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Beyond the Hype: The Future of Digital Assets – UK developments in institutional and wholesale digital assets

Louise Bralsford, Nick Bradbury, Damian Carolan and Tom Roberts

Louise Bralsford

Welcome to this latest episode in the Allen and Overy podcast series, 'Beyond the Hype, the Future of Digital Assets'. I'm Louise Bralsford, a professional support lawyer at Allen & Overy in London, and I'm going to be speaking with Nick Bradbury and Damian Carolan, both partners in the Financial Regulatory practice here, and Tom Roberts, who is a partner in the International Capital Markets team.

In this episode, we'll be looking at the latest UK developments for institutional and wholesale digital assets. Nick, I'm going to start with you if I may. What are the key trends you're currently seeing in this space?

Nick Bradbury

At a very high level, we're seeing jurisdictions developing their own regimes, and this means firms are comparing and assessing these regimes, and trying to work out where's best for their business. Crypto firms tend to be quite portable, so it's often easier, in relative terms, for such firms to move their business to find a favourable regulatory environment.

Then, conversely, we're also seeing increasing calls for international law harmonisation – because divergent regimes which don't cater for cross-border business might undermine many of the benefits of using DLT in the first place. For example, the UNIDROIT Digital Assets Working Group published its Principles on Digital Assets and Private Law last month. This is an ambitious piece of work that covers a wide range of topics, including how to resolve conflicts of law questions.

Louise Bralsford

OK, thanks Nick. And what are you seeing on the UK wholesale side?

Nick Bradbury

Broadly, our sense of the market is that traditional financial institutions are still trying to work out whether, and to what extent, they want to get into the digital asset space.

There has, of course, been some reputational damage during the so-called crypto winter, and we are also seeing emerging regulatory brakes on the speed of expansion, such as the latest work being carried out in Basel on capital requirements – which could increase the balance sheet cost for some players entering this market.

In terms of the UK legal framework, the Treasury consulted on proposals earlier this year on the future regime for cryptoassets. On the wholesale and institutional side, I'd say that a really significant proposal is that the territorial scope of the new regime will potentially cover firms with UK clients who might usually expect to fall out of scope, for example, certain overseas firms. This is quite a departure from the UK's usual position. Generally in the past, the UK has been quite liberal when it comes to wholesale markets, so this approach to territorial scope is novel, and it'll be interesting to see where it lands.

Louise Bralsford

I see. And in practice, what are you seeing as the fundamental issues with the UK legal framework as is?

Nick Bradbury

Well, that's a big question, but it's worth flagging a couple of highlights from recent UK publications.

The UK Law Commission has been working on how digital assets fit with English property law, and is proposing a new category of personal property called "data objects". This would be a pretty radical change and would be a fundamental building block for law and regulation in this space.

Also, as I just mentioned, we've got the Treasury proposals on the future regime for crypto, and a good example of the type of challenge covered by the proposals is how we treat custody services in this context. With digital assets, the activities a custodian does, can – in some cases – be quite different from what we would think of as traditional custodian activities. For example, digital asset custodians could be more like digital wallet providers, storing public and private keys that authorise transactions on the DLT. I'm expecting a range of guidance will be needed on the scope of what constitutes regulated custody services for cryptoassets.

Louise Bralsford Thanks very much, Nick. And so Damian, we've heard from Nick that there's work in progress around the development of the UK regime. What would you add?

Damian Carolan Thank you, Louise. Yes, it's a fair statement to say that the English law hasn't necessarily been the first past the post, in terms of developing a clear set of regulatory rules for digital assets – and here I'm focusing particularly on digital securities, of course.

Generally as English lawyers, we love our common law system of course – it's great, it's very flexible – but one benefit of civil law systems, by contrast, is that when you want to develop new concepts, it's much easier and much quicker.

But we do know that English law can accommodate digital assets. A lot of work has been done in this area, including by the Law Commission, as Nick mentioned, and the UKJT. It's just that there are certain aspects of the legal and regulatory framework that weren't really created, designed or implemented with this type of technology in mind.

Louise Bralsford I see. So what's a good example of a particular bit of the framework that needs to be looked at then?

Damian Carolan Well, one big impediment to the growth of the market in digital security, certainly, is the fact that existing market infrastructure for securities relies on central securities depositories or CSDs, as indeed do the regulatory regimes looking to embed related market protections.

And of course, one key benefit of DLT is that it doesn't need old-fashioned centralised infrastructure, and this is in contrast to the traditional CSD model for the holding of securities. Now, having CSDs at the heart of legally robust settlement systems is just part of the furniture for the UK, and the legislative framework currently reflects this expectation – certainly as to digital securities for which certainly on-venue secondary trading is planned, and of course, that's critical to developing liquidity in these markets. In that case, there must always be a CSD, in current terms.

So in practice, as things stand, it can be really difficult to generate the deep liquidity pools you need without a CSD. And of course, in an innovative market that arguably creates a barrier to innovation and disruption.

Louise Bralsford Understood. And so what's happening on this?

Damian Carolan Well, the main thing at the moment in the UK really on this front, is the proposal for a financial markets infrastructure sandbox, or the FMI Sandbox as it's referred to in the Financial Services and Markets Bill that's just passing through Parliament now.

