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*Ahead of the Curve:
Crypto for Christmas -
UK cryptoasset
regulatory framework*

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Introducing



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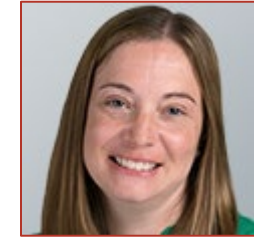


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Supervisory toolkit for critical third parties

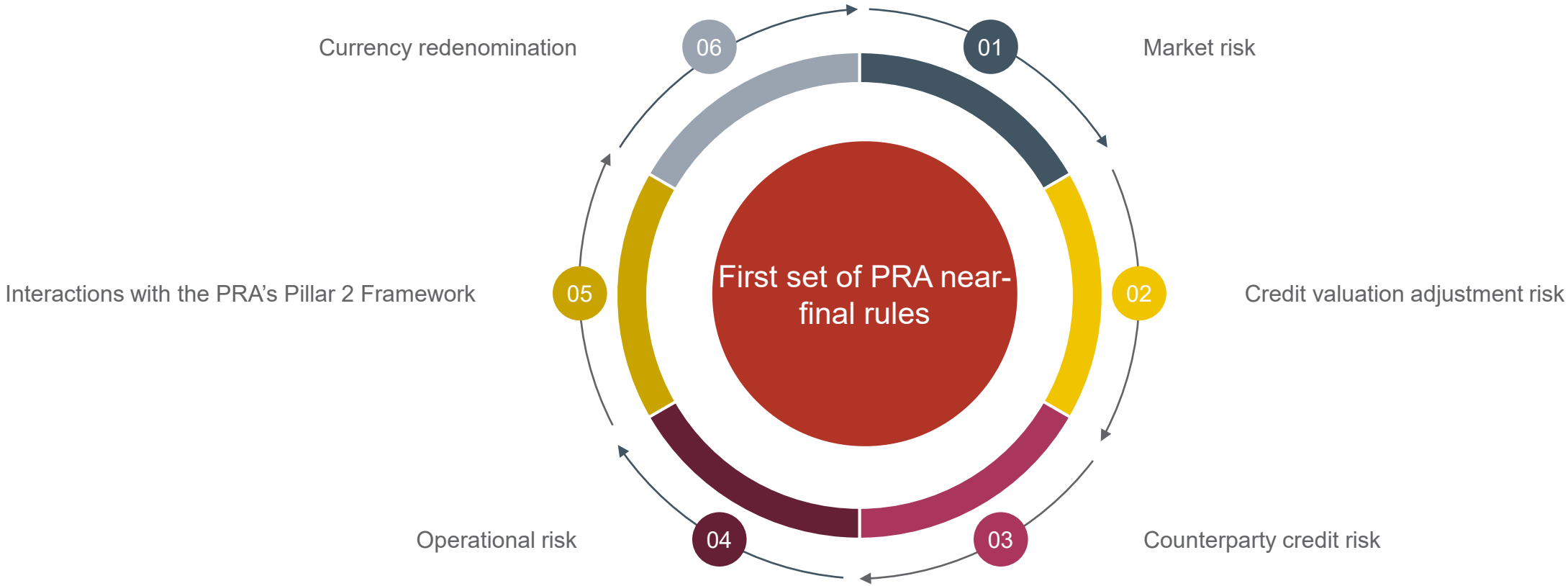
Financial Services and Markets Act 2023

- Grants HMT the power to designate certain third parties as CTPs
- Gives the regulators:
 - Rulemaking powers
 - Powers of direction
 - Information-gathering and investigatory powers
 - Disciplinary powers

BoE/PRA/FCA joint consultation

- How the regulators might identify potential CTPs to recommend for designation
- High-level fundamental rules and operational risk and resilience requirements
- Information-gathering and testing, self-assessment and information sharing expectations
- Notification requirements
- BoE and PRA intend to consult on a joint statement of policy in relation to the use of disciplinary powers in due course. FCA will also consult around the same time

