Response to HM Treasury Call for Evidence: Regulatory Approach to Cryptoassets and Stablecoins

March 2021

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Financial Markets Law Committee[1]

This response has been drafted by the FMLC Secretariat[2]

[1] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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TABLE OF CONTENTS

1. INTRODUCTION

1.1. The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2. In January 2021, HM Treasury published a Consultation seeking views on how the U.K.'s regulatory framework may be amended in view of challenges posed by new technologies, including risks to consumers and stability, while supporting innovation and competition. The Consultation represents the first stage in the consultative process and focuses on establishing a sound regulatory environment for stablecoins. It can be divided roughly into two parts. The first part—in chapters 2 to 4—sets out the landscape for cryptoassets and their status under the U.K.'s current regulatory framework and presents HM Government's proposed policy approach, including in relation to specific proposals with respect to cryptoassets used for payments purposes. The second part, in chapter 4, seeks views on a broader range of questions in relation to cryptoassets used for investment purposes and the use of DLT in financial services.

1.3. The FMLC has commented in the past on the characterisation of cryptoassets and on the E.U. proposals to regulate cryptoassets.[3] The Committee appreciates this opportunity to draw attention to issues of legal uncertainty arising in the context of the U.K.'s proposal to regulate cryptoassets.

2. ISSUES OF LEGAL UNCERTAINTY

<u>Definition of a token</u>

2.1. The Consultation states that the term "token" is used interchangeably with "cryptoasset", which it describes as

> a digital representation of value or contractual rights that can be transferred, stored or traded electronically, and which may (though does not necessarily) utilise cryptography, distributed ledger technology or similar technology.

[3] FMLC work on legal uncertainties arising in the context of regulating cryptoassets may be accessed here: http://fmlc.org/Topic/cryptoassets/.

This descriptive definition is aligned with definitions used in other pieces of legislation governing cryptoasset, such as the proposed extension of financial promotions regime. For a piece of legislation aimed at considering the broader regulatory approach to cryptoassets, however, this definition may be found to be too imprecise, especially since the concept of a "token" is already very unclear. Precise definitions are highly important in order to define with equal precision the contours of the regulatory perimeter. That is the case *a fortiori* if the perimeter of any proposed regulatory regime is defined by reference to a "token" (or its transfer or acceptance of a "token" by a third party—for example, in payment).

2.2. First, identifying what a "token" is can be particularly difficult where the relevant technology protocol provides for transfers of value not by way of the transfer of data in any meaningful sense between transferor and transferee. Instead, value transfers are evidenced by the "spending" (i.e., rendering inert but not deleting) of data locked to one address and the creation of new "active" data affixed to the address of the transferee. Identifying the "token" in that context can be highly challenging, unless it refers to the ideational construct associated with the value attributed to the "active" data and the ability to spend it in the manner described above.

2.3. Secondly, the Consultation aspires to provide a "technologically agnostic" regulatory regime. It may be useful to observe, however, that the technology underpinning the token may have a bearing on a variety of factors, including the legal nature of the asset and the risks posed. It may therefore be necessary to identify some of the features that the underlying technology so as to define the regulatory perimeter clearly. Questions may arise, for example, in relation to how a "token" may then be distinguished from the electronic record of an account balance presented in an online application. In this context, the mere deployment by a financial institution of its systems with some form of token-based system should be a neutral event from a regulatory perspective—and, in particular, it should not give rise to a separate regulated instrument—but this is not clear from the proposals. A failure to address the subtleties in the way that token-based systems can be deployed could create significant legal uncertainty.

2.4. Thirdly, a token or entries in a DLT register may be used to:

- constitute rights and obligations in respect of the issuer or real-world assets (such as a legal claim against the issuer or property rights in the referenced assets);

- evidence rights and obligations, in the same way as many other systems of books and records; or

- represent value in and of itself, perhaps because it is treated as having that value under a blockchain protocol and/or smart contract, without creating any separate rights or obligations in respect of an asset extrinsic to the system.

Likewise, the system could be governed by a set of rules to which participants have contractually agreed so that the "token" is merely a record of the contractual (or even property) rights, either owed between two or more participants (with the relevant asset comprising a *chose* in action between them) or providing for the agreed transfer of property interests between participants (whereby the token services as a record of a transfer of property rights). Alternatively, there may be no contractual rights, in which case the "asset" may simply be the unique ability to spend the value represented by the token (based on knowledge of the public-private key combination and the relevant protocol). Equally, there may be a central registrar which has the ability to rectify errors and/or override validation processes or the arrangement may be fully decentralised.

2.5. Given the inherent uncertainty in the shape and function of a token, it is essential that any attempt to create a cryptoasset regulatory framework give some thought to what a "token" is.

