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Future Financial Services Regulatory Regime for Cryptoassets: Consultation
Payments and Fintech
HM Treasury
1 Horse Guards Road
London
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27 April 2023

Future Financial Services Regulatory Regime for Cryptoassets: Consultation and Call for Evidence (the "Consultation Paper")

Dear Sir or Madam,

CryptoUK ("**CUK", "we"**) and its members welcome the opportunity to comment on the Consultation Paper regarding the various amendments proposed to cryptoasset regulation in the United Kingdom ("**UK**"). CUK is the UK's self-regulatory trade association representing the cryptoasset sector. Our members comprise leading companies from across the sector.

In responding to the Consultation Paper, we set out the views of our members and others in the community. We seek to offer pragmatic and relevant suggestions as to how we believe His Majesty's Treasury ("**HM Treasury**") could implement a new regulatory regime that achieves the intended outcomes, whilst still enabling the UK to remain competitive as a destination for the burgeoning cryptoasset market.

Although we consider the points below in both our general comments for each chapter and in our responses to each question, we have included a summary of our overall position as well as the specific points and recommendations that should be considered alongside our comments and answers throughout this response document.

Overall position

We support the concerted effort to bring cryptoasset activities into a regulatory regime in the UK, a move we believe is key in developing and presenting the UK as a competitive destination for the burgeoning cryptoasset market. We support the "same risk, same regulatory outcome" approach adopted in the Consultation Paper and continued UK commitment to the development, promotion, and integration of international standards, given the cross-border nature of the cryptoasset industry. We agree with the choice to bring cryptoasset activities onshore, at least to the extent that firms wish to have, or market directly to, UK customers.

We aspire for the UK to take a leading role in promoting safe and orderly cryptoasset markets, which in turn would support the further development of the crypto industry as well as the UK's competitiveness as a destination for cryptoasset service providers. We welcome

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the proactive engagement with industry from both HM Treasury and the Financial Conduct Authority ("**FCA**") toward the development of the proposed framework and regime, as well as any ancillary or secondary legislation. We believe that it is critical that the period of time between phase 1 and phase 2 as set out in the Consultation Paper is as short as possible and to keep the UK a competitive international landscape for the cryptoasset industry. We encourage HM Treasury and the FCA to consider broader issues when designing the framework so that the UK moves towards becoming a global hub for the cryptoasset industry, such as the proportionate application of the new financial promotions rules to trading venues, addressing concerns of de-banking by the crypto industry, and the development of a progressive tax policy that addresses the nuances of the asset class.

Specific points/ recommendations

- **Predictable and transparent registration process** – We would support an indicative timeline for the entire application process and welcome detailed, clear and upfront guidance on expectations towards industry by the FCA akin the recent feedback statement on good and bad quality applications under the MLRs.
- **Territorial scope should allow for overseas person exemption** – We consider that the current exclusions in the Financial Services and Markets Act 2000 (Regulated Activity Order) ("**RAO**"), such as the overseas persons exclusion, should apply to investment services and cryptoasset activities alike. This is key to promoting cross-border financial activity and investment in the UK by reducing regulatory barriers and encouraging international firms to do business in the country, utilising offshore platforms that gain access to the UK market via onshore authorised firms.
- **Pragmatic disclosure rules** – We believe that disclosure requirements should provide the right information to consumers but not put disproportionate liability on trading venues. We propose that cryptoasset issuers should have primarily responsibility over preparing admission documents or alternatively that trading venues can produce admissions documents on a "reasonable endeavours" basis. We also suggest international alignment with other jurisdictions to avoid multiple disclosure standards emerging.
- **Custody and safekeeping of client assets is fundamental to building consumer trust** – We propose that trading venues should segregate holdings of cryptoassets on behalf of their clients from their own holdings, and make this verifiable through periodic on-chain checks. Custodians should be able to use third party service providers or engage in sub-custody with parties outside the UK, as is currently provided for in existing regimes, while maintaining liability towards their customers.
- **Setting a global standard for safe, transparent, and orderly markets** – We believe through the adoption of a phased approach to market abuse surveillance and prevention (as detailed below in our responses in Chapter 9), the FCA can lead the global promotion of safe, transparent, and orderly cryptoasset markets.
- **Creation of an asset-referenced stablecoin category** – Although we acknowledge the preference and exclusive acceptability of fiat-backed stablecoins as marketable stablecoins or e-money, we believe that the creation of a broader stablecoin category would be prudent given that algorithmic and crypto-backed stablecoins will continue to have use-cases in cryptoasset ecosystems, such as for trading pairs.
- **Support development of cryptoasset related investment products** – We support bringing the activities pertaining to advising and managing of cryptoassets into phase 2 alongside all investment and risk management activities akin to the regulatory approach taken in the European Union ("**EU**") and Switzerland.
- **DeFi remains nascent and non-systemic and may require new approaches** – We are supportive of HM Treasury's forbearance in seeking to develop a prescriptive framework

for the regulation of DeFi before any international standards and approaches emerge. We would support a separate consultation of industry in the identification and development of industry best practices and potential novel supervisory approaches, such as embedded supervision.

- **Clarity on regulatory treatment of staking** – We would support industry consultation on regulatory treatment of staking in the short term given its growing importance for the cryptoasset industry. We intend to submit a separate paper in the near future to discuss our thoughts on staking in further detail.

Consultation Questions

Chapter 2: Definition of cryptoasset and legislative approach

General comment: We appreciate that HM Treasury has considered "innovation" as a desired outcome, but in our view this does not seem to be explicitly woven into the various proposals set out in the Consultation Paper (apart from being mentioned in the foreword, and the overarching policy objectives and principles). Some of our members also consider that it may be more appropriate to replace references to "cryptoassets" with "digital assets" which would have the effect of bringing the UK in line with modern taxonomy, as well as enhancing the crypto nativity of the response.

1. Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please specify why.

We support expanding the list of specified investments to include cryptoassets, while maintaining flexibility in the application and tailoring of financial services regulation to particular subsets of cryptoassets. However, we would welcome a clearer, more specific definition of the subsets of cryptoassets.

We equally support an activity-based approach to regulation. In that regard, HM Treasury and the FCA should provide clarity on the regulatory treatment of different activities when carried on in relation to different types of cryptoassets. Such a clarification could be, for example, an explanation that Non-Fungible Tokens ("**NFTs**") when used for non-financial services activity (e.g. digital art, music) would be excluded from financial services regulation.

While not a focus of the Consultation Paper, we would also welcome the development of a formal and internationally consistent taxonomy of various subsets of cryptoassets as described in Box 2.A, which should be guided by the unique characteristics of cryptoassets. We appreciate that global regulation is not yet at this stage, although such a development would be beneficial to the cryptoasset industry as a whole.

2. Do you agree with HM Treasury's proposal to leave cryptoassets outside of the definition of a "financial instrument"? If not, then please specify why.

We support the approach of keeping cryptoassets, other than security tokens as set out in Box 2.A of the Consultation Paper, outside the definition of financial instruments. HM Treasury may also consider it prudent to define how cryptoassets meet the definition of specified investment under the RAO.

