralisation. At least one respondent added that, although decentralisation was a spectrum, if a single body within the DeFi chain holds 50% or more of voting rights this should not be considered decentralised. Another respondent cited 60% as the threshold figure. Furthermore, respondents added it was also important to account for the nature of the control of the governance tokens, i.e. the extent to

which token-holders vote on the direction of the organisation or more immaterial matters. Distribution of nodes was also raised as a metric for measurement of decentralisation, if a small number of nodes control the majority of the network's processing power, it would indicate a more centralised protocol. Other respondents also raised 'code openness' (the transparency and accessibility of the code) as a measure. One respondent also highlighted that reliance on self-executing smart contracts, non-custodial arrangements (no intermediary has access to client assets) and self-governance were pillars of DeFi arrangements, the lack of this therefore would indicate a centralised entity.

#### **Question 40**

Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?

**11.17** HM Treasury received a total 39 responses to this question. A significant proportion of the responses agreed with the Consultation in that regulating on and off-ramps, especially exchanges, would be the most suitable regulatory hook. However, a number of responses noted that interface providers or front-end platforms would not be appropriate regulatory hooks. These respondents argued that this would go against the principle of activity-based regulation given that these interface providers were not necessarily connected to the governance or decision-making side of the DeFi protocol. An alternative approach suggested that regulators consider regulation of DeFi applications rather than the underlying protocol.

**11.18** Other suggestions in responses included regulators working with smart contract audit companies looking for bugs and stress-testing dApps for vulnerabilities. Other suggestions included attaching regulatory hooks to token issuers and smart contract developers, although it was noted that these in many cases could be less appropriate and relatively complex to enforce.

**11.19** At least one response asked HM Treasury's approach to follow that of the International Monetary Fund in DeFi regulation by focussing on the elements of the cryptoassets ecosystem that enable DeFi. Thus, focusing on stablecoin issuers, centralised crypto exchanges, hosted wallet service providers, reserve managers, network administrators and market makers could all serve as appropriate regulatory hooks.

#### **Question 41**

What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

**11.20** A total of 39 respondents returned answers on other approaches not referenced in the Consultation that could be taken forward. At least 5 respondents noted the importance of international coordination on setting DeFi standards noting the work of supranational bodies including the FSB and the Bank for International Settlements (BIS). Responses also added that the UK should prioritise international engagement with regulators outside of the UK on DeFi to ensure a harmonised regulatory framework.

**11.21** A number of respondents raised that a licensing and certification approach could be applied to DeFi whereby certain activities would not be permitted without an official license. A few respondents reiterated that mandatory compliance with overly prescriptive rules could stifle innovation and thus recommended voluntary frameworks. Other respondents also highlighted that a DeFi regulatory sandbox could be a useful tool to enable firms to decentralise.

**11.22** Respondents also noted that a self-regulatory approach through Self-Regulatory Organisations (SROs) could be useful alternate approach to that proposed in the Consultation. This could, for example, be achieved through embedding supervisory functionality within the technical design of the protocol (such as supervisory nodes). Responses also suggested that the FCA could provide guidance to promote good practice.

**11.23** Other suggestions included establishing an equitable tax framework, requiring every protocol to have separate retail-facing and institutional-facing protocols, and requiring protocols to elect a responsible regulatory board with liabilities similar to those set out in the Senior Managers and Certification Regime (SMCR).

#### **Question 42**

What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

**11.24** HM Treasury received 37 responses on existing best practices that could be formalised. Several respondents asked that the FCA should develop and recognise voluntary best practices through formalisation of a certification process for interfaces and protocols. Certified protocols would feature on approved lists allowing them to be used in regulated financial institutions. A number of respondents also asked for the standardisation of code audits as these would be a key element to mitigate risks, facilitate consumer protection and curtail illicit market activity. Several responses noted that IT security tests and information disclosures would be pertinent to enable the growth of the DeFi market. At least one respondent noted however that these should be industry standards rather than regulatory obligations. Another respondent added that a “Know Your Smart Contract” could be adopted whereby firms would have to consider whether their smart

contract had been verified, their dApps had been tested, that they were able to track movements of assets under the contract, and whether there were other contracts dependent on their smart contract. Amongst other suggestions were DeFi organisations having clear policies and procedures for providing liquidity to their protocols, including risk management strategies.

