BLOCKCHAIN INTELLIGENCE GROUP

# The Cryptocurrency Compliance Playbook

## U.K. Edition



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# Executive Summary

The United Kingdom (UK) has been a global financial hub for over three decades, well known for its innovative regulatory regimes. Cryptoassets, on the other hand, have grown almost exponentially in the past twelve years, significantly shaping financial lives worldwide.

The UK statedly recognises the potential of cryptoassets and their underlying distributed ledger technology, i.e. blockchain. It thus aims to become a leader in cryptoasset innovations by establishing a bespoke, "high quality" regulatory framework at par with international standards.

The UK's current approach to cryptoasset regulations is technology-agnostic, based on a "same risk, same regulatory outcome" principle. Moreover, it retains the existing responsibility divisions as far as possible to ensure minimal disruption while meeting three key objectives:

- **Protecting financial stability and market integrity** through high regulatory standards.
- **Delivering robust consumer protections** by disincentivising unregulated, high-risk financial instruments.
- **Promoting competition and innovation** with measures to ensure open, free and competitive cryptoasset markets.

The UK is currently undertaking the first phase of legislative changes to actualise these objectives, with the Financial Conduct Authority (FCA), Payment Systems Regulator (PSR), and Bank of England (BoE) as primary regulators. The implementation process involves modifying existing legislation to reflect the cryptoasset-specific recommendations of various reports and public consultations commissioned since 2018.

Accordingly, cryptoasset businesses and industry stakeholders operating in the UK must comply with:

Minimum Anti-Money Laundering (AML) and Counter-Terrorist Financing (CFT) requirements, at par with the Financial Action Task Force (FATF) Recommendations.

The Financial Promotions Regime for 'unregulated' cryptoassets, clearly discloses to consumers the risks associated with trading and/or exchanging cryptoassets like bitcoin and ether.

The FCA's Authorisation Regime for e-money tokens, security tokens and other cryptoassets with the capacity to facilitate wholesale payment systems. This requires eligible entities to register with the FCA.

UK authorities focus primarily on stablecoins in the current phase of regulatory implementations. However, in the future, they will broaden their ambit to generally cover cryptoassets like bitcoin, ether, ripple, etc... The government also plans to issue a national Non-Fungible Token (NFT) in collaboration with the Royal Mint, besides establishing a Financial Markets Infrastructure (FMI) Sandbox and Cryptoasset Engagement Group to enhance public-private communications for future-ready policies.

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The contents of this paper are intended as a guide only and investigators are responsible to follow the law, regulation, and policy of their respective jurisdiction.

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# 1. Introduction

The UK Treasury's Economic Secretary, John Glen, said during his keynote speech at the Innovate Finance Global Summit, UK Fintech Week 2022:

> **If there is one message I want you to leave here today with, it is that the UK is open for business – open for crypto businesses.**
>
> **John Glen**
> Economy Secretary
> **UK Treasury**

The Secretary's promise is exciting as such, and all the more so when read within a wider context. It reflects the UK's dedication to retaining its position as a global financial centre that facilitates over $3.6 trillion in daily forex trade. Moreover, it resounds the Chancellor of the Exchequer's vision and 'detailed plan' to bolster London's leadership in providing "high quality" regulations.

Offering bespoke regulatory regimes, legal frameworks and supportive environments to drive innovations has been London's forte for decades. For example, the UK was a pioneer in providing legal frameworks for Limited Liability Companies in the 19th century, as well as for derivates and securities in the 1990s.

Similarly, the British government now aspires to perform a similar role for emerging cryptoasset markets, especially as it realises the immense potential of the 'borderless' technologies enabling such innovations. It has thus commissioned, published and implemented several reports and consultations to this end in recent years.

However, despite its positive intent, the UK has miles to walk before achieving the level of regulatory certainty and clarity befitting its ambition. Stakeholders often face difficulties navigating the UK's fragmented regulatory landscape for cryptoassets, particularly post-Brexit. This is broadly due to two reasons:

a. The UK's Future Regulatory Framework is still a work in progress, presently at a stage where existing legislation is being updated constantly to become future-ready.

b. Since there is no comprehensive documentation, information about cryptoasset regulations and requirements is scattered across multiple publications and policy documents.

Against this backdrop, we present a structured playbook to help financial institutions, digital banks, payment service providers, and law enforcement agencies gain more clarity on cryptoasset regulations in the UK. By reading this paper, you will:

- Get an outline and in-depth insights into existing and upcoming regulatory frameworks, making it easier for you to leverage one of the world's top financial hubs.
- Overcome regulatory uncertainty and non-compliance with practical and actionable guidance while focusing optimally on steady innovations.
- Stay ahead of the curve while moving into UK markets, passing authorisation hurdles with greater ease and minimal risks.

## 1.1 How We Proceed



To enhance accessibility, navigability and readability, we have divided this paper into three broad segments or chapters.

First, we trace the evolution of cryptoassets regulations in the UK from 2018 to 2021. Here we look at some of the key events and publications, highlighting their significance. For example, we analyse the impact of Brexit, besides summarising crucial publications like the Kalifa Review of UK Fintech 2021 and the Financial Conduct Authority's Consumer Research Report 2021.

Second, we dive into the current regulatory scenario, focusing on announcements and publications from 2022, such as the outcome of the HMT's 2021 Consultation on the UK regulatory approach to cryptoassets and stablecoins. Doing so will allow us to elaborate on the UK's regulatory objectives, principles and methods. We will also discuss the relevant definitions, legislation and requirements in this chapter, as well as recommend practical ways of ensuring compliance.