There are additional rules that apply to financial instruments which from a proportionality perspective would not or should not be applicable to cryptoassets (e.g. requirements under onshored MiFID II). However, we would welcome further guidelines (in addition to what has

already been published) on the criteria and conditions of when a cryptoasset may qualify as a security token and/or financial instrument. The guidance should cover not only cryptoassets but also products that involve cryptoassets (e.g. staking products, which we note vary in set-up and operation) so market participants are clear as to where the regulatory perimeter is relevant and which regulatory permissions should be sought.

3. Do you see any potential challenges or issues with HM Treasury's intention to use the DAR to legislate for certain cryptoasset activities?

In principle, we are of the view that the DAR regime could be used to legislate for the oversight of lower risk activities, alongside the use of the Financial Services and Markets Act 2000 ("**FSMA**") regime to oversee higher risk activities. However, as there is no precedent on how this would be implemented in practice, further clarity would be needed so firms are aware of the perimeter implications and which regime they fall within.

Proportionality would be key, and we would welcome a detailed consultation setting out which activities and cryptoassets fall within the DAR regime, as well as future consultations whenever the DAR regime is utilised to cover new activities and cryptoassets. Furthermore, HM Treasury must ensure that there is FCA accountability under the DAR regime so that regulatory overreach does not occur.

Chapter 3: Overview of the current regulatory landscape for cryptoassets

General Comment: We believe that the creation and implementation of this proposed regime represents an opportunity for the UK to benefit from its separation from the EU, and deliver a competitively differentiated framework that provides room for innovation and growth. In particular, this will also enable the UK to become a more hospitable regime to cryptoasset markets and service providers than the EU (following its adoption of the Markets in Cryptoasset Regulation ("**MiCA**")) and provide an opportunity to attract overseas businesses and investment in a post-Brexit setting.

4. How can the administrative burdens of FSMA authorisation be mitigated for firms which are already MLR-registered and seeking to undertake regulated activities? Where is further clarity required, and what support should be available from UK authorities?

We support the objective of having a single authorisation process for firms conducting cryptoasset activities, as in the long term this will ensure that the process is streamlined and that firms are supervised under one coherent regulatory regime.

The FCA should have regard to previous applications made as well as other updates not included in those applications. We therefore also welcome the commitment to avoid duplicative information requests, consider a firm's supervisory history during the authorisation process, and utilise existing information on the firm to fast track firms through the authorisation process.

In order for applicants to prepare comprehensive and complete applications at the outset, detailed and clear guidance should be published by HM Treasury and/or the FCA. We welcome the recent FCA feedback statement on good and bad quality applications under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 ("**MLRs**") and believe a similar initiative for this and future regimes would be valued by industry.

Furthermore, HM Treasury and the FCA should take a constructive approach to enforcing or expecting compliance for firms moving from registration to authorisation. It is important that HM Treasury and the FCA communicate their expectations clearly and transparently to avoid unwanted surprises that may deter firms from the UK. The FCA should work with firms to enable them to complete the authorisation process, rather than asking them to withdraw application on the basis of minor and easily corrected points. By establishing a stronger collaborative approach with the FCA, we can foster more productive relationships and enhance public opinion throughout the sector.

Having supportive leadership who want all sectors of the industry to thrive in alignment with government policy is key in ensuring that the UK maintains its position as an innovative and welcoming cryptoasset market. We support the CityUK's report on improving regulatory efficiency of authorisations, and in particular welcome greater resourcing of the FCA to be able to deal with future cryptoasset service provider authorisation requests. Resourcing should not only be in terms of the number of staff deployed but also ensuring that the staff who are employed are appropriately qualified and are aware of the nuances of cryptoasset products and services as well as the industry as a whole. This will prevent backlogs of applications, as currently present in other jurisdictions, which could potentially deter overseas organisations looking to expand/relocate into the UK.

An indicative timeline for the entire application process (as is the case under EU MiCA regime) would be welcomed. A staged application process, similar to those implemented during Brexit (where the temporary permissions regime allocated landing slots to firms) would make the process more manageable for both the FCA and for firms who are applying for authorisation. This in turn will help reduce any backlog in application reviews and also ensure that the FCA is not inundated with applications against a tight assessment timeframe. Review and determination periods may also need to vary depending on whether the firm is transitioning from registration or applying afresh. For example, transitional firms should be assessed more quickly than new applications. Clear guidance should be provided (and set out in legislation where permissible) on when the assessment process starts, for example, when an application is submitted, picked up, or marked complete.

Finally, transparency, disclosure, and accountability are essential. It is critical that the public are kept abreast of the FCA's approach and position on applications, and cryptoasset service providers generally. Anonymous metrics with regards to successful applications, withdrawals, and rejections should be published on the FCA webpage on a monthly basis. Further, where the FCA has asked a firm to withdraw an application, the FCA should notify HM Treasury of this and provide its rationale. This approach will help better public understanding and FCA accountability.

5. Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

We understand the delineation proposed by HM Treasury, but believe that greater clarity and further guidance is required to help both industry and the public understand (i) the differences between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2), as well as (ii) the features and the nature of the cryptoassets that are likely to fall within phase 1 or phase 2. More specifically, it would be more plausible to have rules

for stablecoin issuers in a first phase and rules for other cryptoasset service providers later, under which scenario custody rules for stablecoins by other cryptoasset service providers would only be applicable in the second phase.

For example, some areas that require further clarity would include (please note that this is not an exhaustive list):

- Phase 1 focuses on "issuers, custodians and payment service providers for fiat-backed stablecoins" and "does not capture exchange or trading activities of stablecoins". When exactly does exchange become custody in the context of stablecoins?
- What is the position with regards to non stablecoin payment tokens?
- Are there intended differences between "fiat backed stablecoin", "fiat backed stablecoin used for payment," and "stablecoin with propensity to be used for payment" as these phrases seem to be used interchangeably throughout the Consultation Paper and HM Treasury communications? If so, how is "used for payment" to be defined?
- Does phase 1 include all stablecoins or only those used for payments?

6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

We appreciate that a single approach may be difficult, and that a phased approach may be more feasible and in line with other jurisdictions. As such, we would welcome indicative timelines for the completion of the necessary secondary legislation for both phases, which we believe should be completed and implemented as a priority. We consider that legislation should be brought in within the next 12 months and implementation of both phase 1 and phase 2 by the end of 2024. We also consider that FCA should consult on their proposed rules for both phase 1 and phase 2 as soon as possible, similar to the approach they have taken with the changes to the financial promotions regime (CP 22/27).

We would support greater clarity on what rules, principles, and guidance would apply to firms that are authorised under phase 1, with respect to their phase 2 activities (if any), during the interim period where the phase 2 regime has not yet come into effect. It is important that firms authorised under phase 1 are not expected to apply the full suite of legislative requirements and FCA rules to products and services that are not yet within scope of the regulatory perimeter, whether under phase 2 or otherwise.

A timely implementation would position the UK competitively against other jurisdictions, including the EU's MiCA regime. We would also welcome clear and sufficient timelines to allow for the operationalisation of any future requirements.

Consequently, it is essential that there are transitional provisions for (i) cryptoasset service providers that are registered under the MLRs while they apply to be authorised under FSMA, and (ii) firms with FSMA permissions that would be required to vary the scope of their permissions to comply with the transition from phase 1 to phase 2. These transitional provisions and the clarity with respect thereof would be critical in ensuring the successful integration of cryptoassets within the UK regulatory perimeter.