## Government response

**11.25** Although the DeFi market is currently small, the government recognises that DeFi may play an important role in financial services as the cryptoasset sector becomes larger and blockchain-based solutions continue to be adopted by financial markets. As such, and in line with the government's innovation-forward approach, the government does not intend to ban DeFi.

**11.26** As identified by numerous international bodies, important challenges remain for authorities to be able to regulate the DeFi ecosystem. HM Treasury recognises, for example, that some firms operating within the DeFi space currently could not be classified as decentralised. HM Treasury agrees with respondents that a spectrum of decentralisation needs to be recognised within the DeFi ecosystem rather than a binary between centralised or decentralised.

**11.27** The government envisions a potential for fully decentralised DeFi service models, if achievable, to play a role in financial services in the future but this will require careful consideration on the management of future risks and extensive international collaboration. For safe and wider adoption of these models, the government would expect them to achieve equivalent regulatory outcomes to those performed in traditional finance.

**11.28** However, in line with Consultation responses, HM Treasury recognises that it would be premature and ineffective for the UK to regulate DeFi activities currently. Instead, the government will support efforts at the international level through work at both the FSB and standard setting bodies (SSBs) to inform a future domestic framework. The government will also continue bilateral engagement with authorities in other jurisdictions and to engage with industry to ensure that cooperation and efforts on DeFi matters remains pertinent.

# Chapter 12

## Call for evidence: other cryptoasset activities

### Recap on original proposals from the Consultation

**12.1** In the Consultation, the government noted that cryptoassets are currently not in scope of the regulated activities of advice and discretionary portfolio management services. The government also noted that cryptoasset investment advice and discretionary portfolio management services were limited and risks to retail consumers were relatively modest. However, there was potential for risks to emanate from conflicts of interest, fraud and loss of customer assets with the risk that these activities could expand to retail consumers. Per the government's overarching approach on cryptoassets, the Consultation noted that the government is considering whether a case exists for bringing these activities into the regulatory perimeter through Article 53 of the RAO and Article 37 of the RAO. Despite these parallels, HM Treasury noted that there were clear differences especially as the value of unbacked cryptoassets is driven by speculative decisions rather than objective market fundamentals.

**12.2** Post-trade activities were another area where the government sought further input before outlining a prescriptive framework. The Consultation noted that some functions such as settlement could be performed on the blockchain with different structures. Thus, there were benefits in regulating settlement to mitigate settlement failure risk and ensuring clarity of ownership – this would be in cases where the activity was deemed to be systemic and proportionate to the scale of the risk. Clearing was noted as another area where future-proof regulations may be of benefit although no central counterparties clearing services were being provided by cryptoasset exchanges.

**12.3** The Consultation highlighted that mining and validation occurring in the UK made up a very small percentage of global mining power. The difficulty in regulating the decentralised nature of certain cryptoassets also extended to how and where cryptoassets are mined. Simultaneously, the challenge of attempting to enforce any regulation at protocol level may simply push mining / validation and certain software development activity abroad. As such, the government outlined that there may not be justification to regulate the activity of mining in and of itself.

**12.4** HM Treasury also noted staking activities could be an area to bring within the regulatory model. The Consultation noted that some models may already fall within the perimeter. However, with a lack of data on staking activity in the UK, the government thought it sensible to seek further data before outlining anything overly prescriptive.

#### **Question 43**

Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.

**12.5** HM Treasury received 30 responses to this question with the majority of respondents (77%) agreeing or generally agreeing that investment advice and portfolio management on cryptoassets should be a regulated activity. Responses to support this position included the increasing proliferation of cryptoassets in the retail space, that regulation would increase consumer confidence, and for consumer risk management. Others noted that customers were often seeking unqualified views as current financial advisors were limited in their ability to advise on such products. One respondent suggested that any regulation should differentiate between advisors servicing retail investors and those servicing HNW persons and institutional investors. Several respondents noted that HM Treasury should seek to bring the activity in scope under phase 2 and take an approach similar to that of Switzerland and the European Union.

