

ALLEN & OVERY

Crypto Regulation in the UK - the Grand Unveiling

Ben Regnard-Weinrabe, Damian
Carolan, Anna Lewis-Martinez,
Nadia Pascal, Rory Copeland

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Introducing



Ben Regnard-Weinrabe

Partner – London

Ben is a partner in the Financial Services Regulatory practice at Allen & Overy. He has a particular focus on fintech and crypto, payments, retail banking and consumer finance and has advised banks, card schemes, crypto-exchanges, fintechs, bigtechs and government entities. He has extensive experience advising on financial services and AML laws and regulation, products, commercial contracts and transactions. He also advises on non-sector specific legislation such as unfair terms, e-commerce and data protection. Ben recently sponsored the participation of Elliptic (the crypto screening solution provider) in FUSE, the A&O incubator hub / accelerator and has authored numerous publications in relation to crypto and AML.



Damian Carolan

Partner – London

Damian is head of A&O's UK Financial Services regulatory practice. He advises financial institutions on national and international regulations, with a particular focus on derivatives and securities regulation and the development of new markets and clearing settlement systems. He regularly advises banks on regulatory reform, including changes to custody requirements, payment systems and the authorisation processes to open new branches and subsidiaries. Damian has assisted industry associations with developing standard form documentation and submitting responses to consultations with regulators. He is also a leading legal and regulatory expert in financial market infrastructure and has been involved in a variety of innovative bank and infrastructure projects as digital assets and distributed ledger technology become an ever more important part of the financial landscape.



Anna Lewis-Martinez

Senior PSL – London

Anna is a Senior knowledge lawyer, supporting the Financial Services Regulatory team in the firm's London office. Anna focuses on core financial services regulation with a particular interest in payment services and fintech initiatives, and assists both clients and internal teams in keeping up-to-date with regulatory developments. Her responsibilities include producing current awareness briefings and thought leadership pieces, and managing the know-how resources. Anna also supports the firm's training function and is involved in internal and external training programmes.



Nadia Pascal

Senior Associate – London

Nadia is a senior associate in the Financial Services Regulatory practice at Allen & Overy. Nadia has extensive experience advising some of the world's leading banks, broker-dealers, trading venues and other financial market infrastructure providers on EU and UK law, including in relation to MiFID II and Brexit. Nadia is a contributor to a chapter in the Oxford University Press publication on Financial Markets and Exchanges Law, covering multilateral trading facilities (MTFs) and organised trading facilities (OTFs).



Rory Copeland

Associate – London

Rory is an associate in the Financial Services Regulatory practice. He advises financial institutions, crypto-exchanges, fintechs, bigtechs, and governments on new cryptoassets and services, the application of crypto, financial services and AML regulations, the structuring of DLT financial markets infrastructures, tokenisation, and the drafting of legislation for virtual assets and the issuance of central bank digital currencies. Rory represents the firm on the R3 Central Bank Digital Currencies working group, peer-reviews for the Journal of Digital Banking and also is on the board of the UK Financial Inclusion Forum.

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Legislative approach



Legislative approach – Future financial services regulatory regime for cryptoassets

- HM Treasury (**HMT**) February 2023 consultation paper and call for evidence on a future financial services regulatory regime for cryptoassets
- 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 Bill 2022-23 (**FSM Bill**)
- Under FSMA, HMT has power to bring activities within regulatory perimeter by specifying them in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**)