Chapter 4: Cryptoasset Activities

General Comment: None.

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

Generally, we support the proposed territorial scope of the regime to capture cryptoasset activities provided in or to UK persons, although greater clarity on when a customer is deemed to be in the UK would be of great value to the industry.

Certainly, we consider that firms based in the UK should be regulated under the proposed regime, and support the push to tighten the regulation of the cryptoasset industry. However, the proposed rules should be applied proportionately to activities provided to UK persons by firms based outside the UK. At present, under FSMA the applicable territorial scope for overseas firms very much depends on the activity being carried out, and different activities such as arranging, dealing, and investment advice have specific considerations when determining whether that activity is “carried out in the UK”. We believe more consideration should be paid to the individual nuances of each activity in a cryptoasset context, and that the application of the proposed territorial scope should be proportionate to the activity or activities carried out by individual firms.

The proposed territorial scope applied to a cryptoasset related activity should not be more wide-reaching than the scope currently applied to the corresponding existing financial service activity, such as investment services. The proposed territorial scope of the regime appears to take a new approach to the UK’s usual territorial scope rules in relation to existing activities under the RAO, and thus marks a departure from the UK Government’s stated approach of “same risk, same regulatory outcome”.

It would also be important for the industry to understand how enforcement against overseas entities providing their services to UK customers would be enacted where there is no place of business or person within the UK to whom this could be enforced against.

We would also welcome clarification on the exemptions proposed by HM Treasury in the Consultation Paper, namely the proposed “reverse solicitation” and “equivalence” exemptions. We would appreciate clarity on what constitutes “reverse solicitation”, how that exemption would be applied in practice, and how this would fit in with the overseas persons exclusion (which itself incorporates the concept of reverse solicitation as a permitted route for overseas firms to do business with UK customers, depending on the regulated activity).

We also consider that the current exclusions in the RAO, such as the overseas persons exclusion mentioned above, should apply to cryptoasset activities. These exclusions play an important role in promoting cross-border financial activity and investment in the UK by reducing regulatory barriers. For example, the overseas persons exclusion allows international firms to utilise existing offshore platforms and gain access to the UK market via onshore authorised firms, which may otherwise be inaccessible due to prohibitive regulatory or operational costs. As such, we believe these exclusions should be extended to firms operating within the cryptoasset space, and we would be happy to provide further clarity on this point if helpful.

Similarly, we would welcome further information on future equivalence arrangements that HM Treasury proposes to pursue, particularly in relation to the process and timing, as this could reduce the need for dual authorisation of firms operating outside of the UK when they have UK customers (for example, if the new regime enters into force before the equivalence arrangements, then this dual authorisation burden would not be reduced). Additionally, given the highly cross-border and decentralised nature of cryptoassets and cryptoasset related

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activities, we believe that HM Treasury should take an active role in facilitating better information exchange between regulators and trade bodies in various jurisdictions and especially where equivalence is sought. This would facilitate industry and regulatory clarity on enforcement, standards, and best and worst practices, as well as to prevent abuse and regulatory arbitrage across jurisdictions. Finally, the territorial scope should conform with the characteristic performance test, which has traditionally been used to determine where a particular regulated activity takes place.

8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

We are broadly supportive of the proposed list of cryptoasset activities that will be brought within the scope of the regulatory perimeter in Phases 1 and 2 (as set out in Table 4.A of the Consultation Paper), subject to our other comments in this response such as in relation to staking, NFTs, advice, and portfolio management. It is important that clear rules and guidance are published on the scope of the proposed economic activities to ensure that there is no room for uncertainty, and that the industry is aware of how cryptoasset activities fit within the UK regulatory regime.

Furthermore, we note that paragraph 4.8 of the Consultation Paper states that "*the list is not exhaustive and activities with a very similar nature, purpose and risk profile could also be captured in the perimeter*." It is critical that the industry can comment on any such extension of this proposed list of economic activities prior to any legislative developments being brought into force. This will ensure that the process remains collaborative between the legislator, the regulator, and the industry. We also consider it key that the various exemptions already set out in the RAO apply to cryptoasset activities in the same way as they do for traditional finance activities, to ensure that firms interacting with cryptoassets are not subject to more burdensome regulation than their counterparts within the existing financial services space.

Finally, we would also like to reiterate our previous points on timing (raised in our comments for Chapter 3 above), particularly in ensuring that the gap between phase 1 and phase 2 is as short as possible to avoid having firms left in a position of regulatory uncertainty.

9. Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?

We are broadly supportive of the proposed prioritisation to bring cryptoasset activities within the regulatory perimeter. However, and as above in Chapter 3 and question 8, we consider that it is critical that the period of time between phase 1 and phase 2 is as short as possible.

We would equally support bringing the activities pertaining to "advising" and "managing" into phase 2 alongside all investment and risk management activities, rather than into a future phase to support the development of cryptoasset-related investment products in the UK, akin to the regulatory approach taken in the EU and Switzerland. As a general point, and notwithstanding our comments for question 5 and 6, we would be grateful for more clarity on the rationale behind (i) the phased approach generally, (ii) the categorisation of cryptoasset activities as currently proposed, and (iii) why HM Treasury considers that certain activities require greater prioritisation than others.

Furthermore, as stated later in our response, we would welcome clarification of the regulatory treatment of staking in the short term, given its growing importance for the cryptoasset industry. We believe that the pledging of tokens (while maintaining ownership) for the

validation of transactions and security of a given network should not have the existing rules for collective investment schemes applied to it and indeed that it should be excluded altogether. We intend to submit a separate document to detail our preferred regulatory treatment of staking.

10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?

We appreciate the risks highlighted by HM Treasury with regards to vertically integrated business models (e.g. trading venues) that also potentially provide a combination of activities (such as custody, post-trade activities, proprietary trading, and/or lending). However, we consider that it is possible for cryptoasset firms with vertically integrated business models to carry on these various activities and "wear multiple hats", especially considering that such arrangements are currently permitted in the traditional finance space, with certain firms able to engage in both proprietary trading and client facing activities (subject to the appropriate regulatory supervision and compliance).

We consider that these risks can be addressed by a combination of the appropriate conflict of interest rules, risk management systems and controls, and the tailoring of proportionate regulatory requirements to each cryptoasset related activity. We would support the adoption of an approach similar to Dubai's Virtual Asset Regulatory Authority ("***VARA***"), which employs:

(i) compulsory rulebooks governing:
   a. companies;
   b. compliance and risk management;
   c. technology and information; and
   d. market conduct; and

(ii) separate activity based rulebooks that include specific requirements with respect to issuing virtual assets.

We of course appreciate that there will be some scenarios and business plans where this approach may not be suitable or sufficient (i.e. where it may not be permissible for a particular firm to wear "multiple hats"), but consider that the industry should be involved in discussions and should be able to comment on such deliberations prior to any final rules being made.

11. Are there any commodity-linked tokens which you consider would not be in scope of existing regulatory frameworks?

No response.

12. Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?

We understand that HM Treasury recognises that it is important to distinguish between so-called algorithmic stablecoins and those backed by either central bank or commercial bank money.

