

# Future financial services regulatory regime for cryptoassets

## **Consultation and call for evidence**

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cryptoassets

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# Contents

<b>Foreword</b>	<b>5</b>
<b>Chapter 1 Cryptoassets and the current regulatory landscape</b>	<b>7</b>
<b>Chapter 2 Definition of cryptoassets and legislative approach</b>	<b>13</b>
<b>Chapter 3 Overview of the current regulatory landscape for cryptoassets</b>	<b>18</b>
<b>Chapter 4 Cryptoasset Activities</b>	<b>24</b>
<b>Chapter 5 Regulatory Outcomes for Cryptoasset Issuance and Disclosures</b>	<b>34</b>
<b>Chapter 6 Regulatory Outcomes for Operating a Cryptoasset Trading Venue</b>	<b>41</b>
<b>Chapter 7 Regulatory Outcomes for Cryptoasset Intermediation Activities</b>	<b>45</b>
<b>Chapter 8 Regulatory outcomes for cryptoasset custody</b>	<b>49</b>
<b>Chapter 9 General Market Abuse Requirements</b>	<b>54</b>
<b>Chapter 10 Regulatory outcomes for operating a cryptoasset lending platform</b>	<b>61</b>
<b>Chapter 11 Call for Evidence: Decentralised Finance (DeFi)</b>	<b>66</b>
<b>Chapter 12 Call for Evidence: Other Cryptoasset Activities</b>	<b>70</b>
<b>Chapter 13 Call for evidence: Sustainability</b>	<b>73</b>
<b>Chapter 14 Responding to this Consultation</b>	<b>75</b>
<b>Annex A : Glossary of Terms</b>	<b>78</b>
<b>Annex B : Market abuse offences under UK MAR</b>	<b>80</b>

# Foreword

The government's firm ambition is for the UK to be home to the most open, well-regulated, and technologically advanced capital markets in the world. Delivering on this ambition means taking proactive steps to harness the opportunities of new financial technologies.

We believe that crypto technologies can have a profound impact across financial services. By capitalising on the potential benefits offered by crypto we can strengthen our position as a world-leader in fintech, unlock growth and boost innovation.

Cryptoasset markets continue to develop with increasing pace and complexity. But this is a nascent sector and as with any emerging technology, this brings risk as well as opportunity. Risk taking is a desirable part of the cycle of innovation and we wish to manage, not stifle, this. Ongoing turbulence in cryptoasset markets has highlighted that risk, with the high-profile collapse of firms like FTX having widespread implications for global cryptoasset markets and investors.

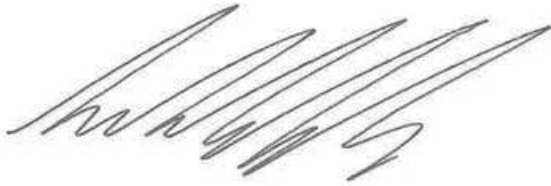
Our view is that this reinforces the case for clear, effective, timely regulation and proactive engagement with industry. Effective regulation will create the conditions for cryptoasset service providers to thrive in the UK, and give people and businesses the confidence to invest with an understanding of the often high risks involved. We have already begun to deliver on this ambition through the Financial Services and Markets Bill, by laying the legislative foundations to bring stablecoins and cryptoassets into financial services regulation. We are also exploring how Distributed Ledger Technology (DLT) could offer benefits to financial market infrastructures and the UK's sovereign debt management. This document marks the next step in the government's plans and sets out proposals for delivering a broader financial services regulatory regime for cryptoassets.

Our objective is to establish a proportionate, clear regulatory framework which enables firms to innovate at pace, while maintaining financial stability and clear regulatory standards. This includes a proposal to bring centralised cryptoasset exchanges into financial services regulation for the first time, as well as other core activities like custody and lending.

Through regular engagement I have already heard first-hand some of the opportunities and challenges faced by industry in this sector, and I am keen to continue our important dialogue. Your responses will help inform the government's approach and ensure the UK's regulatory

framework helps us achieve our ambition for this exciting new technology.

I look forward to your input.

A handwritten signature in black ink, appearing to read 'Andrew Griffith', written in a cursive style.

Andrew Griffith MP, Economic Secretary to the Treasury

# Chapter 1

## Cryptoassets and the current regulatory landscape

### Introduction

**1.1** Over recent years cryptoassets and the activities underpinning their use (or 'crypto') has evolved into an extensive, complex, and rapidly evolving ecosystem. It features a myriad of different activities and business models, each generating different types of opportunities and risks for the actors involved.

