DIGITAL ASSETS: THE EVOLVING REGULATORY ENVIRONMENT

Joining jurisdictions around the world, the UK has recognised that disrupting technologies and failures in the cryptoasset arena have highlighted the need for regulation, not just to protect investors and maintain financial stability, but also to recognise the changes technology has made to the financial services sector.

So, in February 2023, the UK became one of the latest jurisdictions to set out plans to regulate cryptoassets[1] and pave the way for a central bank digital currency (CBDC).

A global consensus

The rise of cryptoassets and the emerging technologies that underpin them has prompted regulators, both individually and collectively, to look at how they should be treated, with global bodies such as the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB) issuing recommendations on how jurisdictions may include cryptoassets into their regulatory oversight.

IOSCO published a report on issues, risks and regulatory considerations relating to cryptoasset trading platforms in February 2020[2], this was followed in March 2020 with the Global Stablecoin Initiatives report which examines the regulatory issues arising from the use of stablecoins and explores how existing IOSCO Principles and Standards could apply to these arrangements. Examples cited in the report include the IOSCO Policy Recommendations for Money Market Funds, the IOSCO Principles for ETFs, the Final Report on Crypto-Asset Trading Platforms, and IOSCO's work on market fragmentation, cyber-resilience, and client assets.

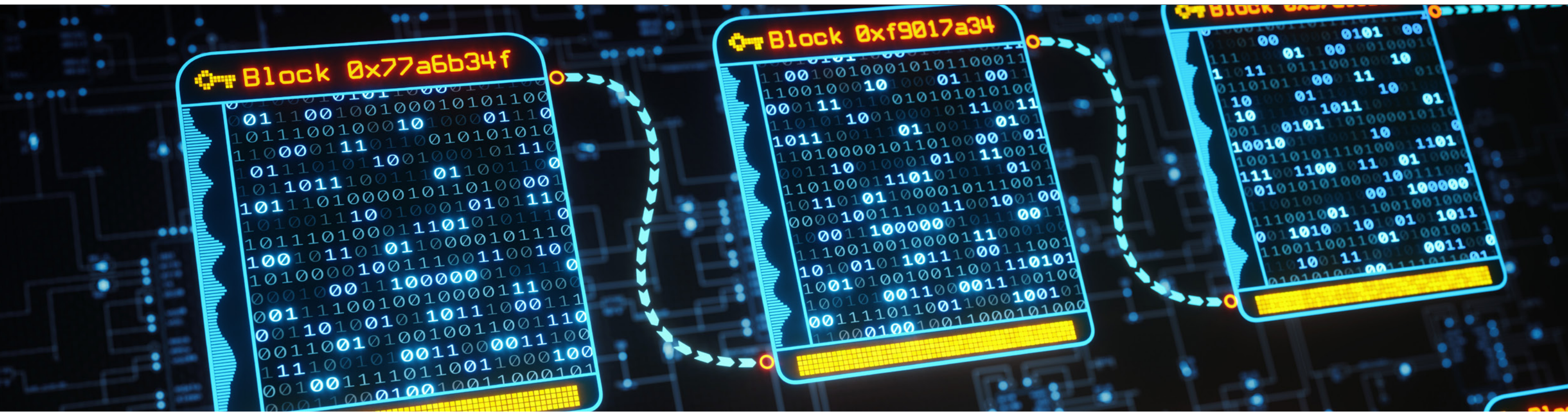
In July 2022 IOSCO published its Cryptoasset Roadmap for 2022-2023.[3] The Roadmap details the establishment of IOSCO's Fintech Task Force (FTF) which will develop, oversee, deliver and implement IOSCO's regulatory agenda with respect to fintech and cryptoassets.

The FTF's initial projects cover: crypto and digital assets, primarily looking at market integrity and investor protection; and decentralised finance (DeFi), looking at market integrity, investor protection, and financial stability risks associated with the use of emerging technologies to remove third parties and centralised institutions from financial transactions.

In October 2020 the FSB published its high-level recommendations for the regulation, supervision and oversight of global stablecoin arrangements. Here the FSB stated that supervisory and oversight capabilities and practices relating to stablecoins should apply under the "same business, same risk, same rules" principle.