Implementation of Basel 3.1



Prospectus regime, more prudential and clearing updates



Small Domestic Deposit Taker Regime

Modification by consent available from 1 January 2024
PRA forms and template directions published



FCA engagement feedback

The FCA is continuing to develop policy proposals to support the new public offers and admissions to trading regime. Aim is to consult in summer 2024 and make final rules in H1 2025



The Central Counterparties (Equivalence) (United States of America) (Commodity Futures Trading Commission) Regulations 2023

Equivalence determination in respect of the regulatory framework that applies to CFTC-authorized CCPs



News on insurers, access to cash, payments and the advice boundary review



Insurers

- PRA Solvency II regime review: consideration for year end 2023
- The Insurance and Reinsurance Undertakings (Prudential Requirements) (Risk Margin) Regulations 2023
- The Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations 2023



Payments and access to cash

- FCA consultation on rules to maintain reasonable access to cash
- PSR reporting guidance for APP scams
- PSR interim report for market review into cross-border interchange fees



Advice boundary review

- FCA / HMT joint discussion paper



Regulators' policy approaches

New secondary objective and changes in regulatory powers and remit

01

PRA consultation paper on its approach to policy:

- Primary objectives, secondary objectives and regulatory principles
- International engagement
- The policy cycle
- The Rulebook

02

HMT response to call for proposals on measuring success in relation to the secondary growth and competitiveness objectives:

- FCA and the PRA intend to publish a range of metrics

03

NAO report on how FCA is responding to changes in its regulatory powers and remit, and to wider developments in the financial services sector:

- Makes four recommendations for the FCA

04

House of Commons Treasury Committee published a report on the progress of the Edinburgh reforms:

- None will make a substantial difference to the UK economy
- When to consider a matter a 'reform' and 'delivered'
- Process often stalls after consultation

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Legislative approach

01

In February 2023, HM Treasury (**HMT**) published its consultation and call for evidence on the future financial services regulatory regime for cryptoassets

02

UK intends to add financial services regulation of cryptoasset activities to the Financial Services and Markets Act 2000 (**FSMA**), as updated by the Financial Services and Markets Act 2023 (**FSMA 2023**)

03

The consultation does not propose making cryptoassets “financial instruments”. Instead, HMT will specify new regulated activities in relation to cryptoassets and any person carrying out certain activities involving cryptoassets “by way of business” within the regime’s territorial scope would be performing regulated activities and will require authorisation, unless an exemption applies

04

HMT’s consultation response was published on 30 October 2023, confirming the Government’s plans to legislate to bring several cryptoasset activities into the scope of regulation for the first time

“HMT’s objective is to establish a proportionate, clear regulatory framework which enables firms to innovate at pace, while maintaining financial stability and clear regulatory standards”

Same risk,
same
regulatory
outcome

Proportionate
and
focused

Agile and
flexible

Definition of “cryptoasset”