We understand that only fiat-backed stablecoins are likely to be considered and/or allowed to be marketed as stablecoins or e-money by regulators in this first phase of regulation, and even then only with the application of the appropriate e-money regulatory permissions. We encourage HM Treasury to make a clear distinction between payment stablecoins that are collateralised by high quality liquid assets and so-called "algorithmic stablecoins" that do not employ a similar collateralisation mechanism. Further, HM Treasury should clearly differentiate tokenised traditional assets (i.e. tokenised cash such as e-money) as a category separate from tokens that use higher risk traditional assets (such as commercial debt, or other less liquid instruments) in their reserve or as a stabilisation mechanism, and cryptoassets that are "stabilised" by any type of "algorithmic" mechanism that is endogenously collateralised.

We agree that algorithmic stablecoins, crypto-backed tokens, and unbacked cryptoassets all require regulation in the UK, and that so-called algorithmic stablecoins should be regulated in the same way as unbacked cryptoassets, and that the government ensures that the same 'systemic' regulation is also applied to so-called algorithmic stablecoins. The creation of a specific category that includes algorithmic stablecoins, crypto-backed tokens, and unbacked cryptoassets would be prudent and reflect the reality that these cryptoassets continue to have use cases in cryptoasset ecosystems, such as trading pairs. This new category or regime would be similar to the EU's MiCA regime towards asset referenced tokens.

However, it is important to note that the exact scope of rules that apply to firms carrying on activities related to these types of assets (e.g. the applicable FCA rules) will need to vary and take into account the differences in composition, natures, and risks related to each of these types of cryptoassets. For example, under the proposed regime, the client asset rules related to crypto-backed tokens would be much more extensive than the client asset rules related to unbacked cryptoassets (the latter of which may be more light touch). It is important the industry has the ability to comment on the specific rules that will apply to these types of cryptoassets at the appropriate time.

13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

At the outset and as per our previous answers, we (and the industry generally) would greatly value a detailed definition of NFTs and of utility tokens from HM Treasury. In response to the question posed, we consider that there should be a specific exclusion relating to NFTs and utility tokens from the proposed regime, as in our opinion a true NFT and/or utility token bears no resemblance to traditional financial instruments or specified investments. They are, in the majority of cases, not used in the context of financial services and we believe that the application of the proposed cryptoasset activities to these tokens would be disproportionate and their exclusion from FSMA should be clearly stated in the proposed legislation. We consider that their inclusion in MLRs should be sufficient to ameliorate risk. We would also like to highlight the approach of the German regulatory body BaFIN, which has yet to identify any NFT as suitable for regulatory classification as a security, given that NFTs usually provide its holder with individual rights and content and as such standardisation and tradability in the regulatory sense do not apply.

Furthermore, we note that the EU's approach to Asset-Referenced Tokens (ARTs) considers the specific nature and use cases of both utility tokens and NFTs, and has both a general exemption for ARTs as well as specific exemptions for certain types of utility tokens. We believe that the UK should consider other regulators' approaches and exclusions in formulating its proposed treatment of NFTs and utility tokens. In addition, we believe there is

an opportunity here for the UK to go further than the EU and create clearer guidance and detail on what may be considered permissible use cases of NFTs and utility tokens, possibly to the extent of creating a separate regime for NFTs and utility tokens. We believe that the provision of clear guidance relating to the regulatory perimeter for these tokens would give the UK a competitive advantage over other jurisdictions by demonstrating its commitment to supporting creative digital industries and professions, and cultivating a cultural workforce which merits promotion and protection.

Chapter 5: Regulatory Outcomes for Cryptoasset Issuance and Disclosures

General comment: Our concern for this Chapter is that the obligations imposed on both exchanges and issuers may be too onerous and would make the UK regulatory regime less attractive than those in other jurisdictions. While we recognise the difficulty in balancing this issue against the need to protect consumers (and retail consumers in particular), we consider that the wholesale and blanket application of the regimes that currently apply to traditional trading venues and issuers would be disproportionate to cryptoasset trading venues and issuers.

It is important that the UK develops a regulatory regime which is flexible and adaptable to future changes, particularly given the fast moving nature of the cryptoasset industry and the development and adoption of its underlying technology. HM Treasury should ensure that the approach to cryptoassets and cryptoasset services is bespoke where necessary, and takes into account any specific nuances and features of these products, including how they could develop in the future.

Separately, as a general point and as applicable to other Chapters in the Consultation Paper, where cryptoassets have gone through a robust issuance and disclosure process, HM Treasury and the FCA should consider the possibility of other entities relying on, or utilising, the information provided by the issuing entity during those processes.

14. Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

We support the push to onshore cryptoasset trading venues, and as such agree with the admission (or seeking of admission) of a cryptoasset to a UK registered trading venue being recognised as a regulatory trigger point. We propose that a public offer of cryptoassets should only trigger regulation if the cryptoasset is offered by a UK firm or directly targeted at UK persons. Conversely, general offers by non-UK firms (which may for example, be available to UK persons over internet, but are not directed at them specifically) should not trigger UK regulation.

Furthermore, we think there is value in having different and tailored approaches to admissions that amount to public offers and those that merely facilitate secondary market trading. This would recognise the different risks applicable to a token issuer seeking public investment, as opposed to investors trading well-established tokens with each other. It would also be more consistent with the treatment of primary and secondary markets in traditional finance.

We also consider that it is important to maintain a level playing field with offshore trading venues through clear guidelines on what may constitute reverse solicitation, to avoid any arbitrage as well as facilitate effective enforcement.

We would also welcome clarification as to whether the definition of a public offer excludes or captures public offerings on decentralised exchanges and launchpads.

15. Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

After extensive consultation with our members, we have reached a position where the majority of our members support this proposal, although there remains some disparity in opinion between different members (themselves representing different components of the industry) as to the extent of such support.

We support trading venues defining content requirements, but believe that it will be important to ensure a consistent requirement of information across trading venues to prevent creating disparity and unequal burdens for issuers, as well as to assess the reliability of the asset or risk of market manipulation (by way of facilitating certain minimum standards). We believe that a standardised template would be useful, and propose that it should be prepared by a regulatory body (such as the FCA) in conjunction with an industry or trading venue panel to ensure it is appropriately bespoke for the cryptoasset industry. For context, the EU's MiCA regime takes this approach to its whitepaper requirement to issuers, as does Japan through the self-regulating role it gives to industry bodies.

We also support allowing trading venues to have their own cryptoasset admission/listing rules in line with certain minimum standards to, for example, assess the reliability of developer teams or the risk of market manipulation, with a view to reject any admission of cryptoassets that could result in investor detriment or harm.

Furthermore, we propose that responsibility to perform proper and appropriate due diligence should lie with trading venues, as this enforces accountability throughout the transaction chain, particularly when the issuer of the token is not identifiable.

We would like to highlight that some of our members believe that the concept of due diligence (as currently understood in traditional finance regulatory regimes and proposed in the Consultation Paper) does not account for various fundamental differences between traditional securities and cryptoassets. The proposals are closely based on traditional finance regulation, which consequently mean they fail to consider situations specific to cryptoassets, such as where there is no traditional issuer, or where an issuer does not applying for admission and simply lists a token. Some members believe that due diligence can in some scenarios be particularly difficult for exchanges to conduct, for example where a project becomes progressively more decentralised and the onus would be on the exchange to identify and contact the original or initial "issuer" to obtain and publish information about disruption events. As such, some of our members believe that a more bespoke regime tailored to cryptoassets is necessary.