Third, we take a look at the UK's regulatory roadmap, discussing the implications of upcoming regulations and how you can be future-ready.

# 2. The Background: From 2018 to 2021

## TL;DR

- The Cryptoasset Taskforce published its report in 2018, marking the beginning of formal efforts to regulate cryptoassets in the UK.
- Following Brexit in 2020, UK-based cryptoasset companies faced difficulties concerning user onboarding and licensing, among other aspects.
- The UK established an AML/CFT regime by transposing the EU's AMLD V through the Money Laundering Regulations (Amendment) 2020.
- The Financial Conduct Authority (FCA) banned cryptoasset derivatives trading in October 2020, citing consumer protection.
- The Kalifa Review of UK Fintech was published in April 2021, providing recommendations for building a 'bespoke regime' for the budding cryptoasset industry.
- The FCA published a comprehensive consumer research report in October 2021, providing clarity on the current state of consumer awareness.
- The Chancellor of the Exchequer announced a 'detailed plan' for future financial regulations at the Mansion House Speech 2021.

Cryptoassets attracted many eyeballs following the so-called 'ICO Craze' of 2017, which more or less continued till late 2018. The UK thus began its endeavours to understand and regulate cryptoassets, setting up the Cryptoasset Taskforce in March 2018 as a part of its Fintech Sector Strategy.

The Taskforce comprised high-ranking officials from the Financial Conduct Authority (FCA), Bank of England (BoE), and HM Treasury (HMT). Published in October 2018, its 'Final Report' was arguably the UK's first major step towards developing cryptoasset regulations with the following considerations:

- Upholding London's reputation as a safe, secure and reliable jurisdiction for financial institutions and other businesses.
- Ensuring world-class regulatory standards for financial markets in the UK.
- Protecting consumers against existing and potential threats, helping them interact with cryptoasset businesses with minimal risks.
- Safeguarding against possible disruptions to the UK's financial stability and national security.
- Fostering innovations while implementing measures to ensure free and fair competition.

The Taskforce's report also defined key concepts like Distributed Ledger Technologies (DLTs) and provided a broad categorisation for cryptoassets. This categorisation provided a sound starting point for the UK's cryptoasset regulations, but it has undergone substantial modifications over time. The considerations mentioned above, however, have remained consistent for most parts.

## 2.1 Post-Brexit Implications



The UK departed from the European Union (EU) on 31st January 2020, marking one of the most significant events in its history. Brexit had far-reaching impacts on various aspects of UK legislation, both positive and negative. Most importantly, at least for our present purpose, it had broad implications for the UK's Anti-Money Laundering (AML) and Counter-Terrorist Financing (CFT) regimes.

As such, the UK's proactiveness in preventing and prohibiting money laundering has been exemplary for over three decades. Even as an EU member, it was among the first nations to adopt and implement AML/CFT directives. The UK thus signed almost every EU Anti-Money Laundering Directive (AMLD) up to the AMLD V adopted in June 2018. It did not, however, sign the sixth AMLD (AMLD VI).

Following Brexit, the UK and EU have remained broadly similar in their AML/CFT efforts, both adopting a 'minimalist' approach with a general agreement to meet Financial Action Task Force (FATF) recommendations. However, the absence of any formal mechanism for UK-EU cooperation on AML/CFT management poses certain challenges for crypto-businesses regarding client onboarding, sanctions implementation, intelligence sharing, and law enforcement.

The lack of clarity around UK-EU AML/CFT management affects stakeholders in three major ways:

- Financial Institutions (FIs) cannot 'passport' between the UK and EU, compelling them to undergo multiple licensing procedures and operational setups.
- Companies have to separately consider various country lists and law enforcement requirements due to the absence of 'equivalence' between the UK and EU AML/CFT regimes, despite their common roots.
- Firms must closely follow FATF developments and sanction lists individually since there is currently no harmonised list of high-risk jurisdictions. Similarly, they must monitor regulatory changes in both UK and the EU.

The UK has nevertheless taken positive steps to mitigate the above concerns, especially through its efforts to frame sovereign regulations against money laundering and terrorist financing.

## Money Laundering and Terrorist Financing (Amendment) (EU Exit) Regulations 2020

The Money Laundering Regulations (MLRs) 2020 currently provide the statute for the UK's AML/CFT regime. The Amendment (2020) transposed the EU's AMLD5 into English law, prioritising the implementation of the FATF Standards.

The MLRs 2020 obliged Virtual Asset Service Providers (VASPs) or firms providing cryptoasset-based services in the UK to register with the FCA. In turn, the FCA, which is currently the primary AML/CFT overseer, established a Temporary Registration Regime for licensing purposes.

However, the UK duly recognised the limitations of merely transposing EU regulations, as well as the need for dynamic and sovereign regulatory frameworks. It thus conducted a public consultation from July 2021 to October 2021, seeking inputs and evidence for its proposed amendments to the MLRs 2020.

The government shall implement the outcome of this Consultation through the Money Laundering and Terrorist Financing (Amendment) (No.2) Regulations 2022 Statutory Instrument. Broadly, this implementation will meet the following agendas:

- Expanding the MLRs' scope to accommodate changes in risk assessment methods and opportunities.
- Modifying certain MLRs to meet the updated FATF recommendations, keeping the UK at par with top-notch international standards.
- Granting UK regulators new powers to seize cryptoassets from criminals, besides giving businesses more confidence to report suspicious activities.

Moreover, in this consultation paper, the government conveys its dedication to consistently implementing the FATF's Recommendation 16 (R.16), i.e., the *Travel Rule*, across the financial sector, regardless of the underlying technology. As we will see later, this technology agnosticism is a lynchpin of the UK's regulatory approach.