1

Definition contained in **FSMA 2023**

2

Broad definition to capture all current types of cryptoasset

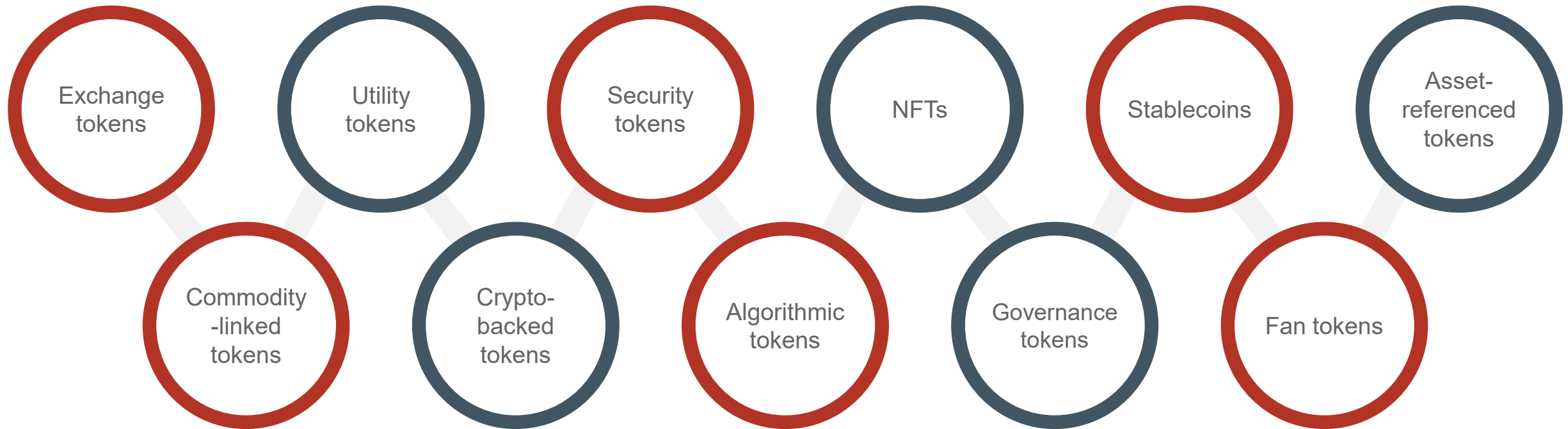
3

- Similar to definition of “**cryptoasset**” used in **regulation 14A(3)(a) of MLRs**, although new definition references wider range of underlying technology
- Similar to definition of “**cryptoasset**” in **EU MiCAR**
- Shares some features with “**virtual asset**” in the **FATF’s recommendations**

“cryptoasset” means “any cryptographically secured digital representation of value or contractual rights that— (a) can be transferred, stored or traded electronically, and (b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)”

Different types of “cryptoasset”

The different types of cryptoasset which **could** become subject to financial services regulation when they are being used for certain new regulated activities:



Phased approach to regulating cryptoassets

Phase 1

- Focus is on regulation of **activities relating to fiat-backed stablecoins used as a means of payment**
- Expect to see finalisation of rules for consultation in H2 2024

Phase 2

- A regulatory regime for a **broader set of cryptoassets** (such as Bitcoin and other stablecoins, such as algorithmic stablecoins)
- Introduced with a longer timetable

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Territorial scope of proposed new regime

Location of the provider	Location of the customer	
	UK	Overseas
UK	In Scope	In Scope
Overseas	In Scope	Out of Scope



Territorial scope (continued)

1 → HMT to capture cryptoasset activities **provided in or to the United Kingdom**

2 → HMT does not support expanding the overseas persons exclusion (**OPE**) commonly available for traditional financial services firms, allowing them to access the UK market on a cross-border basis, to cover cryptoassets

3 → HMT intends to pursue equivalence type arrangements whereby firms authorised in third countries can provide services in the UK without needing a UK presence, provided they are subject to equivalent standards and there are suitable cooperation mechanisms. However, the requirements for equivalence are not yet established and are unlikely to be useful to cryptoasset firms operating in the UK in the near term

4 → Approach required that will facilitate access to global liquidity pools under specific circumstances which would apply on a time-limited basis for the interim period before appropriate equivalence/deference type arrangements are in place

5 → Could permit UK firms who are operating a regulated cryptoasset trading venue in an overseas jurisdiction to apply for authorisation for a UK branch extension of their overseas entity:

- Branch could be authorised to specifically handle trade matching and execution activity
- Specifics of these requirements on physical location would be determined by the FCA

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Cryptoasset activities to be regulated under Phase 2