Finally, we consider that firms should be able to use publicly available information in their disclosure documents where there is no issuer or an issuer cannot be identified, given that the necessary information cannot be obtained directly from the issuer.

16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?[1]

[1] This draft response is subject to further input from bigger exchanges.

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We believe that the liability position should differentiate between whether there is an issuer of the cryptoasset present or not. Where there is an issuer, the issuer should have primary responsibility over the preparation of the admission documents, as only they have access to all the relevant information. Major and recent advancements in distributed ledger technology are making this kind of enforcement more feasible.

Where an issuer is not present, including where a project matures, trading venues should have liability only to ensure that admission disclosure documents are in line with the FCA rulebook requirements and to produce admission documents for cryptoassets without an issuer on a “reasonable endeavours” basis. In this case, the FCA guidance would need to be specific, with sufficient granularity, to ensure the trading venues are not overly burdened and to ensure that the requirements are achievable in practice. The industry should be involved and have the opportunity to comment on any such guidance.

As mentioned in our answer to question 15, we propose that firms should be able to use publicly available information in their disclosure documents. Our intention behind this proposal is not to reduce the liability of a firm that relies on such information when preparing and publishing the disclosure documents, but rather to create a proportionate scale of liability that is based on the nature of the documents and the context of the cryptoasset vis a vis the presence of an issuer (as per our comments more generally for question 15. We would also like to reiterate that it would be unreasonable to apply the existing regime under MiFID without first tailoring it to the cryptoasset market and the nuances that apply to cryptoassets given the fundamental differences between cryptoassets and traditional MiFID assets, as highlighted previously. We would be happy to provide further information on this point if helpful.

We also believe that any prudential requirements should be proportionate to the risk of losses arising from liability in regard to a specific cryptoasset (e.g. the liability for Bitcoin will differ to any liability for a meme coin). Our opinion is that prudential safeguards should give the choice between maintaining an adequate levels of own funds or entering into professional indemnity arrangements. However, prior to implementation, the insurance industry should be involved in the development of any such requirements to ensure that the relevant professional insurance can and will be made available, as otherwise these requirements may be difficult to satisfy in practice. We encourage HM Treasury, the Bank of England, the Prudential Regulation Authority, and the FCA to be involved in this process and ensure that the insurance industry is in a position to provide suitable insurance products.

As a separate point, we also propose that there should be grandfathering of disclosure requirements for cryptoassets that are already listed on trading venues before the UK legislation enters into force.

17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?

We support the proposed information test, but believe that the risks posed by investments in unbacked cryptoassets (and cryptoassets which share similar features to unbacked cryptoassets) are almost impossible to objectively measure. In light of the liability proposed for the entity responsibility for the preparation of admission disclosure documents, we would welcome clarity on how the “prospects and risks” of these types of cryptoassets should be described in admission disclosure documents, and suggest that a high level requirement which is no more prescriptive than the MiFID approach (as onshored in the UK) with respect to investments should be introduced.

We also suggest alignment with other jurisdictions to avoid multiple standards emerging and to also account for the variation in disclosure requirements required for different types of cryptoassets.

18. Do you consider that the intended reform of the prospectus regime in the Public Offers and Admission to Trading Regime would be sufficient and capable of accommodating public offers of cryptoassets?

We believe that when there is a public offer, the proposed reforms of the prospectus regime should be applied equally to the cryptoasset market, as it will to securities in the traditional finance space.

Chapter 6: Regulatory Outcomes for Operating a Cryptoasset Trading Venue

General comment: None.

19. Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

We support the use of existing RAO activities to cover the operation of trading venues as the basis for the regulation of cryptoasset trading venues, insofar as they consider and accommodate the specific characteristics and risks of cryptoasset trading activities.

20. Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?

We are generally supportive of the proposed design features for cryptoasset trading regimes, and would welcome a UK regulatory framework that pursues as much international consistency as possible. We welcome the recognition of, and support for, the use of blockchain analytical and reporting tools for obliged entities to satisfy regulatory demands, and believe that the UK can play a leading role here. We would also encourage alignment with other jurisdictions to ensure the UK remains an attractive venue.

However, we caution that certain nuances specific to the cryptoasset industry, and the technological differences between the cryptoasset industry and the traditional investment space, must be taken into account so that the regime is tailored to the nature of the industry. For example, order book data is sensitive proprietary information for "Over-The-Counter" venues, and as order books are generally in a ledger, requiring a hash for every executed trade would be an overly burdensome obligation and in any case near impossible to satisfy.

Furthermore, whilst we broadly agree with the location requirements, firms must be able to conduct certain activities related to the businesses outside of the UK (e.g. using third party service providers and/or outsourcing to other group entities in other jurisdictions).

Finally, we believe that prudential safeguards should allow firms the flexibility to use own funds or rely on professional indemnity insurance to meet their capital requirements, as is currently available with other regulatory regimes in the UK.

Chapter 7: Regulatory Outcomes for Cryptoasset Intermediation Activities

General comment: None.

21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

We support the use of MiFID derived rules as a basis for the high-level regulation of cryptoasset intermediation activity providers, such as dealers and liquidity providers, as long as the implementation of these rules, particularly at the rulebook level, accommodates the specific characteristics and risks of cryptoasset trading activities. For example, best execution in relation to cryptoassets presents different challenges to best execution in a traditional finance context, and any regulatory approach should reflect these differences.

22. Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?

We support the proposals to introduce proportionate prudential requirements for cryptoasset firms engaged in cryptoasset intermediation activities. However, we believe that the prudential requirements need to be more tailored, so that they are proportionate to risk, balanced with investor protection and market integrity. This is analogous to the different requirements (both prudential and otherwise) that apply to different MiFID firms depending on their activities. We also believe that prudential requirements should include both insurance and regulatory capital requirements to ensure the barrier to entry is not too high for new entrants. As mentioned above, prudential requirements may observe leaner stability standards than traditional finance counterparts, given that the sector is still currently less developed.

We believe that adherence to consumer protection, governance, and operational resilience requirements is key to enabling well-functioning markets. Reporting requirements should focus on making on-chain transactions visible. We welcome more clarity on “best execution” expectations as this can be difficult to demonstrate where there are so many venues where orders can be executed, as well as incorporation of more cryptoasset specific concepts such as slippage in liquidity pools.

Chapter 8: Regulatory outcomes for cryptoasset custody

General comment: None.

23. Do you agree with HM Treasury’s proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

We are supportive of the proposal to apply and adapt the existing framework for traditional finance custodians to the specifics of cryptoasset custody activities, provided that there is a clear set of definitions of the types of services that are included in its scope. It is important to distinguish between custody infrastructure providers and providers of regulated custody services.

We proposed that software developers or providers of self-hosted wallet infrastructure, whose functions are limited to the development and/or sale of the software/hardware for self-hosted wallets, should be excluded from the scope of cryptoasset custody regulation. HM Treasury should consider the guidance and approaches of other regulators and governing bodies, such as the Financial Action Task Force (“**FATF**”) and VARA, to ensure that there is international consistency.