Interpretation of certain regulatory definitions and concepts

2.6. The FMLC has previously drawn attention to the difficulties arising from interpreting definitions under existing financial regulation in the context of token arrangements.[4] For instance, the definition of "transferable securities" under Directive 2014/65/EU on markets in financial instruments ("**MiFID II**"), which has been onshored in the U.K., refers to "those classes of securities which are negotiable on the capital market, with the exception of instruments of payment", and provides a non-exhaustive list of examples. The terms "securities", "negotiable", "capital market" and "instrument of payment" are all open to interpretation in relation to novel instruments, and *a fortiori* in the context of tokens where, for instance, it is not clear how the concept of a "capital market" falls in be assessed in the context of decentralised blockchain platforms). Similar issues arise in relation to the definition of "cash" under Directive 2002/47/EC on financial collateral

4 FMLC, *Response to European Commission Consultation: Framework for Markets in Cryptoassets* (17 March 2020), available at: http://fmlc.org/response-to-european-commission-consultation-framework-for-markets-in-cryptoassets-17-march-2020/.

arrangements which refers to "money credited to an account". It is unclear in what circumstances a token-based representation of value would meet this definition.

2.7. Another example concerns the definition of "e-money" under regulation 2 of the Electronic Money Regulations 2011 (the "**E-Money Regulations**") which includes the criterion that the stored monetary value is "accepted by a person other than the electronic money issuer". It is not clear whether data entries recorded by way of a blockchain protocol that facilitates transfers of value by rendering inert certain data at the address of a transferor and activating new data at the address of a transferee (i.e. without any transfer of data, or anything readily identifiable as a "token" which is "accepted") would constitute e-money under the definition. Similarly, it is unclear whether there is e-money where value is transferred by way of entries in a distributed ledger for purposes other than retail payments, such as "collateral" under a decentralised finance application.

2.8. Any new regulatory regime will need to assess any regulatory under/overlap with regard to these definitions, amongst others. There may also be a case to be made for acknowledging, and catering for, the specificities of certain token-based business models in considering any new regime. Some of the activities and instruments associated with token arrangements do not sit neatly within existing regulatory frameworks and there is a risk of unintentional regulatory overlap or underlap as measured against desired regulatory objectives. A token may be associated with activities (such as distributed validation or custody of private keys) that are not attributed with, or connected to, a particular specified investment under existing rules.

2.9. The use of the term "security token" and the phrase "akin to specified investments, like a share or a debt instrument," for example, suggests that such tokens are anticipated to be treated similarly to securities, but, unlike conventional securities, they may not have an issuer and may not have other characteristics of conventional securities. Likewise, the inclusion of potential regulated activities in respect of stable tokens, mentioned in paragraph 3.21 of the Consultation, presumes that a token will have an issuer, which may not always be the case where it is mined or created programmatically. Equally, it is possible that the adoption of tokenisation as a legal technique could lead to entirely new classes of investment and activity that do not fall clearly within the RAO. In such a context, a different model of regulation than that anticipated by the consultation might be considered more appropriate.

"Stable tokens"—definition and interaction with the e-money regime

2.10. The Consultation focuses heavily on stablecoins, which is where HM Treasury judges that the risks and opportunities are most urgent. Stablecoins aim to hold their value, relative to a specified asset or a pool or assets to other assets, meaning that they can be more reliably used as a means of exchange or store of value. HM Treasury therefore proposes to introduce a regulatory regime for what it calls "stable tokens", which can be used as a means of payment, including stable tokens backed by single-fiat and those backed by other linked assets. The new regime would cover both firms issuing stable tokens and firms providing services facilitating the use of stable tokens, based upon a specified list of activities that the government considers should be regulated (including issuing, creating or destroying asset-linked and fiat-linked tokens, transmission of funds, and providing custody and administration of a stable token for a third party). Key participants likely to be caught include issuers, system operators, cryptoasset exchanges and wallet providers. For these entities, the Consultation sets out a list of high-level requirements, including authorisation, prudential obligations, safeguarding, financial crime, conduct and security requirements.

2.11. A degree of uncertainty arises owing to the lack in the Consultation of a definition of "stable tokens." The Consultation only provides guiding principles, as described above. This raises concerns about how the definition of stable tokens will interact with any specified investments under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the "**RAO**"). In particular, it will be necessary to ensure that asset-linked tokens are excluded from qualifying as collective investment schemes, alternative investment funds or from qualifying as contracts for differences.