Activity category	Phase 2 sub-activities (indicative, non-exhaustive)
Issuance activities	<ul style="list-style-type: none">– Admitting a cryptoasset to a cryptoasset trading venue– Making a public offer of a cryptoasset
Exchange activities	<ul style="list-style-type: none">– Operating a cryptoasset trading venue which supports:<ul style="list-style-type: none">i. The exchange of cryptoassets for other cryptoassetsii. The exchange of cryptoassets for fiat currencyiii. The exchange of cryptoassets for other assets (e.g., Commodities)
Intermediation activities	<ul style="list-style-type: none">– Dealing in cryptoassets as principal or agent– Arranging (bringing about) deals in cryptoassets– Making arrangements with a view to transactions in cryptoassets
Lending, borrowing and leverage activities	Operating a cryptoasset lending platform
Safeguarding and/or administration (custody) activities	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 ¹ (custody)

¹ e.g. a wallet or cryptographic private key

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Cryptoasset issuance and disclosures

Proposed Design Features for Cryptoasset Issuance and Disclosures regime

Regulatory trigger points

- **Admitting** (or **seeking admission of**) a cryptoasset to a cryptoasset trading venue
- Making a **public offer** of a cryptoasset via a regulated platform

Responsibility for preparing content

- The **issuer** or the **trading venue**

Liability for content

- Liability would be applied to the preparer of the document *i.e.* the **issuer** or **trading venue**

Necessary information test

- **Necessary information test** would be used to determine liability outcomes - necessary information could include:
 - Features, prospects and risks of the cryptoassets
 - Rights and obligations attached to the cryptoassets
 - Outline of the underlying technology
 - Person seeking admission to trading on a cryptoasset trading venue

Storage and reuse

- Admission/disclosure documents to be stored on a National Storage Mechanism (**NSM**) maintained by the FCA - venues would be required to **search the NSM before new admissions**

Marketing, disclosures, and promotions

- Venues should have rules governing accuracy and fairness of marketing materials
- Marketing materials provided to retail investors will need to comply with the financial promotion regime

Issuance and disclosures – HMT's response

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

- The preparer may use publicly available information when preparing relevant sections of disclosure / admission documents
- Must disclose where information originated and the level of due diligence they have performed

Responsibilities for defining detailed content requirements

- HMT is potentially supportive of a centralised body (e.g. industry association) coordinating more prescriptive rules on content requirements — with FCA oversight

Liability for disclosures

- Exchanges which take responsibility for the disclosures of cryptoassets with **no clearly identifiable issuer** (e.g. Bitcoin) should not be fully liable for all types of consumer losses
 - But the exchange must take reasonable care to identify and describe the risks
 - Liability for forward-looking statements (e.g. relating to the project, and future use cases of the cryptoasset) – recklessness / dishonesty standard
 - Liability for historical, factual statements (e.g. audits which have been conducted and vulnerabilities they identified) – negligence standard

Wholesale vs retail

- Government notes the call for clearer differentiation between venues which cater to retail consumers vs those which only admit institutional investors
- Government agrees, in principle, with the idea that disclosure requirements would be less prescriptive for venues which only admit institutional investors

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Cryptoasset trading venue regime

Proposed Design Features for Cryptoasset Trading Venues

Regulatory trigger points

- **Operating a cryptoasset trading venue**

Authorisation rules

- **Authorisation** will be needed

Regulatory requirements

- **Prudential:** Requirements will be set by the FCA
- **Consumer protection:**
 - Fair, open and transparent access rules and fee schedules
 - Adequate procedures for handling customer complaints
- **Robust governance arrangements**
 - Government won't endorse or prohibit specific business models or execution protocols, but expects **firms to manage conflicts of interest and risks to market integrity appropriately** within their specific business models
- **Operational resilience:**
 - People, processes, systems, controls and arrangements to ensure resilient trading systems
 - Appropriate due diligence and oversight of outsourcing
 - Effective business continuity, disaster recovery arrangements and cyber security protections

Data reporting

- Venues to make **accurate and complete information readily accessible** for transactions
- Specific requirements to be set by the FCA