We believe that custody should also be determined on the basis of who has control of the cryptoasset. In this regard, HM Treasury will need to design the legislation to be innovative and consider future changes to the type and nature of the control exercised over the asset. For example, recent technological advancements have led to a shift in the industry towards the inclusion of accounts controlled by smart contract code, which in turn allows for effective custody on the basis of codes rather than keys.

Some of our members consider that cryptoassets custodians should have similar flexibility in their custodial holding patterns as traditional securities custodians under the FCA's clients assets sourcebook.

Whilst we agree with the proposal to apply and adapt the existing custodian framework, we note that in the cryptoasset industry exchange services are often combined with custody of trading assets as this allows for real-time settlement. This benefit comes with no meaningful risk of misalignment between the incentives of the custodian and the exchange, as the custodian holds the assets, and the exchange matches orders to buy and sell those assets.

24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

We generally support the proposals and we note and/or propose the following points in particular:

- Cryptoasset trading venues should segregate holdings of cryptoassets on behalf of their clients from their own holdings, and make this verifiable through periodic on-chain checks;
- We support legal segregation of cryptoassets to ensure clients' cryptoassets are insulated against the claims of creditors in the event of a custodian's insolvency;
- Segregation at an individual client level is neither necessary nor feasible, as it makes implementation unduly burdensome. An omnibus or nominee account structure, as is currently allowed under the existing regime, is feasible and preferrable;
- Cryptoasset trading venues' custodial liability rules should be similar to those of investment firms when they have control over assets or funds belonging to customers. Thus, custodians should only be liable for any loss or harm suffered by the customer if this is due to fraud, wilful default, or negligence, including the unjustifiable failure to perform their legal obligations in whole or in part;
- Liability and obligations should rest with the custodian, and not a sub-custodian, where this is relevant;
- Stability standards should be equal to traditional finance counterparts. Sufficiently secure storage requirements and audits are an important part of operational resilience;
- We support applying the Financial Services Compensation Scheme ("**FSCS**") protection rules to cryptoassets, to ensure both the benefit and obligations of the traditional finance regime are applied to cryptoassets; and
- Custodians should be able to use third party service providers, outsource, or engage in sub-custody with parties and persons outside of the UK, as is currently provided for in existing regimes.

Chapter 9: General Market Abuse Requirements

General Comment: We consider that the cryptoasset market abuse regime should be implemented through a phased approach similar to that of the proposals regarding regulated activities. Implementation of the market abuse regime should be staggered in order to avoid burdening firms with sudden and extensive compliance and administrative obligations, and an insufficient amount of time to prepare.

A potential timeline of phases could be based on the following elements:

- Phase 1 – Application of venue responsibility for activity on their own venues, and FCA responsibility of activity of the market;
- Phase 2 – Venues connect and find ability to share information and knowledge in a manner that is compliant with their business models and the industry more generally; and
- Phase 3 – Trade surveillance and international cooperation.

We consider that sharing customer-level data and establishing public “blacklists” would be inappropriate. Market operators in traditional finance do not have these obligations, which raise significant privacy concerns and are likely to prove impractical.

Separately, while we acknowledge the role of issuers, trading venues, and market participants in policing market activity (as further elaborated below), we believe that the FCA should take ultimate ownership and responsibility of ensuring that the market is clean, orderly, and transparent. The FCA has the greatest access to data (e.g. suspicious transaction reports) of any single entity, and has the appropriate resources and oversight to monitor the market holistically. As such, it should be the FCA that implements the appropriate market conduct requirements and undertakes the monitoring and enforcement of compliance with such obligations.

In contrast, trading venues do not have access to the level of data necessary to enable them to do this efficiently, nor would it be efficient in terms of both time and costs for each trading venue to attempt to police the market as a whole. Finally, we do not believe it would be feasible or appropriate for a venue to decide when and how an instance of market abuse has occurred, but instead believe it would be more appropriate the venue to raise their suspicion to the regulator, who would be more able to decide whether such market abuse activity has occurred.

25. Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?

We acknowledge that the highly globalised, fragmented, and borderless nature of cryptoasset markets makes the cross-border challenges of identifying and controlling market abuse behaviours more difficult. Other challenges that are specifically relevant to the cryptoasset industry include, for example:

- The use of code;
- The role of validators in ordering transactions; and
- Nuances in relation to on-chain and off-chain risks.

We support the UK (potentially through the FCA) taking a leading role within the International Organisation of Securities Commissions (“**IOSCO**”) in the development of minimum global market integrity standards for cryptoasset trading venues (including adoption of trade surveillance systems), as well as in fostering the exchange of relevant information between trading venues (with data anonymised as necessary) and with/between regulatory supervisors. The industry should also be involved with this to ensure that the regime is tailored to the nature of the cryptoasset market and is not simply an application of the traditional finance regime without modification. For example, the parameters used to identify actions that may be considered market manipulation in traditional finance may not be directly applicable regarding cryptoassets, due to the technological differences of the latter.

As above in our general comment for this chapter, we also consider it critical that the FCA takes a significant role in directly enforcing the market abuse regime against market participants and has ultimate responsibility for implementation and enforcement. Such responsibility should not rest on the issuer, trading venue, or the market participant.

26. Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?

We agree that the market abuse regime should be focused on cryptoassets that are admitted to trading on a centralised venue, regardless of where the trading activity takes place, as many centralised exchanges run a global order book. We consider that global application is permissible on the basis that "exchange denominated" public blacklists are not required.

27. Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?

We agree that the prohibitions should be broadly similar to the UK Market Abuse Regulation ("**MAR**"). We also welcome a legislative proposal to reflect on other cryptoasset-specific market abuse challenges. Other specific nuances related to code orders and code standards should be taken into account, as well as any bespoke aspects of the cryptoasset market. The regime must be applied proportionately to the cryptoasset market and tailored accordingly.

28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?

We agree that the primary responsibility should be on the trading venues to prevent, detect, and disrupt market abuse relating to activity on their own venues only. However as mentioned in the general section of this chapter, we consider that the FCA must also take responsibility and accountability and be responsible for implementing and enforcing a robust market abuse regime in the UK more widely. Where anomalies are flagged by trading venues, this should in turn be flagged to the FCA and the FCA should then take ownership and responsibility of what happens based on the further information it has and its holistic oversight of the market. Trading venues should only be responsible for activity on their own venues, the FCA as a regulator should be responsible for market abuse activity in the market as a whole as it is the FCA that has access to comprehensive information and oversight of activity of different participants.

We would also welcome the organisation of roundtables and other collaborative initiatives to assess opportunities for greater cooperation between trading venues (e.g. such as shared lists of potential bad actors). As a founding member of the Crypto Market Integrity Coalition (CMIC), CryptoUK can utilise this forum to support any MAR initiatives. We believe that "exchange denominated" public blacklists would be unsuitable for purpose, unworkable in practice, and would not account for due process alongside with human rights considerations. Additionally, the sharing of personal data between trading venues in a non-anonymised manner could be problematic and be in breach of data protection rules across certain jurisdictions, with this being equally unworkable.

29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?

