Conclusions from the Cryptoassets Taskforce

Speech by Christopher Woolard, Executive Director of Strategy and Competition at the FCA, delivered at The Regulation of Cryptocurrencies event, London.

Speaker: Christopher Woolard, Executive Director of Strategy and Competition
Location: The Regulation of Cryptocurrencies event, London
Delivered on: 20 November 2018

Highlights:

- Cryptoassets have changed significantly in the last 10 years – we've gone from the original Bitcoin whitepaper in 2008 to a world populated by over 2000 different cryptoassets today.
- The Cryptoassets Taskforce brought together the FCA, HM Treasury and the Bank of England to explore the impact of cryptoassets and distributed ledger technology (DLT) in financial services. The taskforce's final report was published at the end of October.
- There are examples of cryptoassets and other applications of DLT delivering beneficial innovation in financial services. However, the taskforce has also identified 3 major harms: to consumers, to market integrity and the risk of financial crime.
- The FCA, HM Treasury and the Bank of England are each taking a number of steps over the coming months to address these harms and to encourage future beneficial innovation.

Note: this is the speech as drafted and may differ from the delivered version.

Ten years on

Cast your minds back to 2008.

For many of us, the defining event of that year was the collapse of Lehman Brothers, the moment when the enormity of the financial crisis was brought home.

But beyond the memory of Wall Street bankers emerging from skyscrapers with boxes in hands, what will 2008 also be remembered for?

Let me try a few. Michael Phelps eclipsed Mark Spitz's record to achieve 8 Olympic Golds at the Beijing Olympics. And despite millennium-bug style predictions of a black hole catastrophe, the Large Hadron Collider at CERN safely went online for the first time.

But 2008 also marked the publication of the original Bitcoin whitepaper.

Much has changed in 10 years, including with cryptoassets themselves. We've gone from Satoshi Nakamoto's original vision, to a world populated with over 2000 different cryptoassets; from a narrow discussion of 'Bitcoin's Blockchain' with a capital B, to a broader debate around distributed ledger technology (DLT) and its application to financial services.

We learnt many lessons from the crisis, not least the need to understand new, complex products and their wider impact. The scale and pace of cryptoasset change – and what it might mean for consumers and markets – also requires vigilance from policymakers.

And so, in March earlier this year as part of its wider fintech strategy, the Government announced a taskforce between the FCA, HM Treasury and the Bank of England on cryptoassets and distributed ledger technology. And as part of the Budget at the end of last month, the taskforce published its final report.

Today, I want to briefly lay out the key issues identified by the taskforce and the action we've recommended to tackle them. Although our report focused on both the underlying DLT and cryptoassets, today I will focus mainly on the latter.

Winding the clock back

First, I want to briefly provide some context. Four years ago, the FCA established Project Innovate to enable financial innovation in the interest of consumers. Through initiatives like the Regulatory Sandbox we have helped firms to implement emerging technologies, from cryptoassets to advanced analytics, in an innovative, but also compliant, manner.

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Whilst the purpose of today's speech is not to plug the Sandbox (though applications for the fifth cohort close in 10 days' time on the 30th!), it is worth highlighting that initiatives like this from our respective institutions have developed our understanding of cryptoassets over the past few years. And this previous experimentation and analysis proved invaluable when we came to develop a common cryptoassets taskforce framework.

Defining cryptoassets

I'll talk more about the framework shortly. But, first things first, how do we define cryptoassets?

As many of all you present are all too familiar, easy explanations are hard to come by in the cryptoasset world. Our definition is that a cryptoasset is a cryptographically secured digital representation of value or contractual rights that uses some type of DLT and can be transferred, stored or traded electronically.

But what does this framework look like in practice? The taskforce has categorised cryptoassets into three broad types:

1. **Exchange tokens.** Cryptoassets, such as Bitcoin, Litecoin and equivalents, are often referred to as 'cryptocurrencies'. We prefer the more neutral term "exchange tokens" as they do not function as money [3]. Exchange tokens utilise a DLT platform and are not issued or backed by a central bank or other central body. They do not provide the types of rights or access provided by security or utility tokens, but are used as a means of exchange or for investment.