The government further lauds private sector innovators for developing solutions around R.16, besides stating that it "*has been kept informed of technological developments, such as the development of common data standards and the progress of a large number of software solutions.*" Accordingly, the authorities consider "*that the time is now right to begin planning for the implementation of the Travel Rule.*"

## 2.2 The National Crime Agency (NCA) Report, 2020



Cryptoassets found a considerable mention in the NCA's National Strategic Assessment of Serious and Organised Crime report published in April 2020. The report traced certain kinds of financial crimes from 2018 to 2019, recognising their increasing prevalence. Besides encryption tools and the dark web, such crimes involved cryptoassets like bitcoin and other blockchain-based applications.

According to this report, investors lost around £338 million to fraudulent projects promising incredibly high returns on cryptoasset investments in 2018-2019. To make the situation more challenging from a regulatory point of view, tech-savvy financial criminals constantly exploit newer ways of targeting their victims.

Through these insights, the NCA highlights the need for adequate resilience and robustness in the UK's regulatory framework. Moreover, it provides the rationale for stringent MLRs and a world-class AML/CFT regime. Lastly, it implores innovators to develop embedded solutions to mitigate using cryptoassets for criminal purposes.

## 2.3 The FCA's Ban on Cryptoasset Derivatives



In October 2020, the FCA published rules for banning the sale of certain crypto-based derivatives and exchange-traded notes to retail customers. It cited consumer protection as the primary reason for this ban while claiming that '*retail consumers will save around £53m from the ban on these products*.'

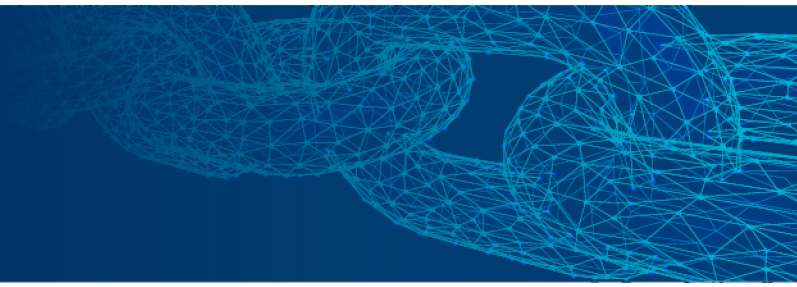
The FCA's announcement expressed concerns around the reliability of the valuation of the said instruments based on the following grounds:

- The absence of any reliable basis for cryptoasset valuation, given their inherently volatile nature.
- The prevalence of abusive and criminal activities in secondary markets, including scams and cyber threats.
- The lack of adequate awareness and understanding of cryptoassets among retail investors.

Considering these factors, the FCA deemed consumers to suffer massive losses by investing in the financial instruments in question. Moreover, it questioned the legitimacy of the need for retail consumers to invest in these products.

The ban came into effect in January 2021. Thus, any firm offering the products mentioned above to UK consumers after this date is most likely a scam.

## 2.4 The Kalifa Review of UK Fintech, 2021



The Kalifa Review, authored by Ron Kalifa OBE and published in April 2021, has been critical in shaping the UK's stance towards cryptoassets. "*The UK has the potential to be a leading global center for issuance, clearing, settlement, trading, and exchange of crypto and digital assets*," according to Kalifa.

To realize this potential, the UK must:

a. Approach cryptoassets in a functional and technology-neutral manner.

b. Deliver a digital financial package with a novel regulatory framework for innovative technology.

c. Establish a Digital Economy Taskforce (DET) to streamline regulations across the government.

d. Take Decentralized Finance (Defi) into consideration while framing its regulatory regimes.

e. Promote international collaboration by establishing the Centre for Finance, Innovation and Technology.

The review also advised the UK to prioritize *regulatory flexibility* while developing its 'bespoke regime' for the nascent and dynamic cryptoassets industry. For the UK to retain its leadership vis-à-vis the EU's 'ambitious' Markets in Crypto-Assets (MiCA), and the U.S. regulations at the global level, it must move as nimbly as ongoing cryptoasset innovations.

Kalifa further lauded the Treasury's focus on stablecoins in its industry consultation from January 2021 to March 2021. However, he suggested that the government eventually expand its regulatory framework for payments to oversee cryptoassets like bitcoin.

## 2.5 The FCA's Consumer Research Report, 2021



There was heightened public and media interest in the booming cryptoassets industry when the FCA conducted its consumer research in June 2021. This was also when financial institutions and service providers increasingly adopted cryptoassets while several new firms entered the market daily.

Against this backdrop, the report fulfilled a dual purpose: (a) providing regulators with a handle on consumer sentiments and awareness levels and (b) helping crypto-oriented businesses gauge the market opportunity.

Some key findings of the report are as follows:

- **78% of the UK's total estimated population of 52 million had heard of cryptoassets by 2021**, whereas 73% did so in 2020.
- Around **2.3 million people (4.4% of all adults) owned cryptoassets in the UK in 2021**, compared to 1.9 million in 2020.
- The **average (median) cryptoasset holding was £300 in 2021**, rising from £260 in 2020.
- **Fewer people (38%) considered cryptoassets a gamble in 2021**, compared to 47% in 2020.
- **Almost 16% more customer checked their balances daily between 2020 and 2021**, highlighting greater engagement and active participation.

The FCA partially attributed these developments to recent regulatory initiatives undertaken in the UK. However, whatever its reasons, the steadily increasing market size and user adoption are what ultimately matter for regulators, consumers, and other stakeholders of the cryptoasset industry.