“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



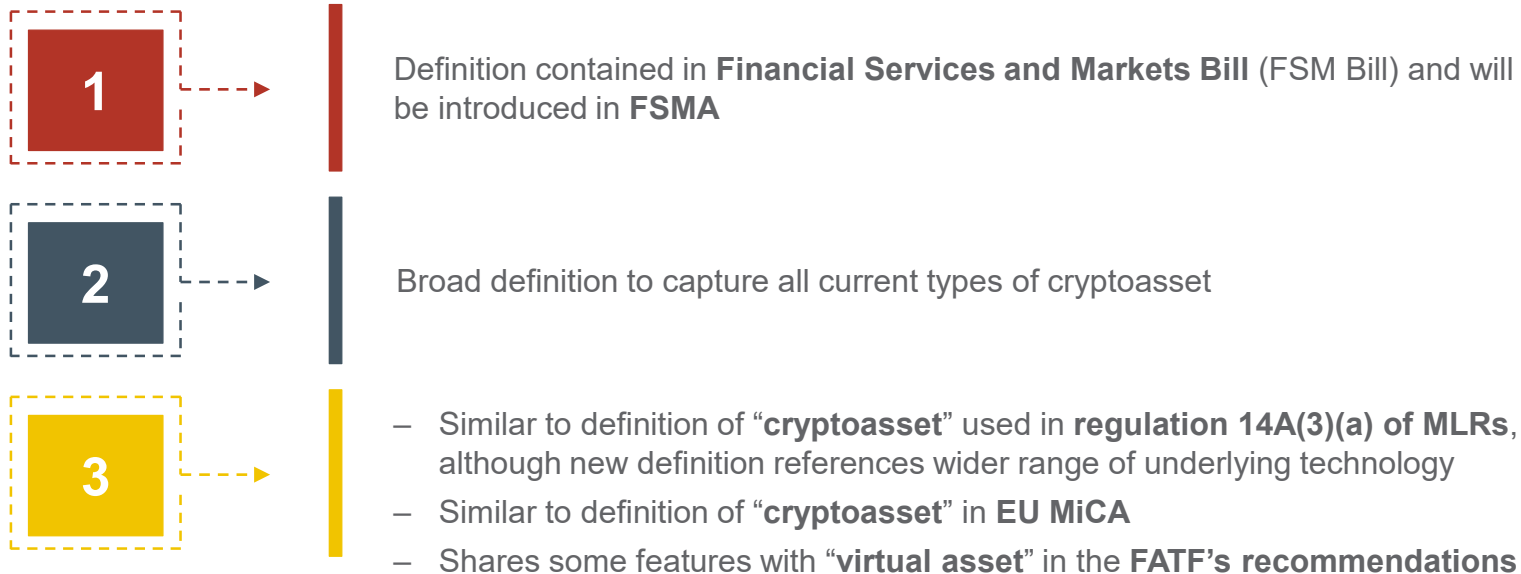
Related developments

- UK Money Laundering Regulations (**MLRs**) already apply to unregulated cryptoasset exchange and custody activities
- HMT expects firms undertaking regulated cryptoasset activities to adhere to same financial crime standards and rules under FSMA that apply to similar traditional financial services activities
- Extension of UK financial promotion regime to include promotion of certain types of unregulated cryptoassets
 - Plus, new financial promotion rules for high-risk investments, including cryptoassets being brought within scope of the regime
- Extension of Financial Market Infrastructure Special Administration Regime to systemic digital settlement asset firms
- EU Markets in Cryptoassets (**MiCA**) Regulation will introduce licensing etc. regime for EEA



Definition of “cryptoasset”

“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)”