2. **Security tokens.** These are tokens, which amount to a 'specified investment'. These may provide rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits. They may also be transferable securities or financial instruments under the EU's Markets in Financial Instruments Directive II [4] (MiFID II).
3. **Utility tokens.** These are tokens which can be redeemed for access to a specific product or service that is typically provided using a DLT platform. They typically fall outside the FCA's regulatory perimeter.

As such, cryptoasssets have no intrinsic value – they are not a claim on any tangible underlying source of value. They may have extrinsic value like many non-financial objects such as a work of art but that value can disappear particularly where there is no physical asset.

We believe these cryptoassets are currently used in 3 main ways:

1. As a means of exchange, enabling the buying and selling of goods and services, or to facilitate regulated payment services
2. For investment, with firms and consumers gaining direct exposure by trading cryptoassets, or indirect exposure by trading financial instruments that reference cryptoassets, and
3. To support capital raising and/or the creation of decentralised networks

Benefits and harms

Across this framework of different cryptoasset types and use cases, there are examples of cryptoassets that are delivering beneficial innovation in financial services.

For instance, we've seen firms in the Sandbox demonstrate that cryptoassets can be used to make existing processes, from international money remittance to traditional issuance of debt instruments, cheaper and easier at small scale. What we haven't yet seen is whether these tests can be scaled.

And whilst cryptoassets are not currently widely used in the UK, and the UK is not a major exchange market for cryptoasset trading relative to the global one, we are concerned about the potential harm posed by current usage of these often poorly-understood cryptoassets.

The taskforce has concluded that there are 3 major harms associated with cryptoassets.

The first harm is to consumers, who may buy unsuitable products, face large losses, be exposed to fraudulent activity, struggle to access market services, or be exposed to the failings of service providers, such as exchanges.

Then there's potential harm to market integrity. Opaque practices and misconduct could damage confidence in wider market functioning.

And of course, we cannot overlook the risk of financial crime, where cryptoassets have been used as part of illicit activity such as money laundering and fraud.

Finally, while we, like the Financial Stability Board, don't believe that cryptoassets pose a current financial stability risk, it's crucial we remain vigilant [5] should the market grow or cryptoassets become more widely adopted.

What next?

Bearing these risks in mind, it's clear strong and speedy action is necessary.

We'll tackle potential risks on several fronts.

First, to help firms better understand the boundaries of current regulation in relation to cryptoassets, the FCA will consult on perimeter guidance by the end of 2018. This will help clarify which cryptoassets fall within the FCA's existing regulatory perimeter, and those cryptoassets that fall outside.

HM Treasury is to then consult on whether the regulatory perimeter requires an extension to capture cryptoassets that have comparable features to specified investments, but currently fall outside the perimeter.

We're concerned that retail consumers are being sold complex, volatile and often leveraged derivatives products based on exchange tokens with underlying market integrity issues. Given this, the FCA will also consult on a prohibition of the sale to retail consumers of derivatives referencing certain types of cryptoassets (for example, exchange tokens), including contracts-for-difference, options, futures and transferable securities.

To combat financial crime risks, the Treasury will undertake one of the most comprehensive responses globally to the use of cryptoassets for illicit activities by applying and going further than the existing directive, the fifth EU Anti-Money Laundering Directive (5AMLD). On this, HMT will first consult and then legislate on how to transpose 5AMLD and broaden the scope of anti-money laundering and counter-terrorism financing regulation further.

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Finally, the Taskforce has also concluded that exchange tokens present new challenges to traditional forms of financial regulation. The Treasury, therefore, plan to complete further analysis on whether regulation could meaningfully and effectively address the risks posed by exchange tokens and what, if any, regulatory tools would be most appropriate. HMT will consult in early 2019 on whether and how exchange tokens, as well as related actors such as exchanges and wallet providers, could be regulated effectively.

However, we also recognise the limits of domestic action on this global, cross-border issue. We will, therefore, also seek to work collaboratively with international counterparts, including standard-setters and other national jurisdictions.

What about 2028?

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My hope is that if someone in 10 years' time was to pause on the world in 2018, they would see our taskforce work as a further step along our journey of encouraging beneficial innovation to thrive in the UK, but in a context in which financial crime is combatted, market integrity is safeguarded and consumers are adequately protected from harm.

Source URL: https://www.fca.org.uk/node/53191
Speeches | Published: 20/11/2018 | Last updated: 23/11/2018

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