**12.6** Of those disagreeing with regulation of the activity at this stage, many responses noted the difference in value of public market instruments whose value is derived from market fundamentals and unbacked cryptoassets whose value is currently driven from speculative decisions. This speculative nature would render it difficult for an investment advisor to meet the existing criteria set out in Article 37 and 53 of the RAO. Respondents also added that given the limited scope of the activity currently, HM Treasury should not prioritise the issue and let the market develop before outlining a prescriptive framework.

#### **Question 44**

Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

**12.7** 41 respondents provided a response to this question with 59% of respondents disagreeing or generally disagreeing that mining and validation activities should be regulated in the UK. A majority of respondents agreed with HM Treasury's assessment that regulation of the limited mining activity would lead to offshoring. A significant number of respondents also asked for the HM Treasury to collaborate with international partners to ensure coherent international standards

for mining. Respondents noted that there was a downward trend in mining given a significant portion of cryptoassets rely on proof-of-stake models instead of proof-of-work. Some respondents also added that mining and validation in and of themselves were technology services and did not constitute a financial service which could be regulated.

**12.8** Those agreeing that mining and validation activities should be regulated listed prevention of abuse/evading sanctions as the major reason. One respondent also asked HM Treasury to regulate any entity which has a presence in the UK or provides UK contracts to clients.

#### **Question 45**

Should staking (excluding “layer 1 staking”) be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

**12.9** HM Treasury received 39 responses to this question with the majority of respondents disagreeing that staking should be an activity to be regulated alongside cryptoasset lending. A significant number of respondents also noted that staking as an activity should be separate from the definition of a Collective Investment Scheme (CIS). Respondents argued that should staking fall within the CIS framework, this would kill off a significant number of products (e.g. staking for the purpose of governance). At least one respondent argued that classifying staking arrangements as CIS would restrict access to staking for UK users who do not meet the conditions for participating in a CIS. Thus, it would burden staking providers with compliance costs resulting in the concentration of larger players. Ultimately, this would severely restrict staking. One respondent suggested that this would result in a *de facto* ban on the activity. Respondents thus suggested that this could be mitigated by the UK introducing *staking-as-a-service* as a regulated activity which would cover platforms allowing customers to participate in proof-of-stake consensus mechanisms.

**12.10** Respondents were also clear in distinguishing staking from lending with some responses suggesting the activity was more akin to mining. Specifically, respondents defined staking as a technological process that should not be regulated under financial regulation noting that risks in cryptoassets lending, i.e. rehypothecation, counterparty credit risk and information asymmetries were not apparent in staking.

**12.11** A significant number of respondents also asked HM Treasury to set out a more explicit definition of what would constitute staking. One response noted that the definition should be explicit that processes such as CeFi lending, yield farming and liquidity farming do not constitute staking. A few responses also outlined that staking pools should fall under CIS (especially where a liquid staking token is received by token holders). Some respondents noted that without a definition and further data, it would not be appropriate to seek to regulate this

activity. Others noted that cryptoasset staking should be regulated under phase 2.

#### **Question 46**

What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?

**12.12** HM Treasury received 23 responses. A significant number of respondents highlighted that centralised intermediaries providing the staking services should be the focus of regulation. One response suggested that providing a staking intermediary service (staking-as-a-service) should be an RAO activity in and of itself. Some responses noted that validators themselves could be regulated given that there were a few participants. Other responses pushed back noting the difficulty in regulating validators and that validation in and of itself was a technological service and thus should not fall under financial regulation. Respondents had mixed reactions to whether staking pools would be an appropriate regulatory hook. There were also suggestions that regulatory hooks should be placed on points of centralisation as these were areas of concentration risks.