## 2.6 Mansion House Speech 2021 & A New Chapter for Financial Services



On 1 July 2021, the former Chancellor of the Exchequer, during his speech at the Mansion House, outlined a vision for "high quality" financial regulations in the UK. He further announced a 'detailed plan' for the coming years which is arguably a culmination of the ongoing developments since Brexit.

As elaborated in the policy paper accompanying his speech, titled A New Chapter for Financial Services, the (former) Chancellor highlighted the five key principles guiding the UK's regulatory policies. These principles are as follows:

- **Openness**: Upholding the Englightenment ideals, the UK believes in open societies, free markets and democratic values, fostering creativity, ingenuity and dynamism.
- **Cooperation**: The UK promotes a rules-based international order for the optimal protection of openness and freedom through high-quality regulations.
- **Sovereignty**: Capitalising on its newfound freedom post-Brexit, the UK will design a tailored regulatory framework to best serve its national interests, as well as the interests of consumers and industry stakeholders.
- **Engagement**: The UK will engage in multilateral arrangements to solve persistent real-world problems through innovations.
- **Action**: The UK will pursue real change, taking concrete actions to ensure tangible and positive impacts on people's lives rather than merely speaking.

These principles may seem vague and abstract at the outset and with good reason. However, the (former) Chancellor's vision indeed underpins the UK's approach toward cryptoasset regulations. This shall become clearer in the next chapter, where we analyse the current regulatory landscape in the UK.

## 2.7 Summary of Government Actions Since 2018



- **Communicating minimum policy requirements**: The HMT, BoE, and Financial Policy Committee have delivered several speeches and reports to clarify the minimum policy expectations and obligations for cryptoassets. For example, global stablecoin projects are restricted from operating without meeting due registration and risk assessment procedures.
- **Amending the MLRs to transpose AMLD5 into UK law**: The HMT and FCA have implemented amendments to the UK MLRs, bringing cryptoasset exchanges and wallet service providers under stringent AML/CFT regulations.
- **Banning the sale of high-risk cryptoasset derivatives to retail consumers**: The FCA has issued rules to ban the sale, marketing and distribution of financial derivatives based on unregulated cryptoassets.
- **Fostering consumer awareness around cryptoasset scams**: The FCA has provided detailed guidance on how consumers can identify and protect themselves from various cryptoasset scams and frauds.
- **Supporting innovations in DLT**: The FCA has set up a Regulatory Sandbox, providing innovators with a safe environment to test DLT-based products and services while receiving real-time regulatory feedback through the authority's Direct Support function.

# 3. The Present: UK's Cryptoasset Regulatory Framework in 2022

## TL;DR

- The UK defines a *cryptoasset* as a digital representation of value that is stored and/or transferred using cryptography and digital ledger technology.
- UK regulators mainly oversee two types of cryptoassets, *e-money tokens* and *security tokens*, whereas *utility tokens* and *exchange tokens* are currently unregulated.
- The UK has a technology-agnostic approach to regulating cryptoassets with objectives like ensuring financial stability, protecting consumer interests, promoting competition and fostering innovations.
- In the first phase of proposed legislative changes to accommodate cryptoassets and stablecoins under existing English law, the government focuses on AML/CFT for 'unregulated' cryptoassets, as well as on stablecoins.
- The Financial Conduct Authority (FCA) and Payment Systems Regulator (PSR) are currently the key cryptoasset regulators in the UK, with the *Electronic Money Regulations 2011* and the *Payments Services Regulations 2017* as their key statutory instruments.
- Companies falling under the FCA's 'authorisation regime' must undergo due registration and licensing procedures to operate in the UK.

We have so far discussed the broad developments that shaped the UK's regulatory approach towards cryptoassets. Now, we shall look into its current regulatory framework, which has started taking a more consolidated form in 2022. Besides helping you better understand current regulatory obligations and requirements, we have designed this chapter to provide practical steps for ensuring compliance.

## 3.1 What is a Cryptoasset?



The first step toward ensuring compliance is understanding how the concerned authorities define a given financial instrument, i.e., cryptoassets in our case.

The UK, for one, uses a very broad definition of cryptoassets, understanding them as "**digital representation[s] 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.**"

The above definition accommodates a wide range of existing and potential crypto-based solutions. However, it glosses over certain granular distinctions between various crypto-asset types, despite the mainstream industry vocabulary commonly retaining and accounting for such distinctions.

For example, crypto 'coins' like bitcoin and ether are technically different from crypto 'tokens' like COMP and DOT. But the UK authorities refer to them both using 'cryptoassets' as a catch-all term. On the other hand, 'stablecoins' represent a separate asset class in the UK's regulatory vocabulary, distinct from ordinary cryptoassets.

Therefore, while building compliance mechanisms for UK markets, you must be mindful of such deviations and overlaps vis-à-vis industry norms since they may often cause misunderstanding, complications and ultimately non-compliance.

## FCA's Cryptoasset Classification

Cryptoassets could be of various kinds and fulfil a diverse set of functions like payments, trading, fundraising and lending-borrowing. The emergence of non-fungible cryptoassets has also made them usable as digital collectables. However, partly due to this broad scope, there is a lack of internationally accepted taxonomy or classification for cryptoassets.

The FCA thus provided a UK-specific classification in its Guidance on Cryptoassets (2019). The UK has currently retained this classification, dividing cryptoassets into *e-money tokens, security tokens and unregulated tokens*.

- **e-Money Tokens**: These are 'digital payment instruments that store value, can be redeemed at par value at any time and offer holders a direct claim on the issuer.' This definition aligns with the one provided for electronic money in the Electronic Money Regulations 2011 (EMRs).