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Cryptoasset intermediation activities

Proposed Design Features for Cryptoasset Intermediation Activities

Regulatory trigger point

- **Dealing** in cryptoassets as **principal** or **agent**
- **Arranging (bringing about) deals** in cryptoassets
- **Making arrangements with a view to** transactions in cryptoassets

Authorisation rules

- **Authorisation** will be needed

Regulatory requirements

- **Consumer protection and governance arrangements:**
 - Act honestly and fairly and in the best interests of clients
 - All reasonable steps should be made to **obtain the best possible result** when executing orders
 - Firms should assess cryptoassets as **appropriate for the consumer** before an order
 - Trading arrangements should be transparent to clients
 - Conflicts of interest should be appropriately identified and managed
- **Prudential** requirements
- **Operational** resilience

Data reporting

- Systems and controls to **detect market abuse** and submit **Suspicious Transaction and Order Reports (STORs)**

Intermediation activities – HMT's response

Wholesale vs retail customers

- Government agrees, in principle, with idea that certain requirements (e.g. disclosures, appropriateness checks) would **differ for intermediaries when dealing with eligible counterparties**
- Government agrees, in principle, with the idea that disclosure requirements would **be less prescriptive for venues which only admit institutional investors**

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Regulatory outcomes for cryptoasset custody

The current regulated activity for custody services is set out at Article 40 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**). However, due to the specific nature of cryptoasset custody services, there are aspects of Article 40 that do not apply to or cover cryptoasset custody services in a suitable or practical way.

01 Article 40 (summary)

- The activity consists of (i) safeguarding assets belonging to someone else and the administration of those assets, or (ii) arranging for one or more persons to carry on the activity in (i)
- The activity is capable of being a regulated activity only if the assets may consist of or include any investment which is a security or contractually based investment

02 Examples of issues for crypto

- The term custody does not have a settled meaning when used by the industry
- The custodian may hold a private key (rather than the asset)
- Unauthorised access has severe implications as transactions may be immutable
- The number of parties that may be involved means the concept of factual control of digital objects is complex and technology specific

Key findings of the HMT consultation in relation to custody

HMT's response concluded that the Government should proceed with a custody regime that was based on RAO Article 40, taking into account the specificities and challenges of cryptoassets.

New regime

The Government will legislate to define a new regulated activity for custody covering:

- Safeguarding
- Safeguarding and administration
- Arranging of safeguarding or safeguarding and administration

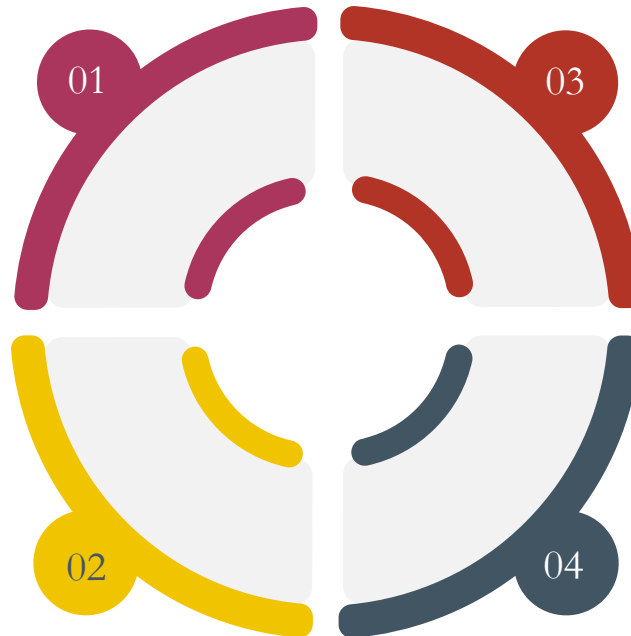
of cryptoassets, and will take a proportionate approach to liability

Detailed rules to follow

Areas including:

- Ownership
- Record-keeping
- Controls
- Governance
- FSCS treatment

will be covered in secondary legislation and regulator rules



Security tokens

- Security tokens may have already been in scope of the regulatory perimeter where they already met the definition of financial instrument
- HMT's response confirms that security token custody will nevertheless be in scope of the new regime

Perimeter of arranging activities

- The consultation considered technology providers for self-hosted wallet services
- Perimeter-wise, these types of services are not intended to be caught by the adapted Article 40 activity (but, for example, secure asset storage services may be in scope)
- **However** operational and outsourcing requirements may still apply to such providers and services which fall outside the perimeter

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Regulatory outcomes for market abuse

HMT consulted on a market abuse regime for crypto which would be based on the existing UK MAR regime.

1

Application

- All cryptoassets admitted or requested to be admitted to trading on a UK cryptoasset trading venue (so does not, for example, include private coin offerings)
- All persons committing market abuse
- Not limited to UK residents or UK venues

2

Offences

- Insider dealing
- Unlawful disclosure of inside information
- Market manipulation

Plus

- *Definition of inside information and insider*

3

Responsibility on market participants and trading venues

- Market participants should have a shared understanding of market abuse and their own obligations
- Primary responsibility placed on trading venues. Trading venues in particular expected to detect, deter, and disrupt market abusive behaviours
- Trading venues should have systems and processes to detect market abuse (and submit STORs)

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Argument for a cryptoasset lending and borrowing regime

Current state of play

Crypto lending platform activities (*i.e.* lending and borrowing) typically – although not always – fall outside the regulatory perimeter

HMT proposal: strong case to develop a regime

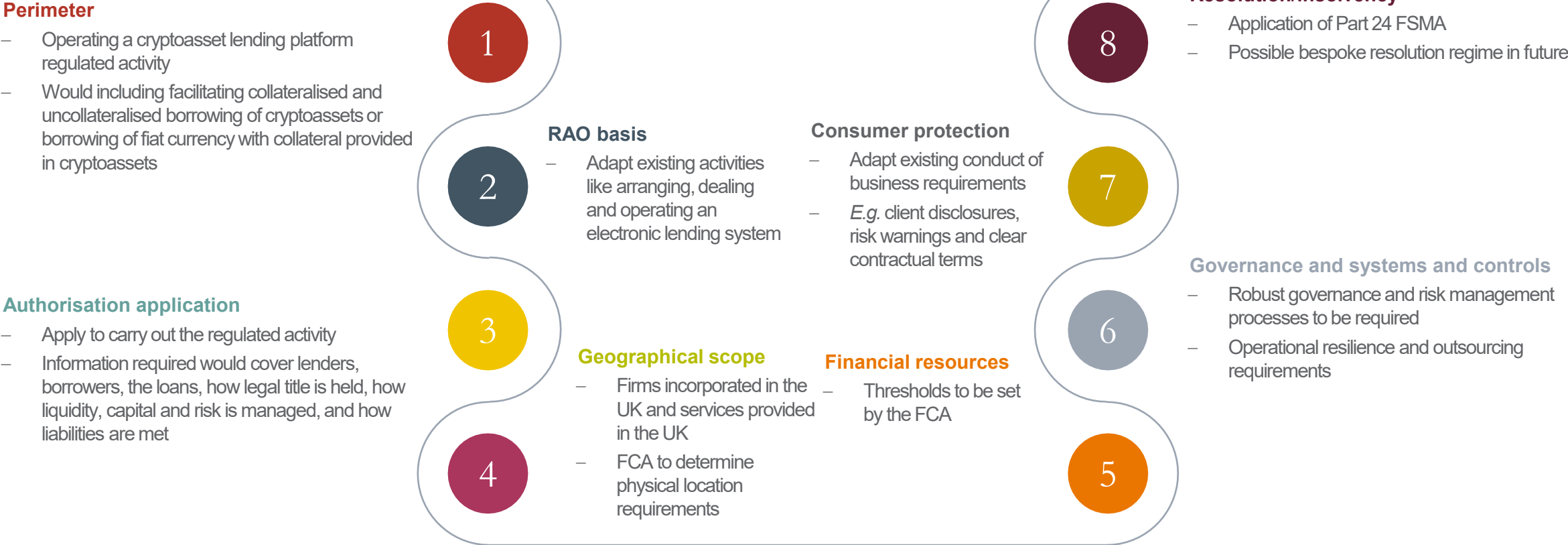
- Safeguards in place for traditional lending and borrowing do not currently apply
- Clients receiving the service may not be aware of the risks in the absence of traditional safeguards
- Credit risk has been a driver of crypto market turbulence
- Sufficient resources needed to manage counterparty credit risk and collateral management
- Clear contractual terms needed around ownership and insolvency ringfencing arrangements