### **Government response**

#### **Cryptoasset Investment Advice**

**12.13** The government recognises the strong sentiment on the need to bring cryptoassets investment advice and portfolio management within regulatory perimeter. The government also recognises concerns on how the intended approach may create divergence versus MiCA and other jurisdictions. However, regulated investment advice is often defined differently between jurisdictions. In the UK, the market structure of regulated advice is markedly made up of many independent and restricted network advisors, whereas some other jurisdictions are dominated by bancassurance advisors. The government maintains the view that the price and value of most cryptoassets is driven by speculative investment decisions rather than market fundamentals which can be objectively assessed. This, coupled with a lack of professional qualifications concerning cryptoassets and the challenges of conducting due diligence on the issuers of cryptoassets competently, results in difficulty for an investment adviser to provide suitable cryptoasset recommendations to customers. We therefore intend to keep this under review, focusing for the time being on the cryptoasset activities which have been prioritised for phase 1 and phase 2 legislation.

## **Mining and Validation Activities**

**12.14** In line with responses to the Consultation, the government does not intend to regulate mining as a regulated activity at this stage. As respondents have rightly identified, mining in the UK makes up an insignificant amount of global activity. Any unilateral action taken by the UK therefore would simply push the minimal activity occurring in the UK to jurisdictions with more lenient or no regulation. The government also recognises that mining, in and of itself, does not constitute a financial services activity.

## **Staking**

**12.15** HM Treasury has listened to industry concerns and understands that clarifying the future regulatory treatment of staking in the UK is a key priority for many stakeholders. Therefore, HM Treasury is accelerating exploratory work which involves extensive engagement with stakeholders and a clear set of steps to work through, including: (i) developing a clear definition of cryptoasset staking on a PoS blockchain and distinguishing this from other, riskier, activities which may be referred to, or marketed as 'staking'; (ii) establishing a taxonomy of the different PoS staking business models currently in the market; and (iii) identifying how to mitigate the associated risks and take advantage of the potential benefits of a carefully defined, permitted form of staking in the UK.

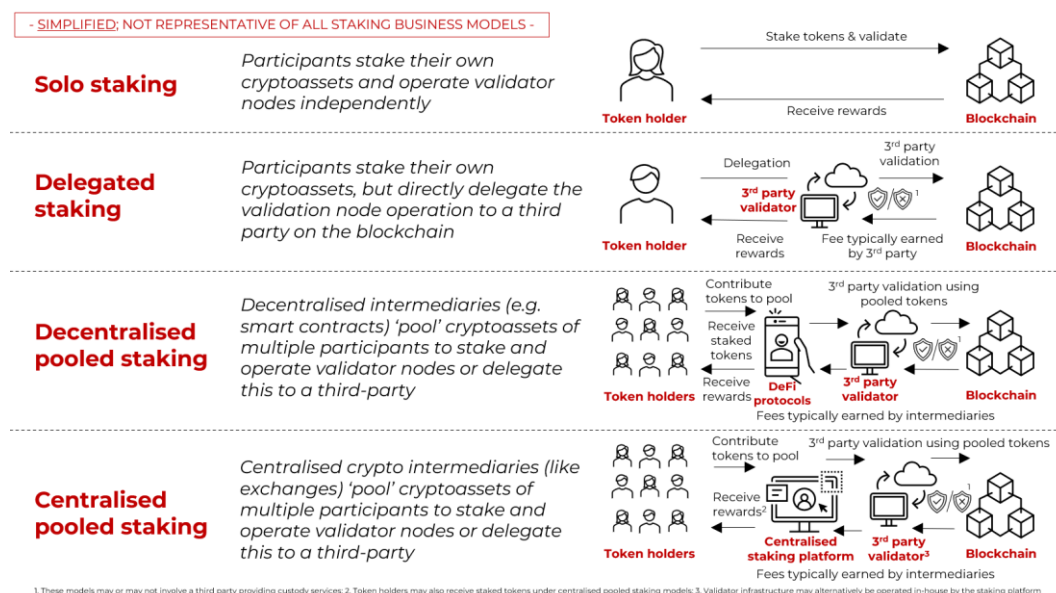
**12.16** The government is also cognisant of various live or recently closed consultations which should not be prejudged, such as the Law Commission's Final report on Digital Assets, HM Revenue & Customs' consultation on lending and staking, and the FCA's planned consultation on Non-Handbook Guidance for cryptoasset financial promotions which is seeking responses to guidance on staking.