Now, this has been designed specifically to test and adopt new technologies and practices such as distributed ledger technology – so it's specifically on point here. And of course we've seen the FCA use sandboxes before in the UK, where it wants to encourage innovation. The idea here again is that, when this regime comes into play, various current markets legislation may be temporarily modified, disapplied or recalibrated, within certain controls and limits, and then tried out by sandbox participants as part of these new, innovative arrangements.

And, amongst other things, we do expect that the FMI Sandbox will indeed be modifying the UK CSDR, which addresses those issues around secondary market on-venue trading, which I've flagged, as this is clearly critical – but there's also a range of other legislation that could be in scope for calibration in this context, MiFID, MAR etc.

Now, currently the Treasury is working on developing the FMI Sandbox parameters with the FCA and the Bank of England. It's a live topic, and is currently being discussed in trade bodies.

There is clearly an appetite to get this up and running, really quite quickly – and so the time to engage is now, if you want to engage in the lobbying around that.

It is clear, I think, the initial scope includes digital securities – as I've mentioned, though, it doesn't seem likely that other cryptoassets and derivatives will be in scope of the first wave at least, but we wait to see. And it will also be interesting to see how it differs from the approach taken by the EU DLT pilot regime, which of course has similar aims in an EU context; although noting that the UK regime currently at least has more scope for flexibility – but we'll wait and see as that develops.

Louise Bralsford This sounds promising. Turning to you, Tom, are you also seeing these kinds of trends on the derivative side?

Tom Roberts Overall, yes, it's part of the same picture.

The good news is that if you look narrowly at crypto derivatives as a product, things start simple, because the regulatory treatment is clear and is generally harmonised – at least across Europe. But once you look more broadly, the same themes emerge, in particular, the themes around the political and regulatory attitudes to crypto – which of course go to whether some want to be in the space at all, but also for those smaller crypto firms, it informs their decisions about where they might locate and where they might license.

We also see the same theme around the treatment of digital assets across different legal systems – particularly, we need to think about collateral arrangements related to derivatives. And again, this theme around the increasing sophistication of the market participants in the crypto derivative space.

Louise Bralsford When we say crypto derivative space, what are we talking about?

Tom Roberts In terms of market structure, I see it as three segments. So OTC markets (and this is both flow, and some of the more complex structured trades) – unlike other asset classes, this is an area that isn't dominated by the traditional market making dealers. Instead of those, we see crypto specific firms – the Cumberlands, the Wintermutes, the B2C2s, to take some examples. Then after that we have centralised exchanges, so CME being an example of that on the traditional end, and then the likes of Coinbase, Binance, and Kraken, as crypto specific exchanges. And then finally, decentralised finance protocols – so, fully on-chain derivatives.

In terms of products, the market's dominated by futures and options referencing Bitcoin and Ether, and then the long tail of other cryptocurrencies. Outside of OTC markets, the dominant product is perpetual futures (typically highly leveraged).

Louise Bralsford Thanks, Tom – all clear. And so in terms of market outlook, what are you seeing across these segments?

Tom Roberts To keep it brief – OTC, there's definitely some questions around liquidity. We've seen some of the prominent market makers, like Jump and Jane Street, publicly pull back from the market. Others like Alameda obviously collapsed. But overall, the institutional interest is still there, and in my view, we will see growth.

I also expect to see product innovation, looking forward. One good example of that is the fully on-chain option executed by Galaxy recently.

Looking at exchanges, the theme, to my mind, is a greater focus on institutional business. In practice, what this means is enterprise-grade tech, greater transparency and a focus on regulatory compliance, governance, and the basis on which assets are being held. I also expect to see growth in exchange traded options.

And then DeFi – where to start, really – but I think the rapid innovation will continue, but with a greater focus on product-market fits. And I also think we'll see more crossover between DeFi and the centralised world, with it being more about utility, rather than ideology (at least for some). And with that, I think an increasing realisation of people operating in the DeFi space that code is not law, and actually law is law, and regulation does matter.

And there, I think there's this big question around how to regulate DeFi, or if to regulate DeFi perhaps. There's a number of different proposals starting to emerge across jurisdictions, and definitely how MiCA 2.0 tackles this is something that people are going to watch very closely. There's a lot to unpack in DeFi, but it's probably a discussion for another day.

Louise Bralsford Thank you very much. And what else are you seeing in practice?

Tom Roberts Just to pick out a few welcome developments. ISDA's now published their digital assets definitions, and intends to address crypto in their rollout of netting and collateral opinion updates. That's going to build a foundation, I think, for standardisation and growth. The next stage for ISDA is going to be looking at digital assets as a collateral type.

There's also some planned updates to the EU and UK derivatives reporting regime, to introduce the long-awaited fields for crypto as an underlying asset. And we're also starting to see more work being done around how derivatives regulation applies to exchanges, which is going to be critical for institutional clients.

Some key topics, though, remain a "wait-and-see". For example, the application of the financial collateral regimes, cryptoassets, and the possibility of some forms of digital asset, I guess most obviously stable coins, being permitted as eligible collateral under global margin rules.

Louise Bralsford Thanks so much, Tom. It does sound like everyone is interested in this quest for clarity and certainty.

Well, I think that's all we have time for today, but just to flag that for more information and discussion, you can head over to aoseminars.com for the webinar Nick, Damian and Tom gave a couple of weeks ago, which goes into more detail on some of what we've been talking about today.

Thank you very much for joining us. Keep an ear out for more Beyond the Hype Podcasts on the future of digital assets, coming soon.