- **Security Tokens**: These cryptoassets are similar to the 'specified investments' defined in Part III of the Regulated Activities Order (RAO) 2001. Some examples of security tokens include debts, options, futures and shares.

- **Unregulated Tokens**: These are cryptoassets that neither qualify as e-Money nor as security tokens. They may, however, be of two kinds:

    - **Utility Tokens**: These tokens provide access to certain DLT-based services, products and platforms, including cloud storage, identity management systems and so on.

    - **Exchange Tokens**: These cryptoassets are primarily used as a means of exchange or payment, such as bitcoin, ether and ripple.

Notwithstanding the above classification, it is worth noting that certain cryptoassets may acquire a hybrid nature, cross-cutting the established categories. In other words, you may use them for overlapping purposes simultaneously. For example, consider bootstrapping funds using, say, the XYZ coin while also using it for payments.

# 3.2 The UK's Policy Approach: Objectives & Principles



The UK authorities have communicated their principled approach to financial regulations in various ways and across platforms. The (former) Chancellor announced five key principles during his Mansion House Speech; the HMT Secretory reinforced them at the UK Fintech Week.

Following a similar course of action, the Cryptoasset Taskforce has identified several objectives and principles that inform the government's efforts to regulate cryptoassets in the UK. These objectives and principles provide the rationale for existing and upcoming legislation, making them a key point of consideration from the compliance perspective.

## Objectives

London's Future Regulatory Framework strives to fulfil three key objectives, summarised as follows:

- **Protecting financial stability and market integrity** – The UK is keen on "*maintaining the appropriate regulatory standards, ensuring infrastructure is operationally resilient and that safeguards are in place to mitigate any risks to financial stability.*"

- **Delivering robust consumer protections** – The UK holds consumer protection in high regard, as we have seen with the FCA's ban on cryptoasset derivatives. It thus strives to provide as much protection and safeguards for cryptoassets as it does for regulated financial instruments.

- **Promoting competition and innovation** – The UK is dedicated to encouraging open, free and competitive cryptoasset markets. It thus encourages and supports innovative businesses in building high-quality products and services that meet global standards.

## Principles

The objectives mentioned above, as well as the efforts being made to fulfil them, are guided by three key principles:

### a. 'Same Risk, Same Regulatory Outcome'

The UK will retain its current division of responsibilities across regulatory bodies to implement new regulations with minimal disruptions to the existing ones. It will adopt a technology-neutral stance while assessing and mitigating risks, as well as foster a level playing field.

The government will thus proceed by modifying existing legislation to symptomatically address concerns as they emerge rather than creating altogether new and unfamiliar regulations. Notably, this makes it easier for stakeholders to gauge regulatory expectations even in areas with less clarity. For example, you can assess beforehand which regulatory authority will most likely oversee a novel business model or proposition.

### b. Regulating Proportionately. Focusing on Risks and Opportunities.

The UK's piecemeal approach to cryptoasset regulations is manifested in its dedication to making regulatory choices in proportion to identified risks and opportunities. The authorities will avoid implementing regulations that are unfair and unjustifiably burdensome on certain stakeholders, for it might stifle innovations. On the contrary, they will regulate cryptoasset markets in an incremental and phased manner while closely monitoring the impact of new legislation.

### c. Ensuring Agility. Reflecting International Standards.

The UK aims to build a dynamic rather than static regulatory framework for cryptoassets, considering the industry's nascency. This framework will also meet global standards to help businesses capitalise fully on the borderless nature of cryptoasset technologies.
Following the (former) Chancellor's vision for international coordination, UK regulators are working closely with other jurisdictions to harmonise regulatory efforts as optimally as possible.

## 3.3 Cryptoasset Legislation in the UK – Phase I



n the first phase of legislative changes and implementation, the government is focusing on cryptoassets that can be '*reliably used as means of payment or store of value*.' It also emphasises regulating stablecoins, recognising their systemic potential and rising adoption for payments worldwide.

However, although 'unregulated' cryptoassets aren't yet being regulated as payment systems, they must meet certain minimum standards to optimise consumer protection.

### Financial Promotions & AML/CFT Regimes

The UK considers the high volatility of 'unregulated' cryptoassets like bitcoin and ether as a key obstacle to their mainstream use for payments. But at the same time, it recognises their potential use for scams, money laundering and other malicious purposes.

According to the UK's Financial Policy Committee, the value of most 'unregulated' cryptoassets is "*currently too volatile to be widely used as a currency or a store of value and, with transaction costs high and settlement times slow, they are an inefficient media of exchange*." Moreover, "*as assets, they establish no claim on any future income streams or collateral. They have no intrinsic value beyond their currently limited potential to be adopted as money in the future, and hence could prove worthless.*"

Therefore, companies offering 'unregulated' cryptoasset services — exchanges, custodial wallets, etc. — are more or less free from authorisation obligations. However, they are subject to stringent regulations governing consumer-facing marketing and communications.

As Rishi Sunak, former Chancellor of the Exchequer, pointed out: "*Cryptoassets can provide exciting new opportunities, offering people new ways to transact and invest – but it's important that consumers are not being sold products with misleading claims. [The UK is] ensurin consumers are protected, while supporting the innovation of cryptoasset market.*"

Accordingly, the rules require otherwise unregulated service providers to:

- Communicate the risks associated with their products and services.
- Duly implement robust AML/CFT compliance mechanisms for monitoring and reporting suspicious activities, as well as enforcing sanctions.

Security Tokens are also subject to similar obligations under the current promotions and AML/CFT regimes.