**12.17** HM Treasury proposes a definition of staking as the process where a given amount of native cryptoassets are locked up (staked) on smart contracts in a PoS consensus mechanism blockchain (on-chain), in order to activate validator nodes (computers) which collaboratively validate subsequent transactions and achieve consensus on the network's current state. Rewards, consisting of newly minted native tokens and/or a portion of transaction fees on the blockchain, are then subsequently allocated to the network participants staking their cryptoassets and to the validator node operators. Any activities, services, or products marketed as 'staking', but which do not directly facilitate a validation process on a PoS blockchain should not currently be considered staking.

**12.18** A proposed taxonomy of current staking business models which consumers use to engage in this activity covers four archetypes (which may or may not involve intermediaries who stake cryptoassets on behalf of participants and may, in some cases, take custody of those assets) is set out in Fig 12.A. It should be noted that this typography does not represent a regulatory definition of staking nor text that would be used in any future legislation. Rather, the below sets out HM

Treasury's thinking on existing business models to inform the policy approach:

## Fig 12.A. Taxonomy of current staking business models (simplified, not exhaustive)



**12.19** While different staking business models exist, the same can be said for PoS blockchains with regard to how they perform validation and governance functions at the protocol level. At present, the government considers that the specific process of operating a validator node using on-chain staked cryptoassets would generally constitute a technical function essential to the operational activities and security of a PoS blockchain, rather than a financial services activity.

**12.20** While the government does not intend to ban staking, there is recognition that many of the activities performed by intermediaries in the pooled staking categories (3 and 4), such as taking custody of and/or pooling cryptoassets and issuing liquid tokens present risks for consumers which need to be addressed. However, there is potentially a case for these activities to be appropriately captured by other regimes – including financial promotions, custody, lending, and intermediation, without needing further regulation. Many of these activities currently labelled as staking present significant consumer risks which will be at least partially addressed through financial promotions, custody, lending, and other cryptoasset conduct regimes.

**12.21** In addition, the Consultation feedback highlighted that existing UK rules for collective investment schemes may capture on-chain staking services provided by intermediaries but may not provide effective regulation of these services. HM Treasury is therefore signalling an intent to carve out certain manifestations of staking within the taxonomy outlined above from the CIS rules; provided that risks are appropriately captured in regulation as set out above – or, alternatively, to introduce a regulatory regime for "operating a staking platform" outside of the CIS framework.

# Chapter 13

## Call for evidence: sustainability

### Recap on original proposals from the Consultation

**13.1** In the Consultation the government reiterated its firm commitment to making the UK a competitive location for sustainable finance. It was suggested that environmental, social and governance (ESG) related reporting requirements may be a proportionate way of achieving the “same risk, same regulatory outcome” principle. The Consultation therefore sought further views on what information about environmental impact or energy intensity would be useful for consumers making decisions about investing in cryptoassets, and at what time in the investor journey these would be particularly helpful to consumers.

#### **Question 47**

When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?

**13.2** The government received 31 responses to this question (though there was a significant degree of overlap between questions 47 and 48 with some respondents choosing to combine their answers). In addition to the quantitative measures and indicators discussed below, respondents frequently mentioned the following types of information as being potentially useful to investors:

- The type of consensus mechanism, and the network infrastructure
- The energy source mix (and associated trends and initiatives)
- Sustainability policies and ESG initiatives

**13.3** Many responses noted that this type of information should be supported by standardised rating systems and consistent terminologies and taxonomies to enable meaningful interpretation and comparisons. On a related note, several responses emphasised that getting this right is complex and needs careful international coordination.