This report was followed by an assessment of the risks to financial stability from cryptoassets which examined the developments and associated vulnerabilities relating to three segments of cryptoasset markets: unbacked cryptoassets (such as Bitcoin); stablecoins; and DeFi and other platforms on which cryptoassets trade.

This report was provided to the February 2022 meeting of G20 Finance Ministers and Central Bank Governors, prompting a Communiqué where they requested that the FSB recommend "coordinated and timely policy actions to preserve global financial stability" in relation to cryptoassets.[4]



As a result, in October 2022, the FSB proposed a framework for the regulation, supervision and oversight of cryptoasset activities with nine recommendations that national competent authorities would be encouraged to adopt.[5] In its work programme for 2023, published in March 2023, the FSB states that it intends to publish its final report on high-level recommendations on the regulation, supervision and oversight of crypto-asset activities and markets, together with updated high-level recommendations on the regulation, supervision and oversight of global stablecoin arrangements, during July 2023.

The Bank for International Settlements (BIS) has published papers on decentralised finance, payments and CBDCs and has been involved in the development of CBDC projects such as Project Aurum, a two-tier system using separate wholesale and retail tokens, which was carried out by the BIS Innovation Hub in partnership with the Hong Kong Monetary Authority and the Hong Kong Applied Science and Technology Research Institute.[6]

Nationally, individual jurisdictions are forging ahead with their plans to regulate the use of cryptoassets and the development of CBDCs.

USA

In the US, the President issued an Executive Order on ensuring responsible development of digital assets in March 2022, which set out a government-wide approach to advance six policy priorities covering consumer and investor protection, promoting financial stability, countering illicit finance, US leadership in the global financial system and economic competitiveness, financial inclusion, and responsible innovation.[7] In response, the Financial Stability Oversight Council issued a report in October 2022 that reviewed financial stability risks and regulatory gaps posed by digital assets and provided recommendations to address these risks.[8] Also included in the Executive Order was a direction to US agencies to take measures to explore a potential US CBDC. As a result, the White House Office of Science and Technology Policy produced a technical evaluation for a US CBDC system in September 2022.[9] This followed an earlier report from the Federal Reserve Board that examined the pros and cons of a potential US CBDC.[10] Recent remarks by government officials indicate that the US is still in the early stages of considering a potential US CBDC.

Asia

Across Asia regulators are introducing laws and regulations aimed at ensuring the safe and secure operation of cryptoasset markets.

For example, in May 2020, the Monetary Authority of Singapore (MAS) published its latest version of its Guide to Digital Token Offerings. This Guide provides general guidance on the application of the relevant laws administered by MAS in relation to offers or issues of digital tokens in Singapore – again a version of the "same business, same risk, same rules" approach.

More recently, in October 2022, the MAS published consultations on a proposed regulatory approach for stablecoin-related activities and regulatory measures for digital payment token services.[11]

In Hong Kong regulators have, so far, also taken the "same business, same risks, same rules" approach to cryptoasset regulation. Therefore, for example, tokens that have the characteristics of a security will be captured under existing rules in the Securities and Futures Ordinance.

However, where products and services have arisen that do not fit comfortably into the current regime, developments have taken place. For example, the virtual asset service providers regime imposes anti-money laundering and counter terrorist financing rules on providers of non-securities cryptoassets. The Hong Kong Monetary Authority published it conclusions to a Discussion Paper on Crypto-assets and Stablecoins in January 2023 where it stated that four key activities relating to stablecoins: governance, issuance, stabilisation, and wallets, will be subject to future regulation. In relation to CBDC, in addition to Project Aurum the authorities in Hong Kong are working on the development of an e-HKD. In February 2023 they published a consultation on proposed requirements for operators of virtual asset trading platforms. This was followed in May 2023 with the launch of an e-HKD Pilot Programme to test potential use cases.

European Union

In the European Union (EU), the Digital Finance Package (the Package) was announced in September 2020.[12] Covering digital finance and retail payments strategies, and legislative proposals on cryptoassets and digital resilience, the Package aims to boost the EU's competitiveness and innovation in the financial sector.