2.12. A similar concern is that stable tokens which are also considered to be e-money tokens may fall within scope of both the new regulatory regime and the E-Money Regulations, especially given the broad definition of e-money under the E-Money Regulations.[5] The definition covers tokens which are: (i) stored electronically, including magnetically; (ii) issued on receipt of funds; (iii) used for the purposes of making payment transactions and (iv) are accepted as a means of payment by persons other than the issuer. Stable tokens, particularly those that are single-fiat-backed, could fall within this definition if their business model allows them in practice to meet broader criteria such as the requirement for safeguarding. A second risk in this context is that existing e-money tokens could inadvertently become subject to the new framework for stablecoins.

[5] The definition of e-money is set out in regulation 2 of the E-Money Regulations.

Questions then arise about how related single-fiat token service providers (including exchanges and access providers) will be regulated.

2.13. Adequate exclusions in any legislative proposal would be useful so as to avoid overlap between the concepts and regulatory frameworks.

Taxonomies

2.14. Much work has gone into the classification of cryptoassets based on their function, resulting in the parallel creation of taxonomies in the U.K. and E.U.[6] In the U.K., three categories of cryptoassets were proposed: (1) exchange tokens, which are used as a means of exchange or for investment; (2) security tokens, which provide rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits; and (3) utility tokens, which can be redeemed for access to a specific product or service, typically provided using a DLT platform.[7] This taxonomy was, for the most part, adopted by the Financial Conduct Authority ("**FCA**") in its *Guidance on Cryptoassets*, with the addition of a new category—that of "E-money tokens"—which it defines as any token which reaches the definition of e-money.[8]

2.15. The Consultation discusses the regulatory perimeter by reference to the FCA's *Guidance on Cryptoassets*. The FMLC has argued in the past that such a categorisation is reductive and does not take into account cryptoassets which do not neatly fall into one or another category, resulting in their exclusion from the regulatory ambit.[9] While the FCA's taxonomy is useful in providing shorthand descriptors to facilitate discussion as to the broad nature of certain tokens and as an approximation of their potential regulatory treatment, it can only ever aspire to very approximate mapping onto complex regulatory regimes (including but not limited to, for example, the RAO, the financial promotions regime, the public offers regime, the rules applicable to collective investment schemes, the payment services and e-money regimes, and the Alternative Investment Funds

6 In the U.K., the Cryptoassets Taskforce, comprising representatives from HM Treasury, the Financial Conduct Authority ("FCA") and the Bank of England, published a report setting out its analysis of cryptoassets. HM Government, Policy paper: *Cryptoassets Taskforce: Final Report*, (October 2018), available at:https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

7 *Ibid*., paragraph 2.11

8 FCA, Policy Statement (PS19/22): Guidance on Cryptoassets—Feedback and Final Guidance to CP 19/3, (July 2019), available at: https://www.fca.org.uk/publication/policy/ps19-22.pdf, p. 14.

9 The FMLC has looked, in particular, at the definition of "virtual currencies" in the Fifth Money Laundering Regulation. FMLC, Report: Exchange Tokens, (23 October 2019), available at: http://fmlc.org/report-exchange-tokens-23-october2019/.

Management regime). The proposed use of such a classification should therefore be gauged accordingly in any future drafting of legislation.

2.16. Finally, the Consultation recommends excluding algorithmically generated stablecoins and other cryptoassets which in practice may be used for payments, at these early stages. The fact that different types of stablecoins may be regulated in different way may raise legal uncertainties and the potential for regulatory arbitrage.

Application of proposed regime to stablecoins used as an accessory to the crypto and Decentralised Finance markets

2.17. Stable tokens are currently used widely outside mainstream payments, specifically as an accessory in the cryptocurrency and decentralised finance markets. These may, for example, be generated algorithmically upon the deposit of crypto "collateral" into a smart contract "vault" and treated by the protocol or smart contract as having a value equivalent to that of a fiat currency. They are typically used only within the platform and in other decentralised finance platforms, where they may be utilised for speculative investment purposes, but generally not for retail consumer purchases. If the new regulatory framework is established such that unregulated tokens and associated activities primarily used for speculative investment purposes initially remain outside the perimeter (as the Consultation suggests), it is worth considering whether the stablecoins used in these contexts should be treated similarly. In any case, it would be helpful for any new regulation to provide clarity on this point.

DLT-based financial market infrastructures

2.18. The penultimate section of the Consultation concerns the benefits and risks of using DLT platforms as core financial markets infrastructure to facilitate transactions in volume. Many of the questions to which the FCA seeks a response are policy questions beyond the remit of the FMLC but at paragraph 4.11 to 4.12, the Consultation notes that

> Consideration should also be given to whether the optimal route is for increased take-up of DLT by existing FMIs, rather than DLT solely being utilised by new entrants.

and goes on to ask whether existing law and regulation poses barriers to entry for new market infrastructure providers

> The government is also seeking feedback regarding what regulatory or legal barriers exist that currently limit the adoption of DLT in U.K. financial markets. In particular, the government would like views as to whether existing UK legislation is adequate for capturing DLT-based FMIs, and whether the current legislation or regulation makes creating and operating a DLT excessively burdensome. It would be useful to hear feedback regarding how DLT will interact with existing rules around transfer of title, settlement finality, financial collateral, shareholder rights and corporate actions, and whether there is a need to optimise legislation across these areas to better accommodate DLT FMIs while safeguarding stability and security.