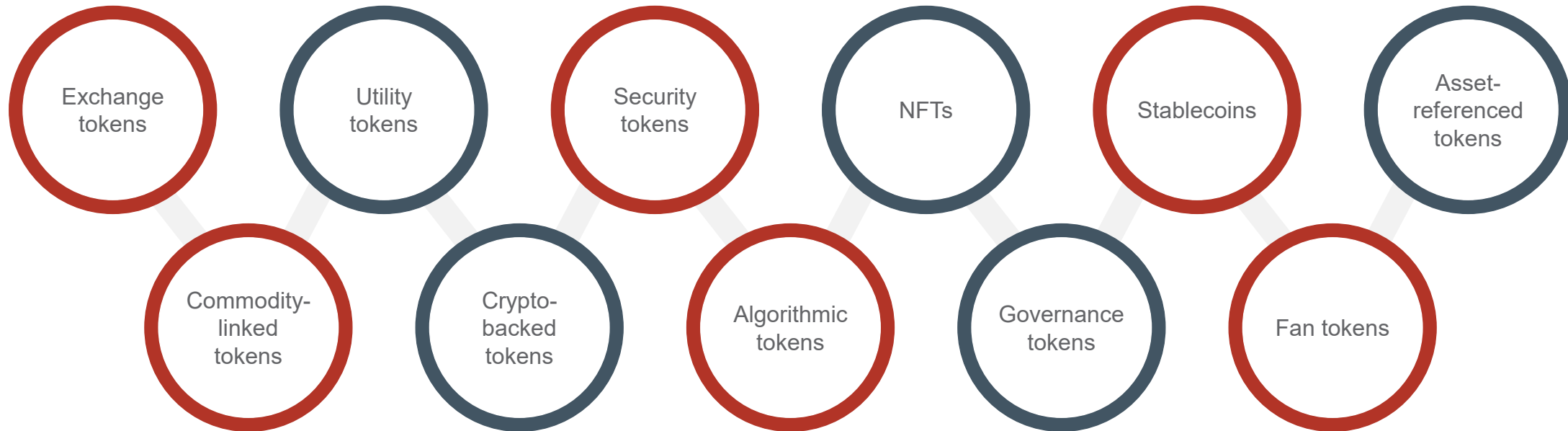


“digital settlement asset” means “a digital representation of value or rights, whether or not cryptographically secured, that (a) can be used for the settlement of payment obligations, (b) can be transferred, stored or traded electronically, and (c) uses technology supporting the recording or storage of data (which may include distributed ledger technology)”



Different types of “cryptoasset”

Box 2.A sets out glossary of the different types of cryptoasset which could become subject to financial services regulation when they are being used for certain financial services activities:



Phased approach

HMT intends to continue to pursue a phased approach to regulating cryptoassets, which is prioritised according to the areas of greatest risk and opportunity:

Phase 1

- Regulation of fiat-backed stablecoins which are used for payments
- Regime will address:
 - issuance activities relating to fiat-backed stablecoins
 - payment-related activities for fiat-backed stablecoins
 - custody activities relating to fiat-backed stablecoins

Phase 2

- For a broader range of cryptoassets, regulation of:
 - issuance activities
 - exchange activities
 - investment and risk management activities
 - lending, borrowing and leverage activities
 - safeguarding and/or custody activities
- Not all cryptoasset activities to form part of Phase 2

Future Phases

- Future phases include:
 - cryptoasset investment advice and portfolio management
 - post-trade activities in cryptoasset transactions (where not already covered in Phase 2)
 - crypto mining and transaction validation
 - operating a node
- DeFi
- Sustainability

Territorial scope



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



Territoriality (continued)

- HMT to capture cryptoasset activities **provided in or to the United Kingdom**
- HMT to consider **possible exceptions** to this:
 - E.g. to accommodate narrowly construed “**reverse solicitation**” of cryptoasset activities that are provided from overseas companies
 - Application of other current RAO exemptions unclear, e.g. OPE
- Whether firms carrying out cryptoasset activities would be required to have a physical presence in the UK in order to obtain authorisation is under consideration
 - For the FCA to determine at the point at which firms apply for authorisation
 - UK presence is more likely to be required for e.g. exchange activities
- 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



Phase 1



The legislative story so far

- On April 4 2022, HMT announced that:
 - Stablecoins to be regulated under an amended e-money framework
 - Extension of Part 5 of the Banking Act 2009 to include systemic stablecoin activities - the Bank of England will be the lead prudential authority
 - Scope of Financial Services (Banking Reform) Act 2013 (**FSBRA**) to be extended to ensure relevant stablecoin-based payment systems are subject to appropriate competition regulation by the Payment Systems Regulator (**PSR**)
- In July 2022, the FSM Bill introduced legislation that will allow stablecoins used as a means of payment to be brought within the regulatory perimeter
- February 2023 consultation adds that scope of regulatory perimeter as regards stablecoins and related activities will be defined in a statutory instrument by HMT



What's coming within scope?

Digital Settlement Assets (DSAs)

“Digital settlement asset” is defined as “a digital representation of value or rights, **whether or not cryptographically secured**, that (a) can be used for the **settlement of payment obligations**, (b) can be transferred, stored or traded electronically, and (c) uses **technology supporting the recording or storage of data** (which may include distributed ledger technology)”

- Potentially broad range of assets “can be used for the settlement of payment obligations”
- Systemic DSA systems and service providers will come within scope of Banking Act and FSBRA powers of supervision over designated / recognised payment systems and service providers

Stablecoin issuance, custody and use as a means of payment

Stablecoins to be defined as “*payment cryptoassets*”, which will “*bring into scope any cryptographically secured digital **representation of monetary value** that is, among other things, **stabilised by reference to one or more fiat currencies** and/or is **issued and used as a means of making payment transactions***”