Included in the Package is the Markets in Crypto-assets Regulation (MiCA). Designed to provide legal clarity and certainty for cryptoasset issuers and providers, MiCA includes safeguards covering capital requirements, custody of assets, a mandatory complaint holder procedure available to investors, and rights of the investor against the issuer. Issuers of significant asset-backed cryptoassets would be subject to more stringent requirements (e.g., in terms of capital, investor rights and supervision). MiCA is expected to be published shortly after publication of this e-briefing in the Official Journal of the EU, and will enter into force 20 days after that (early Summer 2023) and start applying from early Summer 2024.

Finally, the European Central Bank (ECB) has been looking at the feasibility of a digital Euro since July 2021 with the aim of producing advice on the potential for design, implementation and issuance by autumn 2023.[13] As with other jurisdictions, the ECB's plans, if implemented, may include issuing the digital Euro alongside cash, and is a response to consumers' demands to pay digitally in a fast and secure way.

The UK's approach

The UK government launched its Cryptoassets Taskforce in March 2018, consisting of HM Treasury (HMT), the Financial Conduct Authority (FCA), and the Bank of England (BoE). In October 2018, the Taskforce published its final report recommending that action should be taken to address the risks associated with cryptoassets that fall within the existing regulatory framework, and set out a path to establish the UK's policy and regulatory approach to cryptoassets.

In January 2019, the FCA issued a consultation paper on potential guidance on cryptoassets with the policy statement, and full guidance, published the following July. This guidance clarifies where the different categories of cryptoasset tokens fall in relation to the FCA's regulatory perimeter at that time.

On 1 February 2023, the UK government launched a consultation and call for evidence on the future financial services regulatory regime for cryptoassets.[14]

In this latest consultation the UK government states that its approach is not to regulate technologies as they emerge, as it recognises that this would be difficult as they tend to evolve quicker than regulation, but to regulate the use of those technologies.

UK government's objective

The UK government's stated objective is to establish a proportionate, clear regulatory framework which enables firms to innovate at pace, while maintaining financial stability and clear regulatory standards.

Maintaining financial stability and clear regulatory standards are key to the proposals with the UK government's starting point being that the technology must fit existing regulations where possible and only in limited examples will the Regulatory Activities Order (RAO), the basis of financial regulation in the UK, or the Financial Services and Markets Act (FSMA) be amended.

As a result, the UK government approach is technologically agnostic, in other words, the technology is not the issue, it's what is done with it.

One of the examples of where the UK government views the current rules to be sufficient is in relation to security tokens. As noted in the glossary of terms (at the end of this e-briefing), the UK government states that this type of cryptoasset already meets the definition of a specified investment under the RAO. In other words, if it looks like a share in a company and acts like a share in a company, it's treated like a share regardless of the technology involved – again "same business, same risk, same rules".[15]

Conversely, one area where the government may need to amend the RAO to include emerging technology is in respect of stablecoins, specifically fiat-backed stablecoins, as this will ensure future CBDCs are catered for.

Also, expanding the RAO to include exchange tokens would mean that the wider world of Bitcoin, Ether, etc., would be brought into the regulatory perimeter. This would give regulators greater powers to protect investors.

Regulatory outcomes

Looking at the consultation discussion points in more detail, the UK government has proposed five regulatory outcomes:

Cryptoasset issuance and disclosures: The UK government proposes to establish an issuance and disclosures regime for cryptoassets grounded in the intended reform of the UK prospectus regime – the Public Offer and Admissions to Trading Regime – and tailored to the specific attributes of cryptoassets.

Operating a cryptoasset trading venue: HMT is proposing to establish a regulatory framework which is based on existing RAO activities of regulated trading venues – including the operation of a multilateral trading facility (MTF).

Cryptoasset intermediation activities: The UK government proposes that requirements applying to analogous regulated activities – such as "arranging deals in investments" and "making arrangements with a view to transactions in investments" set out in Article 25 of the RAO – would be used and adapted for cryptoasset market intermediation activities.

Cryptoasset custody: The UK government is proposing to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities, making suitable modifications to accommodate unique cryptoasset features, or putting in place new provisions where appropriate.

Operating a cryptoasset lending platform: For the regulation of cryptoasset lending and borrowing activities the UK government is proposing to apply and adapt existing RAO activities, while making suitable modifications to accommodate unique cryptoasset features.