## The Focus on Stablecoins

The UK recognises that stablecoins could potentially facilitate wholesale and mainstream payment systems, unlike exchange and utility tokens. Moreover, it understands that stablecoins could cross-cut the FCA's cryptoasset classification, serving either as e-money tokens, exchange tokens or utility tokens. They could even be used as securities in certain scenarios.

### a. Types of Stablecoins

Stablecoins belong to a somewhat new category of regulated tokens. In defining this category, though, the UK takes the distinction between algorithm-based (algorithmic) and asset-based stablecoins into consideration. This distinction may be summarised as follows:

- **Algorithmic Stablecoins**: These stablecoins use automated algorithms to stabilise their price by regulating supply in proportion to demand. However, given the inherent instability of most existing algorithmic stablecoins, the UK refrains from considering them as potential payment instruments. Thus, the new category mentioned above does not refer to algorithmic stablecoins.

- **Asset-Backed Stablecoins**: These stablecoins achieve a stable value by referencing one or more financial assets. The process by which stablecoins link their value to fiat currencies, commodities or other cryptoassets is commonly known as *pegging*. For example, the value of Tether (USDT) is pegged with USD in a one-to-one ratio, i.e., the price of USDT is fixed at $1. Central Bank Digital Currencies (CBDCs) and other forms of tokenised payment methods are also recognised as asset-backed stablecoins by UK authorities.

### b. Stablecoin Risks

Although stablecoins address one of the cryptoasset industry's most pertinent concerns, i.e., volatility, they present a novel set of risks from the regulatory perspective. The UK identifies these risks as follows:

- **Financial Stability & Market Integrity Risks**
  The wide use of stablecoins for payments could potentially destabilise 'real' economies. Moreover, in the event of an outage or disruptions in stablecoin-based payment systems, consumers could lose access to their assets. There could also be unexpected price

fluctuations if the stabilising mechanism fails. For example, the price of TerraUSD 'crashed' einMay 2022, falling significantly below its pegged value of $1.

- **Consumer Risks**
  Consumers could lose substantial amounts of money when stablecoin systems break down. Moreover, the consumer protection mechanisms of certain stablecoin projects may be inadequate or ineffective, hampering key features like redeemability. Stablecoin providers might also abuse the consumer's financial information, besides indulging in various fraudulent activities.

- **Competition Risks**
  The uneven market domination of stablecoins and incumbent assets could potentially disrupt the level playing field, posing threats like regulatory arbitrage.

### c. The FPC's Regulatory Expectations for Stablecoins

Considering the potential and risks mentioned above, the FPC has laid out two regulatory expectations for systemic stablecoins. These expectations have been discussed in the Financial Stability Report (2019) and can be summarised as follows:

- Payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Firms in stablecoin-based systemic payment chains that are critical to their functioning should be regulated accordingly.

- Where stablecoins are used in systemic payment chains as money-like instruments, they should meet standards equivalent to those expected of commercial bank money in relation to the stability of value, the robustness of legal claim and the ability to redeem at par in fiat.

## 3.4 Regulatory Scope & Requirements



Because of its 'Same Risks, Same Regulatory Outcome' approach, the UK has decided to regulate cryptoasset-based payment services similarly to their traditional counterparts. In doing so, however, the authorities consider scenarios where cryptoassets may have hybrid usage, as we discussed previously.

The UK uses two existing legislation, namely the Electronic Money Regulations 2011 and the Payments Services Regulations 2017, to regulate cryptoasset payments. The FCA and Payment Systems Regulator (PSR) govern relevant payment activities based on these statutes.

To reiterate, the UK's regulatory perimeter for payments currently covers only those cryptoassets that 'could reliably be used for retail or wholesale transactions.' Thus, e-money tokens and asset-backed stablecoins must comply with the FCA's authorisation regime. Security Tokens, however, are not yet obliged to get the FCA's authorisation. Nevertheless, the FCA does regulate these assets similarly to *specified investments*.

## Who is subject to the payment regulations?

The UK authorities recognise that multiple entities facilitate cryptoasset payments, either independently or in combination with other entities. These entities, however, need not necessarily be legal or natural persons.

Having said that, you must comply with the payment regulations regime if you are:

- **a cryptoasset issuer** responsible for issuing e-money tokens or stablecoins at par value;
- **a systems operator** responsible for managing system-level rules, maintaining the payment infrastructure and burning or minting cryptoassets;
- **a cryptoasset exchange** enabling consumers to buy, sell and transact cryptoassets and/or stablecoins; or,
- **a wallet service provider** taking custody of the consumer's cryptoassets and/or managing their private keys.

In other words, you must ensure compliance while undertaking the following activities or creating the rules governing their execution:

- Issuing, creating or destroying (burning) asset-backed tokens and/or single fiat-linked tokens.
- Managing the reserve assets for any stablecoin and ensuring their value stabilisation.
- Validating cryptoasset transactions and ledger records.
- Enabling consumers to access any service or support channel.
- Overseeing the safe transmission and settlement of cryptoasset transactions.
- Offering custodian services for cryptoassets and/or stablecoins.
- Executing stablecoin transactions either for yourself or for others.
- Providing on-ramp and off-ramp services to facilitate exchanges between fiat currencies and cryptoassets.

## What are the current regulatory requirements?

The FCA has issued a set of high-level requirements for businesses and entities meeting the criteria mentioned above. The following checklist will help you ensure compliance with all of these requirements.

- ☐ **Authorisation Requirements**: Register your business under the FCA's authorisation regime if eligible.
- ☐ **Prudential Requirements**: Protect consumer interests and financial stability through efficient liquidity and capital management, besides stringent auditing.
- ☐ **Asset Management Requirements**: Maintain the quality and quantity of reserve assets transparently to ensure optimal value stabilisation.
- ☐ **Failure & Insolvency Requirements**: Implement preparatory measures for failures, insolvency and/or administrative changes.