- Won't include asset-backed tokens, even though these:
 - (i) may function as stablecoins
 - (ii) are within scope of DSAsThese will be covered in Phase 2
- But will include stablecoins backed by a basket of fiat currencies
- Electronic Money Regulations (**EMRs**) and Payment Services Regulations 2017 (**PSRs**) will be amended as necessary

Standalone custody of stablecoins

- Licensing requirement for firms which provide or arrange / make arrangements with a view to custody of stablecoins (and other cryptoassets) and means of access e.g. private keys
- Regulated activity will cover the activities of someone other than the issuer, where that person is holding the stablecoin used as a means of payment (or means of access to the stablecoin) on behalf of a customer
- Will capture wallet providers or any firms offering similar services e.g. exchanges

What does the consultation tell us?

Phases 1 and 2 will be designed “*in a consistent and compatible way in order to streamline common processes wherever possible*”
But will Phase 1 set the direction of travel for Phase 2?

‘Vertically integrated’ business models

Regulators may limit or closely scrutinise the combinations of activities which stablecoin issuers can perform, in order to prevent e.g.:

- Conflicts of interest arising from firms having several roles in the value chain
- Concentration risks where risk-taking in one business line (e.g. lending) could impact the soundness of other business lines e.g. custody

Rules for stablecoin issuance

- No reference to issuance of stablecoins (or how the EMRs will be amended) in the consultation
- One route is for Phase 1 stablecoins to be defined narrowly and be required to adhere to the EMRs as currently drafted – will be a challenge for multi-currency stablecoins
- May also need to introduce rules on promotions of stablecoins to prevent mis-selling:
 - Consultation considers FinProm rules to prevent algorithmic stablecoins being marketed as “stable” and “payment instruments” where this would be misleading
- May need to be adopted more broadly

Custody rules

No rules aimed at stablecoin issuers and other stablecoin custodians / custody arrangers:

- Consultation says Phase 1 and 2 custody rules will be consistent
- But only covers custody for cryptoassets other than stablecoins

Rules for custody of other cryptoassets include:

- Rules based on CASS – e.g. on commingling, books and records, controls and governance
- Clear firm disclosures and contractual protections
- Potential FSCS protection – may e.g. apply to stablecoin custody but not to all other cryptoassets
- Prudential requirements e.g. regulatory capital
- Potential onshoring requirement

Further developments expected, including on private law reforms (if required) and custodian liability standards for e.g. hacks

Phase 2



Cryptoasset issuance and disclosures

Proposal to establish a cryptoasset issuance and disclosures regime based on the intended reform of the UK prospectus regime

Proposed Design Features for Cryptoasset Issuance and Disclosures regime

Regulatory trigger points	<ul style="list-style-type: none">– 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	<ul style="list-style-type: none">– The issuer or the trading venue
Liability for content	<ul style="list-style-type: none">– Liability would be applied to the preparer of the document i.e. the issuer or trading venue
Necessary information test	<ul style="list-style-type: none">– Necessary information test would be used to determine liability outcomes - necessary information could include:<ul style="list-style-type: none">– 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	<ul style="list-style-type: none">– Admission/disclosure documents to be stored on the NSM - venues would be required to search the NSM before new admissions– Venues would be able to accept other regulated trading venues' disclosure / admission documents if they chose
Marketing, disclosures, and promotions	<ul style="list-style-type: none">– 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



Cryptoasset trading venue regime (1)

Proposal to establish a regulatory framework which is based on existing RAO activities of regulated trading venues – including the operation of an MTF

Proposed Design Features for Cryptoasset Trading Venues	
Regulatory trigger points	<ul style="list-style-type: none">– Operating a cryptoasset trading venue
Authorisation rules	<ul style="list-style-type: none">– Authorisation will be required– Applications to include:<ul style="list-style-type: none">– Details of operations, services and business plans– Description of organisational and governance arrangements,– Description of controls and risk management processes, cybersecurity, outsourcing arrangements and financial resources
Jurisdictional perimeter	<ul style="list-style-type: none">– Firms incorporated in the UK– Services provided to UK persons (natural or legal)– Requirements on physical location to be determined by the FCA<ul style="list-style-type: none">– But firms operating cryptoasset trading venues would likely require subsidiarisation in the UK



Cryptoasset trading venue regime (2)