In addition to the regulatory outcomes the UK is proposing a cryptoassets market abuse regime based on elements of the existing market abuse regime for financial instruments. The offences against market abuse would apply to all persons committing market abuse on a cryptoasset that is requested to be admitted to trading on a UK trading venue. This will apply regardless of where the person is based or where the trading takes place. It would entail obligations for certain market participations, in particular cryptoasset trading venues who would be expected to detect, deter, and disrupt market abusive behaviours.

Request for information

In respect of the call for evidence the UK government has asked for information on:

- **Decentralised finance:** DeFi is an umbrella term used to cover a range of financial services - including lending, exchange, asset management and insurance – which are offered without the use of traditional financial intermediaries. As a novel and rapidly evolving industry, DeFi presents complex and unique challenges for policy makers and regulators. The underlying protocols are influenced and controlled by varying levels of decentralised governance mechanisms. Furthermore, DeFi organisations are especially globalised and borderless in nature, with participants operating across many jurisdictions. Despite the UK government's view that its regulatory outcomes and objectives should apply to cryptoasset activities regardless of the underlying technology, infrastructure, or governance mechanisms, due to the challenges associated with DeFi, including the rapidly evolving nature of the sector, the way this is achieved may well differ and take longer to clarify.
- **Other cryptoasset activities**:
  - *Cryptoasset investment advice and portfolio management*: The UK government states that these activities could be considered as analogous to the current regulated activities of "advising on investments" and "managing investments" (Article 53 of the RAO and Article 37 of the RAO). It is therefore considering whether there is a case for bringing these activities into the regulatory perimeter.
  - *Post-trade activities in cryptoasset transactions*: Beyond trading cryptoassets, the UK government recognises that cryptoasset exchanges provide services beyond solely trading venue activities and can include financial market infrastructure (FMI) activities such as settlement, with the functions of a central securities depository being completed (typically) on a blockchain.

Rather than setting out initial proposals in the consultation, the UK government's regulatory outcomes for the settlement of cryptoassets will be shaped from what it learns from the ongoing work in the broader DLT space such as the FMI Sandbox initiative.[16]

  - *Crypto mining and validation*: The UK government states that there may not be justification in regulating the activity of mining[17] in the UK, given the limited exposure the UK has to global mining.[18] However, the UK government is interested in any views on whether any other regulatory outcomes should be pursued in regulating mining; for example, whether "miner extractable value" – whereby miners choose how to sequence transactions to extract value from other traders – should be considered.

- **Sustainability**: Although mining is currently outside the scope of the UK government's proposed regulation, a typical Proof of Work mining rig can have a high environmental impact. For illustrative purposes, the UK government states that the latest estimates put Bitcoin's global annual energy consumption at around 118 TWh, which amounts to approximately 39% of the UK's annual total energy consumption. The UK government is seeking further views from respondents as to what information about environmental impact or energy intensity would be useful for consumers making decisions about investing in cryptoassets, and at what time in the investor journey these would be particularly helpful to consumers.

The consultation and call for evidence closed on 30 April 2023.

No dates are given for any further technical consultations by the UK government, or UK regulatory authorities, as a result of this consultation and call for evidence.

Progress towards a CBDC

On 7 February 2023, the BoE and HMT published a consultation paper on a potential for a digital pound.[19]

The digital pound will be the UK's CBDC, a fiat-backed stablecoin tied to sterling and issued by the BoE. As mentioned earlier in this e-briefing, other jurisdictions around the world are looking at the feasibility of issuing CBDCs with the US, European Central Bank, and Hong Kong (amongst others) in various stages of planning and implementation.

HMT and BoE set out their ambitions for the digital pound stating that "it would be used by households and businesses for their everyday payments needs. It would be used in-store, online and to make payments to family and friends." However, the consultation acknowledges that it is too early to commit to build the infrastructure, but HMT and BoE are convinced that further preparatory work is justified.

One major issue the consultation looks at is that of trust. To date, transactions in cryptoassets have been almost entirely conducted pseudonymously[20] and HMT and BoE acknowledge that the launch of a digital pound would require deep public trust in this new form of money – trust that their money would remain safe, accessible, and private. Other jurisdictions have also acknowledged the need to ensure the public's trust in the use of CBDCs.