We believe that the FCA's 'Innovation Pathways' and 'Digital Sandbox' initiatives could be leveraged to support start-up and more established providers in the RegTech space to support the development and uptake of market abuse and trade surveillance services and products. This could inform the development of FCA guidance on what constitutes best practices to encourage all industry participants to take further steps towards prevention, detection and disruption of market abuse. Additionally, industry round tables (in collaboration with trade bodies, HM Treasury, and the FCA) may also be a useful tool to share information and know-how.

30. Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?

We generally support the use of insider lists to limit the flow of Material Non-Public Information (MNPI) and track activity of those that have it within cryptoasset trading venues, provided that there is clear guidance on what constitutes MNPI in the context of decentralised networks like those present in cryptoassets.

Please note that some of our members disagreed with the use of insider lists and take the view that while there should be an obligation on the issuer to have an insider list (or persons acting for and on behalf of the issuer), requirements for insider lists for general market participants should not be imposed, particularly because the MAR does not impose these requirements on such a wide range of participants in traditional finance.

Chapter 10: Regulatory outcomes for operating a cryptoasset lending platform

General comment: As a general comment, we believe that the proposals need to clearly distinguish between activities that are:

- akin to retail banking – we suggest these should be heavily regulated;
- akin to consumer lending – we suggest these should be regulated in a similar way to the current consumer credit regime; and
- akin to wholesale borrowing and lending – we suggest these should not be regulated at all,

in line with the existing regime in traditional finance.

We welcome clarity on what is and is not considered within scope of cryptoasset lending and note that cryptoasset staking, or the supply of liquidity, are not the same as cryptoasset lending. See further in our response to question 35 below.

31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?

We agree that the main regulatory challenges posed by cryptoasset lending and borrowing platforms are related to capital and risk disclosure requirements. We believe that staking and supplying liquidity providers should be treated separately from the regulation of operating a centralised cryptoasset lending platform as these activities are inherently different. Separately, a distinction between retail and wholesale activities is key, with only the former subject to consumer protection rules and authorisation requirement.

We intend to submit a separate document to detail our preferred regulatory treatment of staking.

32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?

We agree that risk warnings and disclosures (e.g. terms of legal ownership, lack of FSCS protection, etc.) play an important role in ensuring that a minimum standard of information is available to enable consumers to make informed risk-based decisions. However, this would not have prevented the failure of certain cryptoasset lending platforms or mitigate the harms which consumers suffer because of the failure of cryptoasset lending platforms. We therefore welcome the emphasis on the imposition of effective capital and liquidity safeguards and, if applicable, ring fencing of retail funds in case of insolvency.

33. Do you agree with the idea of drawing on requirements from different traditional lending regimes for regulating cryptoasset lending? If so, then which regimes do you think would be most appropriate and, if not, then which alternative approach would you prefer to see?

We are supportive of HM Treasury's idea of drawing on regulatory requirements from different traditional lending regimes to cover the various business models that have been adopted by centralised cryptoasset trading platforms, only insofar as the risks and activities of such operators are comparable. However, this would only apply to true cryptoasset lending platforms and not cryptoasset staking platforms. As such, we welcome regulations being tailored to account for different business models and further clarity on its scope.

We are broadly supportive of a mixture of consumer credit regulation and FCA conduct of business rules concerning margin requirements to apply to these true cryptoasset lending platforms.

34. Do you agree with the option we are considering for providing more transparency on risk present in collateralised lending transactions?

We agree with ensuring customers understand the risks associated with cryptoasset lending protocols, and believe that the disclosure provisions under the FCA Conduct of Business Rules would provide a good basis for these rules.

Conversely, we believe that the disclosure provisions derived from the Securities Financing Transactions Regime are not suited to regulating cryptoasset consumer lending, given that their primary objective is to allow regulators to monitor systemic risk across wholesale credit markets.

We appreciate that disclosure would not change the underlying position and risks, and that the incoming financial promotion rules would also require promotions to be clear, fair, and not misleading.

35. Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?

We believe that the regulatory treatments between lending and staking, and supplying liquidity, ought to differ, and that the transfer of title is a key differentiator between these products. Cryptoasset staking involves locking cryptoassets for a set period of time to support the operation of the blockchain, and the ownership of the assets is retained. Likewise, liquidity providers retain the ownership of their assets and can withdraw their liquidity anytime. This is in contrast to cryptoasset lending, where ownership is transferred, thus creating different risks.

We appreciate that, historically, some cryptoasset lending products have been marketed as cryptoasset staking. However, true cryptoasset staking presents lower risks to consumers

because of this lack of transfer of title to the staked cryptoasset, and so should not be subject to the same capital requirements and risk disclosures.

We welcome the development of a bespoke regulatory framework for staking and regulatory guidance on how and when existing staking products and services may fall within the regulatory perimeter.

We intend to submit a separate document to detail our preferred regulatory treatment of staking.

Chapter 11: Call for Evidence: Decentralised Finance (DeFi)

General comment: Our suggestion is that the UK should consider how the international approach develops before forming its own rules, as this area is developing and requires a broader, longer term view. We must keep in mind that DeFi presents different risks and as such, replicating existing frameworks set out in traditional finance and/or for centralised cryptoasset finance may not be feasible. The DeFi regime should be tailored to the nuances of the DeFi market.

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

We agree with the assessment of the unique challenges that DeFi presents, especially when applying existing financial services regulation that usually relies on the authorisation and supervision of individuals and firms undertaking specified activities. However, we would strongly encourage a clear definition of what activities fall in scope of DeFi, and which are instead considered “CeFi.” We also believe it is key to monitor and mitigate risks as they relate to how centralised finance and DeFi interact, as evidenced from the Mango Markets exploit.

We would caution against the notion raised in paragraph 11.6 of the Consultation Paper of defining the action of “establishing or operating a protocol” as a regulated activity under the RAO (or DAR) and requiring the persons carrying out those activities to receive authorisation from the appropriate regulatory body. This will drive any and all cryptoasset business away from the UK and in any case is not possible to enforce. The establishment and operation of a protocol should not require authorisation.

A better approach may be to use the embedded supervision approach which is used in the EU. We believe it is important to present a positive approach that supports innovation and considers what decentralisation could look like as it evolves, to ensure the UK remains an attractive and competitive location.

37. How can the size of the “UK market” for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?

We understand the importance of these questions and that it would be helpful for HM Treasury to understand the size of the market under its jurisdiction in the UK. We believe one option to gauge the UK market for DeFi would be to work with remote procedure calls (“**RPC**”) providers, which are technology protocols used by blockchains that enable the nodes in a network to communicate with each other and verify transactions. The RPC provider Infura recently announced the collection of IP addresses of users that interact with the blockchain through their service. Thus, it could be possible to obtain information from RPC providers in order to geographically categorise DeFi-related segments. We also like to

refer to a [Chainalysis Global DeFi Adoption Index] and [the Chainalysis 2022 Geography of Cryptocurrency Report].

38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?

We agree that HM Treasury should avoid seeking to develop a prescriptive framework for the regulation of DeFi before any international standards and approaches emerge. These standards could include technical standards, such as conducting regular, independent code audits and IT security tests, as well as standards around information disclosures about services provided and associated risks. We also note that such innovation would need to account for the different activities and risks that are inherent to DeFi and how emerging technology can revolutionise checks (e.g. KYC checks), and set new international standards.