Proposed Design Features for Cryptoasset Trading Venues

Regulatory requirements

- **Prudential:** Thresholds to be set by the FCA
- **Consumer protection:**
 - Fair, open and transparent access rules and fee schedules
 - Adequate procedures for handling customer complaints
 - Conflicts of interest should be appropriately identified and managed
- **Robust governance arrangements**
- **Operational resilience:**
 - People, processes, systems, controls and arrangements to ensure resilient trading systems
 - Appropriate due diligence and oversight of outsourcing arrangements
 - Effective business continuity, disaster recovery arrangements and cyber security protections

Data reporting

- Cryptoasset trading venues to make **accurate and complete information readily accessible** for transactions
- Specific requirements to be set by the FCA - likely to require order book data, transaction information and information on management of large positions

Resolution and Insolvency

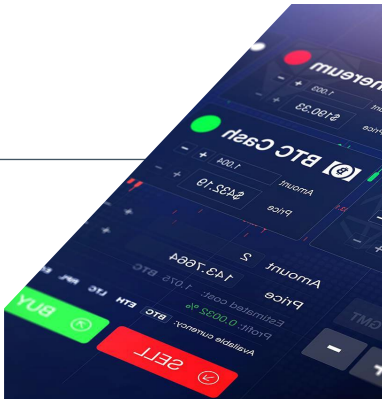
- Insolvency powers under Part 24 of FSMA to apply
- UK Government will consider whether a bespoke resolution regime should be developed in time



Cryptoasset intermediation activities (1)

Proposal to introduce cryptoasset intermediation regulated activities based on the existing regulated activities conducted by investment firms

Proposed Design Features for Cryptoasset Intermediation Activities	
Regulatory trigger point	<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
Authorisation rules	<ul style="list-style-type: none">– Authorisation will be required– Applications should include:<ul style="list-style-type: none">– Details of operations, services and business plans,– Description of organisational and governance arrangements,– Description of controls and risk management processes, cybersecurity, outsourcing arrangements, and financial resources
Jurisdictional perimeter	<ul style="list-style-type: none">– Firms incorporated in the UK– Services are being provided to UK persons (natural or legal)– Requirements on physical location to be determined by the FCA - FCA's existing framework for international firms



Cryptoasset intermediation activities (2)

Proposed Design Features for Cryptoasset Intermediation Activities

Regulatory requirements

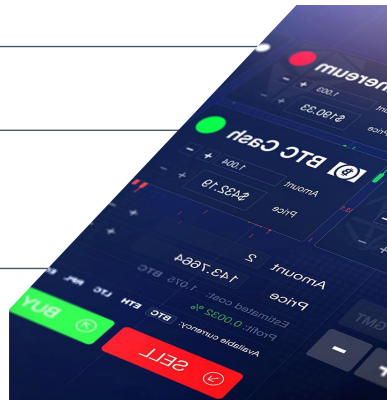
- **Consumer protection and governance arrangements:**
 - Act honestly and fairly and in the best interests of clients
 - All reasonable steps should be made to **obtain the best possible result** when executing an order
 - Firms should assess cryptoassets as appropriate for the consumer before an order to purchase
 - Conflicts of interest should be appropriately identified and managed
 - Trading arrangements should be transparent to clients
- **Prudential** requirements:
 - Sufficient financial resources to conduct business in a prudent manner
 - Thresholds to be set by the FCA
- **Operational** resilience:
 - Adequate people, processes, systems, and controls to mitigate operational resilience risks
 - Appropriate due diligence, ongoing oversight, and formal documentation of outsourcing arrangements

Data reporting

- Systems and controls in place to be able to **detect market abuse and submit STORs** to trading venues

Resolution and Insolvency

- Insolvency powers under Part 24 of FSMA should apply
- Government will consider if a bespoke resolution regime should be developed in time



Cryptoasset lending and borrowing regime (1)

UK Government considers developing a cryptoasset lending and borrowing regime as a priority Phase 2 activity

Proposed Design Features for Cryptoasset Lending and Borrowing

Regulatory trigger point

- **Operating a cryptoasset lending platform**
 - Including facilitating collateralised and uncollateralised borrowing of cryptoassets or borrowing of fiat currency with collateral provided in cryptoassets

Authorisation rules

- **Authorisation** will be required
- Applications should:
 - Include details of operations, services, business plans, organisational and governance arrangements
 - Set out persons who are lending assets and borrowing assets
 - Set out any loans received or provided and legal title of assets
 - Set out collateral, liquidity, capital and risk management practices and how liabilities are met in crypto and fiat at any point in time