The issue of the consultation paper and an accompanying Technology Working Paper[21], which explores technology design considerations which help to form a basis for the BoE's current thinking on the technology requirements of the digital pound and which will likely have significant impact on the design choices for it, are the conclusion of Phase 1 of a three-phase programme as detailed in the BoE's indicative digital pound roadmap.

Phase 2, estimated to run from 2023 through to 2025/2026, will look at the potential design of a digital pound, including technical development work and proof of concepts on the proposed model and developing the digital pound platform. Phase 2 will conclude with the decision whether to proceed into Phase 3 and commit public investment on developing a prototype digital pound and live testing.

It is therefore unlikely that a digital pound will be issued before 2025, at the earliest.

The consultation is open until 7 June 2023.

The way forward

Jurisdictions around the world are moving forward to regulate the use of emerging technologies in financial services, such as tokenisation of assets previously done through the issuance of shares traded on established markets.

However, instead of focussing on the technology, the proposals aim at regulating their use, thereby ensuring that new products fit into the current regulatory framework.

Some changes will need to be made, not least in the definition of fiat-backed stablecoins so that countries can move forward with their respective plans for digital currencies.

And although there may be kudos in being the first country to issue a CBDC, there appears to be no rush to do so, with lawmakers taking a measured approach to its implementation.

These moves by regulators to clarify how cryptoassets are classified will bring certainty to asset managers seeking to invest in them or use them in the operation of their own products, such as the tokenisation of collective investment schemes as discussed in the FCA's recent discussion paper on updating and improving the UK regime for asset management.[22]

Glossary of cryptoassets

Based on Box 2A: Glossary of commonly used terms for cryptoassets contained in the HMT Call for Evidence

- **Exchange tokens**: cryptoassets which are not issued or backed by a central bank or other central body. They are used as a means of exchange or for investment purposes but do not provide the types of rights or access provided by security tokens or utility tokens. Bitcoin and Ether are prominent examples. These are often referred to as "cryptocurrencies", though the UK government deliberately avoids this terminology since it draws a potentially unwarranted equivalence with government-issued currencies (fiat currencies).

- **Utility tokens**: cryptoassets which provide digital access to a specific service or application (e.g., digital advertising or digital file storage). They do not provide the rights or features associated with a security token (e.g., share or ownership rights), and do not function as a means of payment – though they can be traded on cryptoasset trading venues for investment purposes.

- **Security tokens**: cryptoassets which already meet the definition of a specified investment under the RAO and are therefore already subject to regulation.

- **Non-Fungible Tokens (NFTs)**: cryptoassets which confer digital ownership rights of a unique asset (e.g., a piece of digital art). NFTs do not provide the rights or features associated with a security token and do not function as a means of payment.

- **Stablecoins**: exchange tokens which attempt to stabilise their value by referencing one or more assets, such as fiat currency. The UK's proposed legislation for stablecoins used in payments will initially apply, specifically, to fiat-backed stablecoins which are expected to include stablecoins that seek to maintain a stabilised value of the cryptoasset by reference to, and which may include the holding of, one or more specified fiat currencies. Further details on the government's approach to fiat-backed stablecoins will be set out in due course. Various types of tokens which are currently marketed or labelled as stablecoins might not meet the requirements under these future regimes.

- **Asset-referenced tokens**: a subset of exchange tokens which include commodity-linked tokens and crypto-backed tokens.

- **Commodity-linked tokens**: a subset of asset-referenced tokens which aim to maintain a stable value relative to the underlying commodity price by being collateralised with one or more commodities or real-world assets, or act as a digital representation of an underlying real-world asset such as gold, property, or oil, etc.

- **Crypto-backed tokens**: a subset of asset-referenced tokens which reference their value in relation to other cryptoassets.

- **Algorithmic tokens**: exchange tokens that aim to maintain a stable price largely, or in some part, through an algorithm that facilitates a change in supply and demand between the coin and one or more cryptoassets that support it.

- **Governance tokens**: a subset of utility tokens which are used solely by holders to vote on a blockchain or network's decisions, but do not provide any kind of exclusive perks or discounts.

- **Fan tokens**: a subset of utility tokens which give holders access to a variety of fan-related membership perks like voting on club decisions, rewards, merchandise designs and unique experiences.