2.19. In this regard, the FMLC would note that although European and British regulatory authorities have repeatedly expressed the view that technology neutrality is one of their guiding principles for the regulation of digital innovation, the policy is difficult to apply with regards to the legislative measures which specifically concern FMI—including, Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**"), Regulation (EU) No 909/2014 on improving securities settlement in the European Union and on central securities depositories (the "**CSDR**"), Directive 2002/47/EC on financial collateral arrangements ("**FCAD**") and Directive 98/26/EC on settlement finality in payment and securities settlement systems ("**SFD**")—all of which contemplate an existing market infrastructure, in which activities such as clearing and settlement and actors such as intermediaries play a key role. These texts--and the onshored versions in effect in the U.K. following Brexit--use concepts which reflect the traditional market infrastructure of intermediated securities, such as "central securities depository", "account", "finality" or "portability", most, if not all, of which cannot readily be applied to a DLT context.

2.20. For instance, while the SFD currently offers certainty as regards holdings in central securities depositories and as to the finality of transactions in some clearing and payment systems, there remain questions about its application to a DLT context. According to the definition of a transfer order under Article 2 of the SFD, which provides that

> "transfer order" shall mean:
>
> any instruction by a participant to place at the disposal of a recipient an amount of money by means of a book entry on the accounts of a credit

> institution, a central bank or a settlement agent, or any instruction which results in the assumption or discharge of a payment obligation as defined by the rules of the system, or
>
> an instruction by a participant to transfer the title to, or interest in, a security or securities by means of a book entry on a register, or otherwise

it is possible that transfer orders could only exist when legacy ledgers are maintained. If so, a DLT system without double-entry accounts would not be considered a securities settlement system for the purposes of the SFD.

2.21. Equally, the provisions of the CSDR, which have been onshored in the UK by the Central Securities Depositories (Amendment) (EU Exit) Regulations 2018, contemplate the existence of a "securities account" where transactions are recorded in "book-entry form". Article 3 provides

> Where a transaction in transferable securities takes place on a trading venue the relevant securities shall be recorded in book-entry form in a CSD

and Article 2(28) provides that a "securities account" means an account on which securities may be credited or debited.

2.22. This raises the question whether, without further amendment, a ledger entry in a DLT-based securities holding system can be classed as a book-entry and whether a system in which the securities are issued as tokens rather than merely as entries on the ledger would infringe existing legislation.

2.23. When it comes to identifying the law applicable to securities transactions, the SFD, FCAD and Directive 2001/24/EC on the reorganisation and winding up of credit institutions (the "Credit Institutions Winding-up Directive") all designate the applicable law based on the place of the relevant register or account (and in the case of the Settlement Finality Directive and the Winding-up Directive, the centralised depository system). An approach of this kind may be difficult to apply to a DLT system in part for the reason that concepts such as "securities account", "forms a credit in..." and "book entry" are not particularly easy to map onto the operations of a distributed ledger. One might note, by way of example, that Article 1(5) states that

The evidencing of the provision of financial collateral must allow for the identification of the financial collateral to which it applies. For this purpose, it is sufficient to prove that the book entry securities collateral has been credited to, or forms a credit in, the relevant account and that the cash collateral has been credited to, or forms a credit in, a designated account.

2.24. Another reason why a location-based approach to the applicable law is problematic for a DLT system is that the very distribution of the ledger is antithetical to the idea of the "place of the register". This is likely to prove not only an issue of scope and definition but also one with ramifications for the conflict of laws and regulation.[10]

3. CONCLUSION

3.1. In this response to HM Treasury's consultation on a possible regulatory framework for cryptoassets and stablecoins, the FMLC has drawn attention to a number of legal uncertainties. These include definitional questions, such identifying what a "token" is, as well as the difficulties arising from interpreting definitions under existing financial regulation in the context of token arrangements. The FMLC has also drawn attention to the possible overlap of the new regime for stablecoins with the existing regime under the E-Money Regulations. Finally, the Committee notes the difficulties arising from the application of concepts present in financial services regulation which reflect the traditional market infrastructure of intermediated securities, most, if not all, of which cannot readily be applied to a DLT context.

[10] FMLC, Report: Distributed Ledger Technology and Governing Law, (27 March 2018), available at: http://fmlc.org/report-finance-and-technology-27-march-2018/.

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