Jurisdictional perimeter

- Firms incorporated **in the UK**
- Services provided **to UK persons** (natural or legal)
- Requirements on physical location to be determined by the FCA - FCA's existing framework for international firms



Cryptoasset lending and borrowing regime (2)

Proposed Design Features for Cryptoasset Lending and Borrowing

Regulatory requirements

- **Prudential** requirements:
 - Sufficient financial resources to meet their liabilities as they fall due
 - Thresholds to be set by the FCA addressing the potential for harm from ongoing operations and the ability to wind-down in an orderly manner
 - Monitor and manage liquidity and funding risks across different time horizons and stress scenarios
- **Consumer protection and governance requirements:**
 - Robust governance arrangements and risk management processes in place
 - Conduct of business requirements should apply
 - Clear terms and disclosures should exist regarding collateral requirements and margin calls
- **Operational resilience:**
 - Systems and controls requirements should apply
 - Adequate people, processes, systems and controls to mitigate operational resilience risks
 - Appropriate due diligence, ongoing oversight, and formal documentation of outsourcing arrangements

Resolution and Insolvency

- Insolvency powers under Part 24 of FSMA should apply
- Government will consider whether a bespoke resolution regime should be developed in time



Cryptoasset custody regime

- Custody requirements will be addressed through **Phase 1 for fiat-backed stablecoins** and under **Phase 2 for other types of cryptoassets**.
- The expectation is that **the same custody requirements will be adopted for all types of cryptoassets**.
- For cryptoassets that already meet the definition of a specified investment, the existing regulatory framework **to be amended**.
- Availability of **FSCS protection** for claims against failed authorised cryptoasset custodians **under consideration** and to be determined by FCA.



Market abuse requirements



Market abuse requirements (1)

- Cryptoassets will not fall within the scope of the existing UK market abuse regime (**MAR**)
 - But the types of market abuse activities and behaviours within cryptoasset markets are similar
- Proposed regime would only apply to cryptoassets that are traded on a UK cryptoasset trading venue vs UK MAR which applies to financial instruments traded on EU as well as UK trading venues
- **Primary responsibility would be on the trading venues** for preventing, detecting and disrupting market abuse
- Trading venues would be expected to:
 - establish “who” the offenders are
 - establish information sharing arrangements with other venues that admit the same cryptoassets
 - have an effective regime for disrupting market abuse
- Civil offences of market abuse would be similar as for traditional markets i.e. **insider dealing, market manipulation and unlawful disclosure of inside information**
 - Scope of the proposed offences remains unclear – i.e. what would constitute inside information?

Market abuse requirements (2)