- ☐ **Custodial Requirements**: Ensure top-grade security for consumer assets held in your custodial products and services.
- ☐ **Risk Management Requirements**: Mitigate risks across your business systems and control mechanisms.
- ☐ **Notification Requirements**: Notify regulators about internal policy changes.
- ☐ **Record-Keeping Requirements**: Establish robust and reliable record-keeping mechanisms that are easily accessible for compliance purposes.
- ☐ **Conduct Requirements**: Provide and protect consumer rights at all costs, offering them high-quality support.
- ☐ **Financial Crime Requirements**: Build effective AML/CFT compliance systems and report suspicious activity promptly.
- ☐ **Outsourcing Requirements**: Outsource key business components only after thorough due diligence to ensure continuous and adequate functioning.
- ☐ **Operational Resilience Requirements**: Set up resilient backup frameworks to enable business continuity despite physical, electronic, governance or other possible failures.
- ☐ **Security Requirement**s: Safeguard consumers against cybersecurity risks, technological risks and undue opportunity costs.

## Who needs authorisation from the FCA?

The FCA regulations broadly apply to each entity and activity enlisted in Section 3.4, Parag "Who is subject to the payment regulations?". However, you need to register with the FCA and comply with its authorisation before performing the following activities within UK jurisdiction:

- Issuing, creating or burning e-money tokens, asset-backed tokens or single fiat tokens.
- Providing custody for third-party cryptoassets and managing their private keys as an exchange or wallet service provider.
- Offering security tokens that qualify as 'specified investments' under the RAO 2001.

## How to register with the FCA?

The FCA's registration process is fairly straightforward. You can fill out the application form and pay the registration fee online using Connect.
The FCA takes about three months to process applications and may seek additional information during this period. It performs strict, case-by-case assessments of submitted applications, holding them to high standards.
Therefore, you must keep the following things in mind while registering:

- ☐ **Be prepared**: Do your homework by reviewing sample forms available on the Connect website before filling out your application.

- ☐ **Complete applications**: Answer all questions completely and honestly, disclosing all requested information.

- ☐ **Provide updated information**: Make sure to only use up-to-date information and reuse older documents only when it is necessary.

### a. What information do you need to provide?

The FCA follows a data-driven approach while assessing submitted applications and seeks detailed information about:

- ☐ The activities performed by your cryptoasset business.
- ☐ Your business plan, objectives, potential employees, target consumers, governance mechanisms and future projections.
- ☐ The adequacy of financial and non-financial resources, as well as expected transaction volumes, number of customers and pricing.
- ☐ Your marketing plan, consumer persona and communication or distribution channels.
- ☐ Your organisational structure and possible outsourcing avenues.
- ☐ Your key information systems, control mechanisms, and associated security policies and procedures.
- ☐ The key beneficiaries and other individuals with close links to your business enterprise, especially as facilitators or sponsors.
- ☐ Your governance structure and internal control mechanisms, particularly for risk assessment and sanction enforcement.
- ☐ Your AML/CFT compliance procedures and the systems for business-specific risk mitigation.
- ☐ Your business-wide monitoring policy concerning security and consumer protection.
- ☐ The public keys and wallet addresses for all cryptoassets associated with your business.

Moreover, you must disclose your customer onboarding arrangements, due diligence and record-keeping procedures, business continuity plan and budget forecasts for the first three years. Top executives and directors should also fill out individual money laundering reporting forms.

### b. The 'fit and proper' test

The FCA has issued a set of high-level requirements for businesses and entities meeting the criteria mentioned above. The following checklist will help you ensure compliance with all of these requirements.

- The Sole Proprietor, partner and/or director of the business.
- The Board member and/or Nominated Officer for overseeing regulatory compliance.
- The Nominated Officer for reporting suspicious activities to the NCA.
- Beneficial owners with voting rights and more than 25% share in the business.
- Other persons holding positions of substantial influence and/or responsibility.

The FCA seeks detailed information about the aforementioned entities and treats non-disclosures very seriously, while providing misleading information is a criminal offence. The regulator also considers the applicant's honesty, integrity, skills, experience and financial soundness while assessing them as fit and proper.

On the other hand, some of the reasons for automatically failing the test are as follows:

- Unspent convictions as listed in Schedule 3 of the MLRs.
- Failure to pay a penalty under Part 9 or Part 11 of the MLRs, as well as a charge imposed on the individual under Regulation 35(1) or 42(1) of MLRs 2007.
- Reasonable grounds to suggest the entity's possible failure to comply with MLRs, Part 3 of the Terrorism Act 2000, as well as Part 7 and Part 8 of the Proceeds of Crimes Act 2002.
- High potential for a business being used for money laundering, terrorist financing and/or sanction evasion.

## Considerations for Stablecoin Payment Systems

The UK has made some special considerations for stablecoins with systemic potential, over and above the high-level or authorisation requirements discussed so far.

Accordingly, the Payment Systems Regulator (PSR) and Bank of England (BoE) shall regulate stablecoin payment systems in the UK. Following the Financial Services (Banking Reform) Act 2013 (a.k.a. FSBRA 2013), the regulators define payment systems as a 'system that enables persons to make transfers of funds.'

Part 5 of the Banking Act 2009 (BA 2009) grants the BoE and PSR the powers to regulate systemic stablecoin arrangements, following recognition by the HMT. A payment system is considered systemic under BA 2009 based on its:

- Potential to disrupt the UK financial system.
- Scope for hurting consumer interests.
- Expected volume, value and nature of transactions.
- Links to other systems, internally or externally.
- Substitutability and use by the BoE.