#### **Question 48**

What reliable indicators are useful and / or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and / or associated emission metrics, or other disclosures)?

**13.4** The government received 25 responses to this question (again noting the overlap with question 47), suggesting the following types of indicators:

- Energy / electricity consumption (total energy use, average energy use per transaction or block, average energy use per node)
- Carbon emissions (total emissions, average emissions per transaction, average emissions per hash)
- Number of total nodes, number of total transactions
- Other metrics already used in existing frameworks (e.g. the Crypto Climate Impact Accounting Framework)
- Trends over time or time series data for all of the above

**13.5** As above, many responses emphasised the need for extensive international coordination. Much of the feedback also warned of the difficulties in developing accurate and standardised indicators (e.g. due to lack of consistency in definitions and taxonomies, different accounting standards and systems of measurement, and fundamental differences in the underlying infrastructures and protocols of different tokens). Indeed, some responses fundamentally disagreed with the merits of having obligatory sustainability disclosures for this reason suggesting that the upsides would be outweighed by the significant costs and complexity. Others in this camp also argued that sustainability disclosures would go above and beyond the requirements which exist for some activities or asset classes which are in some ways comparable. For example, these types of disclosures are not required for market participants to trade currency pairs.

#### **Question 49**

What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?

**13.6** The government received 18 responses to this question. Many existing frameworks and indicators for cryptoassets were highlighted including the Cambridge Centre for Alternative Finance (CCAF) indices (e.g. the Cambridge Bitcoin Electricity Consumption Index), the Crypto Carbon Ratings Institute (CCRI) indices, the Crypto Climate Impact

Accounting Framework, the Luxor Hashrate Index, and the World Economic Forum's Guidelines for implementing Blockchain's Environmental, Social and Economic Impact. Some responses also discussed well established indicators and frameworks which are used in traditional financial services (or other established industries) that could be extended to cryptoassets – for example, traditional OECD indicators as well as the Greenhouse Gas (GHG) Protocols, the Green Claims Code, and Renewable Energy Certificate (REC) procurement mechanisms.

#### **Question 50**

How interoperable would such indicators be with other recognised sustainability disclosure standards?

**13.7** The government received 17 responses to this question. Most agreed that a high degree of standardisation and interoperability was desirable and ultimately necessary, with many arguing that further international coordination work was required before defining requirements. Some pointed out that there are various consortia already committed to globally standardised approaches – e.g. the Crypto Climate Accord and the Crypto Impact and Sustainability Accelerator (CISA) and that some useful metrics are already very standardised (e.g. emissions per OECD standards). Some responses again highlighted practical difficulties – e.g. arising from different consensus mechanisms, underlying infrastructures and accounting standards.

#### **Question 51**

At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?

**13.8** The government received 15 responses to this question. Many argued for disclosures to be made at the initial decision-making stage of the consumer journey (i.e. prior to investment). Some also argued that information should be made available on a regular basis thereafter (e.g. every 1 to 2 years) to help monitor for improvements. Some warned of risks of overloading consumers and recommended extensive consumer engagement and consumer research. A few organisations again voiced their objections to a mandatory sustainability disclosures regime in their response to this question.

#### **Question 52**

Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?

**13.9** Only 11 responses were received on this question. One response suggested that the proposed approach – since it would involve leveraging the existing FSMA framework – could have a disproportionate approach on groups with protected characteristics. This response took the view that the existing financial services industry (and the policymaking which has shaped it) perpetuates inequality, discrimination and exclusionary practices based on race. The majority of the other responses did not see any differential impact on protected characteristic groups arising from the government’s proposals but talked more broadly about potential benefits from financial inclusion in a world with increased adoption of cryptoassets.

## Government response

**13.10** The government will proceed with the approach of tackling sustainability issues primarily through disclosures in the first instance. While there is a robust debate about the environmental impact of the cryptoasset sector (and the magnitude of this compared to traditional financial services), sustainability disclosures will play an important role in fulfilling the government’s overarching policy objectives and commitments on climate.