HMT proposal: a priority Phase 2 activity

- HMT confirmed in its response that its proposals were aimed at retail lending
- Approach would not include all the same traditional safeguards (*e.g.* FSCS protection)
- HMT received feedback that there should be clear differentiation between cryptoasset lending and cryptoasset staking

Proposed cryptoasset lending platform regime

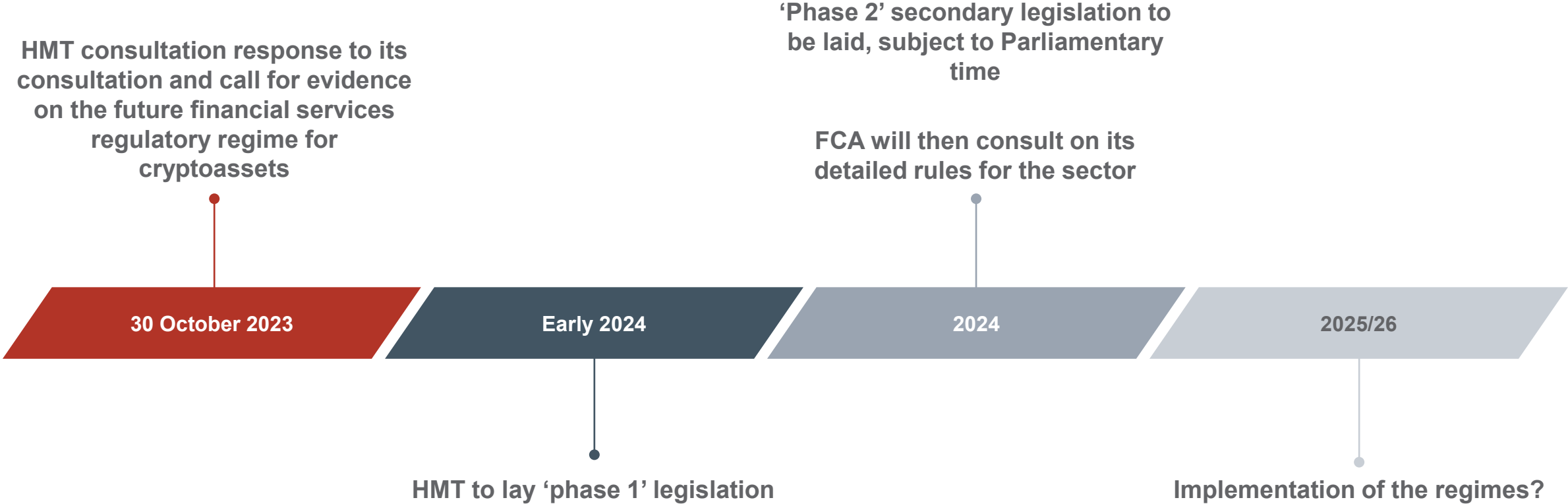
Key elements of HMT’s proposal for a regime that regulates the lending and borrowing of cryptoassets:



Next steps



Estimated timeline for regulators' next steps



Questions?

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