Besides meeting the minimum requirements discussed above, systemic stablecoin payment systems must produce a compliance self-assessment report annually.

# 4. The Future: UK's Cryptoasset Regulations Roadmap

## TL;DR

- The UK is moving steadily towards implementing a sovereign, robust and agile regulatory framework for cryptoassets.
- The Financial Services and Markets Bill 2022 was introduced in Parliament in July 2022. The key agenda of this Bill is to enforce the recommendations of the Future Regulatory Framework (FRF) Review.
- The government will also take several non-statutory measures, such as issuing an NFT from the Royal Mint, establishing a Financial Markets Infrastructure (FMI) Sandbox, and so on.
- UK regulators will also strive to bring 'unregulated' assets under their purview in the near future.

The UK government is substantially modifying its legislative and regulatory framework to accommodate the burgeoning cryptoasset industry, and it will continue to do so in the coming years. Particularly post-Brexit, London has undertaken various long-term and short-term measures to become a global leader in cryptoasset innovation and regulations.

While announcing the government's plan to make the UK a preeminent 'cryptoasset technology hub,' the (former) Chancellor of the Exchequer said: "*We want to see the businesses of tomorrow – and the jobs they create - here in the UK, and by regulating effectively we can give them the confidence they need to think and invest long-term.*" The UK's journey toward this goal has already begun, and it will unfold in phases over the rest of this year and next.

## 4.1 Financial Services and Markets Bill 2022



The Financial Services and Markets Bill was introduced in the UK Parliament on 20 July 2022, providing a comprehensive statutory instrument for regulating the financial sector post-Brexit. Enabling a regulatory framework tailored to UK markets is among the primary objectives of the Bill. It will thus help bolster international competitiveness and coordination while delivering better outcomes for consumers and industry stakeholders.

The Bill will implement the outcomes of the Future Regulatory Framework (FRF) Review published in July 2022. The key recommendations of this review are as follows:

- Amending the UK regulators' statutory objectives and regulatory principles.
- Increasing the accountability of the PRA and FCA to the Parliament.
- Strengthening the relationship between HMT and other UK regulators.
- Enhancing the regulators' engagement with industry stakeholders.
- Repealing retained EU laws and establishing a comprehensive model based on the Financial Services and Markets Act (FSMA) 2000.
- Creating a Designated Activities Regime (DAR) to regulate activities carried out by unauthorised persons in proportion to their risks.

## 4.2 Non-Statutory Measures



Besides legislating the FSMA 2022, the UK government has decided to take certain non-statutory measures as a part of its cryptoasset regulatory roadmap. Some of these steps are as follows:

- Establishing a Financial Market Infrastructure (FMI) Sandbox to boost experimentation and innovations in DLT-based financial market solutions.
- Initiating a research programme to explore the scope and benefits of using DLT for issuing sovereign debt instruments.
- Incorporating a Cryptoasset Engagement Group chaired by the Economic Secretary to convene key authorities and industry stakeholders to advise the government on the future of cryptoasset regulations.
- Working with the Royal Mint to issue a Non-Fungible Token (NFT) emblematic of the UK's progressive vision and support for the cryptoasset industry.
- Conducting CryptoSprints where industry participants can work closely with the FCA and receive actionable feedback in real-time.
- Exploring ways to enhance the UK tax system's competitiveness, with the additional objective of assessing how cryptoasset-based Defi loans can be treated for taxation by future regimes.
- Consulting on expanding the scope of the Investment Manager Exemption to accommodate cryptoassets.

# 4.3 The UK Central Bank Digital Currency



The Bank of England is closely considering the possibility of producing a central bank digital currency (CBDC), although it is yet to decide on this matter as of mid-September 2022. In doing so, the UK central bank recognises the rising demand for digital (or electronic) money vis-à-vis physical money like notes and coins, particularly post-COVID-19.

The UK CBDC shall have stable value if and when produced, unlike ordinary cryptoassets. It will most likely be issued in denominations of the pound sterling, usable for diverse purposes, from merchant payments to international settlements. However, the government does not intend to replace cash and bank deposits with a CBDC.

As a part of the UK's efforts to "rebuild" its payment infrastructure using cutting-edge technology, the CBDC can provide citizens with a novel form of money, a future-ready payment method. To this end, the government has so far taken the following steps:

- In March 2020, the Bank of England published a Discussion Paper on CBDC outlining a possible approach and seeking feedback from various public and private stakeholders.
- In April 2021, the Central Bank Digital Currency (CBDC) Taskforce was set up with the HM Treasury and Bank of England. The CBDC Engagement and Technology Forums were also established at this time.
- In November 2021, the HMT and BoE announced the next steps for its CBDC exploration, including launching a public consultation in 2022.

The BoE also published a summary of the responses to its Discussion Paper in June 2021. According to this publication: "*...the Bank would provide the core technology infrastructure and minimum necessary functionality for CBDC payments. This would then serve as a platform for private sector Payment Interface Providers (PIPs) to connect to in order to provide customer-facing CBDC payment services and any additional value-added services as part of a competitive and diverse payments landscape*."

Therefore, although regulatory guidance is still far-fetched and how the exploration actually pans out remains to be seen, a UK CBDC could significantly broaden the scope of businesses and other entities. For one, it could enable new business models and revenue streams in both national and international scenarios. Lastly, as long as the government efficiently mitigates the risks of totalitarianism and system failure associated with a CBDC, it can provide a robust leeway to futuristic innovations.

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sales@blockchaingroup.io www.blockchaingroup.io