1. Throughout this e-briefing we use the term "cryptoasset" to describe a digital token which uses technology, such as distributed ledger technology, to support the recording or storage of data.

2. Issues, Risks and Regulatory Considerations Relating to Crypto-Asset Trading Platforms Final Report FR02/2020 at www.iosco.org/library/pubdocs/pdf/IOSCOPD649.pdf

3. IOSCO Crypto-Asset Roadmap for 2022-2023 at www.iosco.org/library/pubdocs/pdf/IOSCOPD705.pdf

4. Paragraph 12, G20 FMCBG Communique Jakarta 17-18 February 2022 at www.g20.org/content/dam/gtwenty/about_g20/previous_summit_documents/2022/G20%20FMCBG%20Communique%20Jakarta%2017-18%20February%202022.pdf

5. FSB proposes framework for the international regulation of crypto-asset activities at www.fsb.org/2022/10/fsb-proposes-framework-for-the-international-regulation-of-crypto-asset-activities

6. Project Aurum at www.bis.org/innovation/bis_open_tech_aurum.htm

7. Executive Order on Ensuring Responsible Development of Digital Assets at www.whitehouse.gov/briefing-room/presidential-actions/2022/03/09/executive-order-on-ensuring-responsible-development-of-digital-assets/

8. Report on Digital Asset Financial Stability Risks and Regulation at https://home.treasury.gov/news/press-releases/jy0986

9. Technical Evaluation for a U.S. Central Bank Digital Currency System at www.whitehouse.gov/wp-content/uploads/2022/09/09-2022-Technical-Evaluation-US-CBDC-System.pdf

10. Money and Payments: The U.S. Dollar in the Age of Digital Transformation at https://www.federalreserve.gov/publications/money-and-payments-discussion-paper.htm

11. Consultation Paper P009-2022 on Proposed Regulatory Approach for Stablecoin-Related Activities at www.mas.gov.sg/-/media/mas-media-library/publications/consultations/pd/2022/consultation-on-stablecoin-regulatory-approach_finalised.pdf and Consultation Paper P008-2022 on Proposed Regulatory Measures for Digital Payment Token Services at www.mas.gov.sg/-/media/mas/news-and-publications/consultation-papers/2022-proposed-regulatory-measures-for-dpt-services/consultation-paper-on-proposed-regulatory-measures-for-digital-payment-token-services-v2.pdf

12. Digital finance package at https://finance.ec.europa.eu/publications/digital-finance-package_en

13. Digital euro at www.ecb.europa.eu/paym/digital_euro/html/index.en.html

14. Future financial services regulatory regime for cryptoassets at www.gov.uk/government/consultations/future-financial-services-regulatory-regime-for-cryptoassets

15. This is very much in keeping with other jurisdictions, such as the US Howey Test for determining whether a transaction qualifies as an investment contract, and therefore would be considered a security.

16. Launching in 2023 the FMI Sandbox will enable firms to experiment with and adopt DLT in providing the infrastructure services that underpin markets.

17. Crypto mining is the competitive process that verifies and adds new transactions to the blockchain for a cryptocurrency that uses the proof-of-work method. The miner that wins the competition is rewarded with some amount of the currency and/or transaction fees.

18. For example, the UK government states that the UK makes up 0.23% of global Bitcoin mining.

19. The digital pound: A new form of money for households and businesses? www.bankofengland.co.uk/paper/2023/the-digital-pound-consultation-paper

20. In a pseudonymous transaction all parties are represented by a code that makes it virtually impossible to identify any "real" person. The idea behind this was so that transfers of value, information, etc. can be undertaken without the need for governments or government-sponsored entities. We previously looked at the origins of cryptoassets and trustless transactions in Global Trustee and Fiduciary Services News & View Issue 50 – Cryptocurrencies and initial coin offerings: The greatest show or so much humbug? at www.citi.com/mss/sa/flippingbook/2018/Global_Trustee_and_Fiduciary_Services_News_and_Views_Issue_50/68/index.html

21. The digital pound: Technical Working Paper at www.bankofengland.co.uk/paper/2023/the-digital-pound-technology-working-paper

22. DP23/2 Updating and improving the UK regime for asset management at www.fca.org.uk/publications/discussion-papers/dp23-2-updating-and-improving-uk-regime-asset-management

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