We believe that an international approach to regulation of DeFi activities is required given the global reach of DeFi protocols that have no operational address. We agree that centralised business models which brand and market themselves as DeFi should be subject to the same regulatory treatment as CeFi activities. However, we note that DeFi does not subscribe to individual jurisdictions in the way that traditional finance does, and so welcome clarity on how this will be practically enforced.

We would suggest this be looked at as a progressive technological growth that needs to be allowed to mature and innovatively managed and regulated, instead of being limited by traditional regulation.

39. What indicators should be used to measure and verify “decentralisation” (e.g. the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?

We believe that there are quantitative measures that can be used to measure and verify the degree of decentralisation. This could notably include the level of control maintained over the protocol and the level of maintenance required of the protocol. Depending on the level of decentralisation, different regulatory outcomes will be required. However, we must also be mindful that decentralisation is not a static concept and that protocols tend to decentralise over time.

We would also point towards academic research that has been conducted on the decentralisation of protocols, such as “[DQ: Two approaches to measure the degree of decentralisation of blockchain]”. These papers outline the way to build a “decentralisation quotient” and then use it as a way to measure how decentralised a protocol is.

40. Which parts of the DeFi value chain are most suitable for establishing “regulatory hooks” (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?

We believe that the framework should be based on the principle of regulating DeFi applications and businesses, rather than protocols. While businesses can comprehend and comply with jurisdictional regulations, the software itself cannot. From this perspective, we also believe that investor protection should underlie any such framework, and could focus on, for example, a requirement for businesses to conduct an adequate level of due diligence

before the application interacts with a protocol, and liabilities that the application or business would bear for a lack of proper disclosure or due diligence.

41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

We believe that the development of best practices at the code level will enable more effective and direct avenues for regulating activities that are less reliant on centralised players. Technical standards and rules embedded in the code itself can constrain certain prohibited or illegal activities, through the disablement or prohibition of code that, for example, designates a "rug pull" scam. Therefore, regulators should keep an open line of communication with developers both in the UK and abroad in order to support and integrate technical standards that are reasonable, safe, and flexible enough to adapt to future innovations. Similarly, regulators should themselves keep abreast of, and be open minded to, the possible application and adoption of nascent technologies such as Zero-Knowledge Proofs to compliance and regulation.

42. What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

Some best practices that exist in the industry today include smart contract security audits, digital identity issuance for protocol users, and on-chain analysis for Know-Your-Transaction monitoring.

However, we believe that the best practices that exist within DeFi organisations today should remain or become industry standards rather than be formalised into regulatory obligations. While we would support best practices to undertake a security audit of smart contracts, we believe the application of Web2 security best practices to the surrounding infrastructure of a Defi Protocol, in particular security of the private key or governance structure for upgrading smart contracts, is as important as the smart contracts themselves. We also support the future-proofing protocols to enable compatibility with existing or incoming solutions (both in Web2 and Web3 infrastructure) that facilitate compliance.

Chapter 12: Call for Evidence: Other Cryptoasset Activities

General comment: None.

43. Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.

We support the regulation of cryptoasset investment advice and cryptoasset portfolio management regulated activities in phase 2 rather than at a later, unspecified stage, as this would benefit the development of exchange traded products and other cryptoasset -related investment products that could in turn benefit consumers if provided by appropriately regulated players. We support a lighter touch regulatory framework based on the existing regimes for traditional financial instruments, which should be sensitive to the possibility of creating a disproportionate or excessive regulatory burden on advisory and portfolio management service providers, as discussed in the Consultation Paper.

44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

We do not see merit in regulating mining and validation activities in the UK. However, we believe certain aspects of mining and validation that create risks can be addressed through

market abuse provisions. To the extent that "maximal extractable value" raises considerations on market structure and integrity, they should be addressed through market abuse provisions.

45. Should staking (excluding "layer 1 staking") be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

We intend to submit a separate document to respond to this question more comprehensively and to detail our preferred regulatory treatment of staking.

However, as a general point, we would appreciate clarity on the definition of staking, given how many types of staking services are available. Furthermore, we would also appreciate a clear definition of "layer 1 staking activity", and what would be considered as excluded from that definition. Based on our understanding of the terminology used in the Consultation Paper, we believe that a distinction between layer 1 and layer 2 staking has been drawn to either distinguish between (i) staking done to "secure the network" and staking done "for rewards"; or (ii) direct staking and liquid staking. We believe the former would be a misguided distinction (as fundamentally all instances of staking are meant to bolster the projects' consensus mechanism), and if it is for the latter dichotomy, we submit that the regulation of liquid staking poses enough complexity that it should be considered fully and consulted on separately.

More generally, we believe that staking should be considered alongside lending, and that it may be appropriate to do so in phase 2. However, we do not believe that staking should be regulated in the same way as lending. Specifically, we believe that neither layer 1 nor layer 2 staking should be considered a collective investment scheme, and that they should exist under an exemption from section 235 of FSMA. They are intrinsically different from funds and investments, and are structured and intended to develop and advance a network, rather than for profit or investment. We believe staking services may also not need to be regulated where for example the following features are present:

- users retain day-to-day control of their staked assets;
- the staking returns are determined by the underlying protocol, as opposed to the staking service provider's management of the staked assets; and/or
- the service provider simply uses publicly-available software and basic computer equipment to perform validation services, rather than provides management services with respect to the staked assets i.e. the provision of IT services, not investment services.

46. What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?

On the assumption that "layer 1 staking activity" refers to direct staking, we believe regulation should focus on centralised intermediaries providing these services for end investors, such as exchanges. As above, we intend to submit a more detailed and separate response on our preferred regulatory treatment of staking.

Some of our members also consider that an entity simply staking its own assets (within products offered on their platform/ venue/ exchange) should not be subject to regulation. This would be similar to the current regime for dealing as principal, in that this activity would be performed on an entity's own balance sheet and therefore is not regulated.

Chapter 13: Call for evidence: Sustainability

Crypto UK

General comment: This comment encapsulates our responses to questions 47 and 52.

Due to the rapidly evolving nature of the underlying technology, the involvement of international institutions and governments, and the natural shift of focus in the industry towards the environmental and social concerns as highlighted in these questions, we believe that regulators should approach the creation or application of a disclosure regime specific to these issues with hesitation, relying on industry research as it develops rather than creating a regime that may become obsolete quickly.

These potential disclosure requirements should not only consider the rapid development of technology (such as those that ameliorate the high levels of energy use associated with some, but not all, consensus mechanisms used in the cryptoasset industry), but should also be sensitive to the decentralised nature of many cryptoasset service providers, particularly on who these obligations would be imposed on, and the application of disclosure requirements that even leading financial institutions have difficulty with quantifying. If a regime or specific disclosure requirements must be implemented as soon as possible, we submit that they should be aligned with other international regimes.

47. When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?

We do not have any further comments to this question.

48. What reliable indicators are useful and / or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and / or associated emission metrics, or other disclosures)?

We do not have any further comments to this question.

49. What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?

We do not have any further comments to this question.

50, How interoperable would such indicators be with other recognised sustainability disclosure standards?

We do not have any further comments to this question.

51. At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?

We do not have any further comments to this question.

52. Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?

We do not have any further comments to this question.