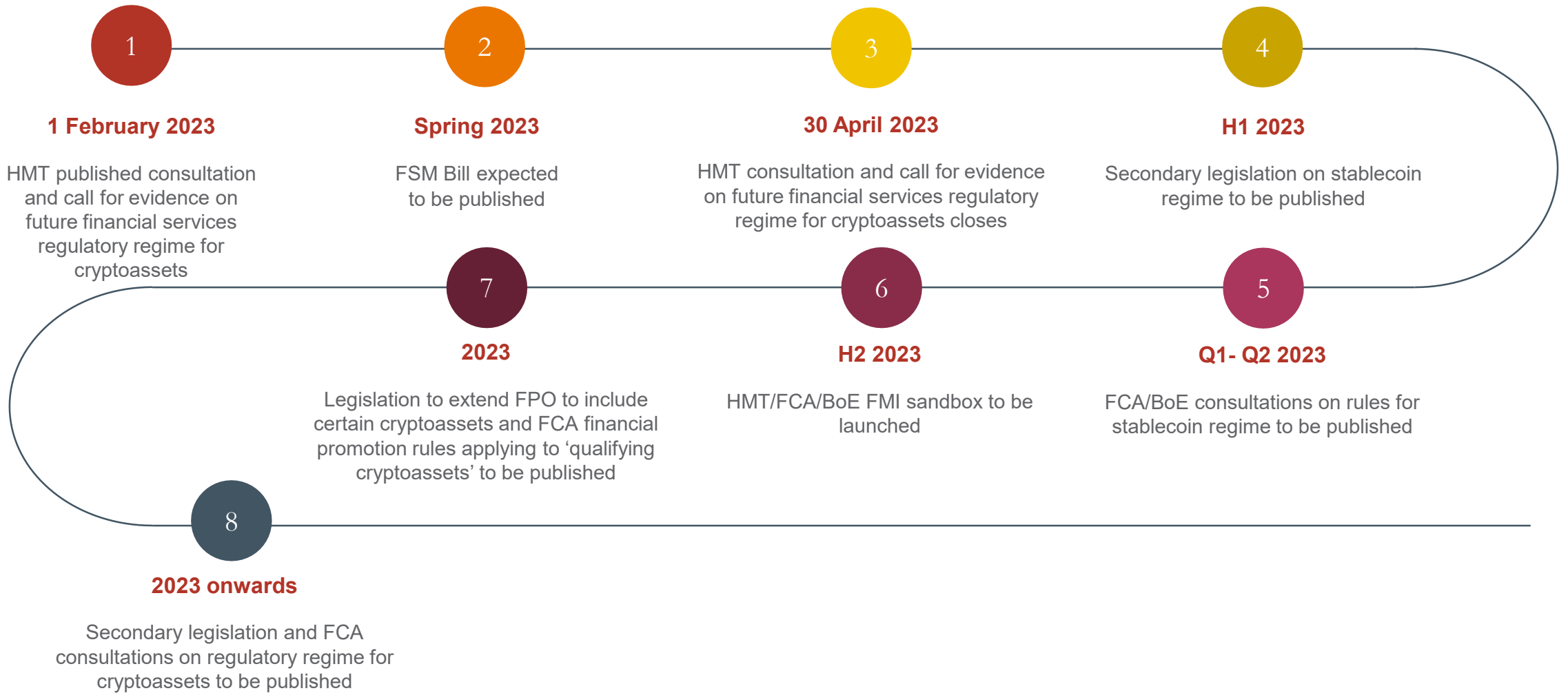
Proposed Design Features for Cryptoasset Market Abuse Regime

Regulatory trigger point	<ul style="list-style-type: none">– Requesting admission of a cryptoasset to a UK cryptoasset trading venue– Applies regardless of the location of the market abuse activity
Scope of offences	<ul style="list-style-type: none">– Similar civil offences as for traditional markets - insider dealing, market manipulation and unlawful disclosure of inside information– All persons would be subject to these prohibitions regardless of where they are based
Enforcement mechanism	<ul style="list-style-type: none">– The primary means of taking action would be trading venues disrupting occurrences of this activity– Onus on trading venues
Obligations for trading venues	<ul style="list-style-type: none">– Establish systems and controls to prevent, detect and disrupt market abuse– Responsible for determining appropriate systems, controls and methods of disruption subject to FCA supervision<ul style="list-style-type: none">– This could include KYC requirements, public blacklists, order book surveillance, STORs, information sharing between venues, use of blockchain analytics and providing the means for ongoing disclosures of information to the market– Required to investigate suspected abuse on their markets and to sanction individuals
Obligations for other market participants	<ul style="list-style-type: none">– Persons arranging or executing transactions should establish systems and controls to prevent and detect market abuse– All regulated firms would be required to disclose inside information and maintain insider lists

What happens next?



Timeline



Register today for our upcoming webinar – Crypto’s Regulated Future in the EU & UK – What happens now?

Wed 22 March, 9:00 am to 10:00 am (UK time)

Mia Dassas - ICM, Allen & Overy, Paris, Partner, **Baptiste Aubry** - ICM, Allen & Overy, Luxembourg, Counsel, **Nikki Johnstone** - Financial Services Regulatory, Allen & Overy, London, Partner

Synopsis: Both the EU and the UK have announced the introduction of new legal frameworks for the provision of cryptoasset activities. The EU’s Markets in Crypto-assets Regulation (MiCA) in particular will come into force soon (from April 2023). The UK’s proposed measures are aimed at mitigating specific risks posed by crypto firms, which shall be under consultation until 30th April 2023. In this session, lawyers from our European and UK regulatory teams discuss the various ways that crypto firms can prepare for this new regulated environment, including:

1. understanding how your products, services or token offering(s) might be in-scope of these new regimes;
2. devising a licensing strategy for your key markets; and
3. anticipating future guidance from competent authorities.



Questions?

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