**13.11** However, the government agrees that there is a clear need for significant international cooperation to develop interoperable metrics to facilitate meaningful comparisons. The government’s intention is to advance this through existing international forums (e.g. IOSCO).

**13.12** The cryptoasset sector is rapidly evolving and metrics that are relevant now may become less relevant over time. For instance, the metrics best suited to evaluating PoW blockchains may be less suited to the increasingly prevalent PoS model. So as to avoid committing to a bespoke disclosure requirements too early, and to mitigate the risk of an un-level playing field, further exploratory work on whether existing frameworks and indicators could be applied will be undertaken. Authorities will continue to monitor developments in the industry, and should it become apparent in time that a bespoke regime is desirable or necessary then this could be developed.

# Annex 1: Glossary

Acronym	Definition
<b>BIS</b>	Bank for International Settlements
<b>CASP</b>	Crypto Asset Service Provider
<b>CASS</b>	The FCA's Client Asset Sourcebook
<b>CCAF</b>	Cambridge Centre for Alternative Finance
<b>CCRI</b>	Crypto Carbon Ratings Institute
<b>CeFi</b>	Centralised Finance
<b>CIS</b>	Collective Investment Scheme
<b>CISA</b>	Crypto Impact and Sustainability Accelerator
<b>CRR</b>	Capital Requirements Regulation
<b>Custody</b>	Safeguarding or safeguarding and administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset
<b>dApps</b>	Decentralised Applications
<b>DAR</b>	Designated Activities Regime
<b>DeFi</b>	Decentralised Finance
<b>DeXs</b>	Decentralised Exchanges
<b>DLT</b>	Distributed Ledger Technology
<b>DSA</b>	Digital Settlement Asset
<b>DSS</b>	Digital Securities Sandbox

Acronym	Definition
<b>ESG</b>	Environmental, Social and Governance
<b>FCA</b>	Financial Conduct Authority
<b>“Fifteenth Report-Regulating Crypto”</b>	A Treasury Select Committee inquiry published in May 2023
<b>Financial Promotions SI</b>	The Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023
<b>FMI</b>	Financial Market Infrastructure
<b>FSB</b>	Financial Stability Board
<b>FSCS</b>	Financial Services Compensation Scheme
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>FSMA 2023</b>	The Financial Services and Markets Act 2023
<b>GHG</b>	Greenhouse Gas
<b>HNW</b>	High Net Worth
<b>IOSCO</b>	International Organisation of Securities Commissions
<b>IP</b>	Intellectual Property
<b>KYC</b>	Know Your Customer
<b>MAR</b>	Market Abuse Regulation
<b>MCD</b>	Mortgage Credit Directive
<b>MEV</b>	Maximal Extractable Value

<b>MiCA</b>	The EU's Markets in Crypto-Assets Regulation
<b>MiFID</b>	The EU's Markets in Financial Instruments Directive
<b>MIFIDPRU</b>	The FCA's prudential sourcebook for MiFID Investment Firms
<b>MLRs</b>	Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017
<b>MTF</b>	Multilateral Trading Facility
<b>NFT</b>	Non-Fungible Tokens
<b>NSM</b>	National Storage Mechanism
<b>OPE</b>	Overseas Persons Exclusion
<b>OTF</b>	Organised Trading Facilities
<b>PoS</b>	Proof of Stake
<b>PoW</b>	Proof of Work
<b>RAO</b>	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
<b>REC</b>	Renewable Energy Certificate
<b>Reg-Tech</b>	Regulatory Technology
<b>RIEs</b>	Recognised Investment Exchanges
<b>SFTR</b>	Securities Financing Transactions Regulation
<b>SMCR</b>	Senior Management and Certification Regime
<b>SRO</b>	Self-Regulatory Organisation
<b>SSBs</b>	Standard Setting Bodies
<b>Stablecoins Update</b>	HM Treasury's update on plans for the regulation of fiat-backed stablecoins
<b>TVL</b>	Total Value Locked
<b>VoP</b>	Variation of Permission