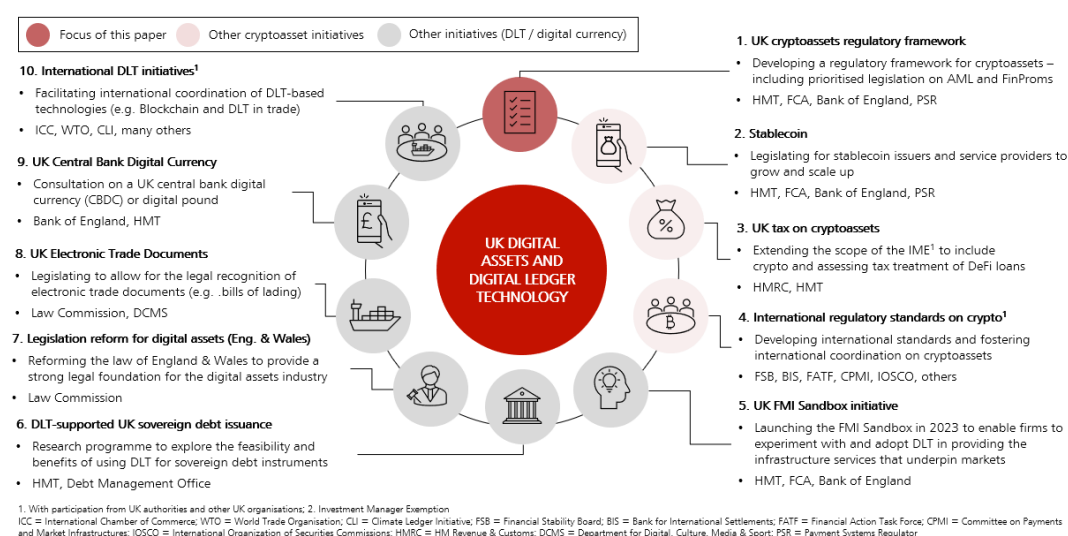
**1.2** The government's view is that the technology underpinning this innovation could bring a number of benefits, and with appropriate regulation and safeguards, certain cryptoassets and associated activities can offer significant new financial services opportunities for users. However, these benefits can only be realised sustainably if the technology is adopted safely and accompanied by an effective and appropriate regulatory framework for financial services. Against this backdrop, the government and the financial services regulators are already taking a number of steps to bolster the UK regulatory framework in order to harness this innovation and mitigate or clearly communicate the most pressing risks. However, most cryptoasset activities are not currently subject to broader financial services regulation, covering such matters as conduct and prudential requirements.

**1.3** The government's view is that cryptoassets and the activities underpinning their use should follow the standards expected of other similar financial services activities, commensurate to the risks they pose, while harnessing potential benefits of the technology behind them. Having such a framework in place should stimulate growth and innovation in the sector by giving responsible actors the regulatory certainty and confidence to participate in cryptoasset markets, and investors the confidence to invest in the UK for the long-term. This consultation marks the next – but not the final – phase of the government's approach to regulating cryptoassets and delivers on the government's commitment to set out proposals for the financial services regulation of cryptoasset investment and trading activities. In doing so, the government is seeking views from a wide range of market participants and users.

**1.4** This consultation builds on a series of HM Treasury publications on cryptoassets, including the “UK regulatory approach to cryptoassets, stablecoins, and distributed ledger technology in financial markets” published in April 2022, “Cryptoasset promotions” published in April 2022 and the related policy statement on cryptoasset financial promotions to be published alongside this consultation. In addition, the Financial Conduct Authority (FCA) and Bank of England have issued a number of discussion papers, consultation papers, policy statements and regulatory guidance notes on cryptoassets, including the FCA’s consultation paper on financial promotions for cryptoassets (published in January 2022). In parallel, international organisations such as the Financial Stability Board (FSB), the Bank for International Settlements (BIS), the International Organization of Securities Commissions (IOSCO), the Organisation for Economic Co-operation and Development (OECD) and the Financial Action Task Force (FATF) have been developing global standards for many aspects of cryptoasset regulation.

**1.5** This consultation focuses specifically on the future UK regulatory framework for cryptoassets used within financial services, rather than the wider application of distributed ledger technology (DLT) in financial services or the use of cryptoassets outside financial services. There are a number of UK government and regulator initiatives in the broader DLT space, such as the UK’s Financial Market Infrastructure (FMI) Sandbox and DLT-supported debt issuance initiative. Figure 1.A provides a high-level summary of the main initiatives relating to cryptoassets, digital assets and DLT more broadly which the UK is leading or participating in, as well as some of the main organisations involved.

**Figure 1.A Overview of consultation work on crypto and broader digital assets and DLT topics**



## Overview of cryptoasset markets

**1.6** As well as emerging as a new asset class for investment, cryptoassets and their underlying technology have the potential to



disrupt various parts of traditional finance. Further, this continues to be a very volatile sector, with cryptoasset price volatility significantly exceeding that of many traditional asset classes such as equities or commodities. However, both retail and institutional participation in the sector continues to grow. On the retail side, most recent surveys show that 5-10% of UK adults now own cryptoassets, an increase of more than 100% over the past 1-2 years<sup>1</sup>. Institutional participation has been limited but is growing.<sup>2</sup> A number of large banks and other traditional financial services institutions with a material presence in the UK are undertaking crypto-related activities including execution, brokerage, market making, custody and tokenisation of traditional assets.

**1.7** Cryptoasset markets have undergone a turbulent year. Total global market capitalisation of cryptoassets is currently around \$0.8 trillion, down around 75% from a peak of roughly \$3 trillion in November 2021. The second quarter of 2022 saw the failure of several cryptoasset lending and trading platforms, such as Celsius Network and Voyager Digital. The recent FSB report – published in October 2022 – noted that this episode exposed a number of vulnerabilities in those markets, arising from unsuitable business models, liquidity and maturity mismatches, the extensive use of leverage, and a high degree of interconnectedness within the cryptoasset ecosystem. These vulnerabilities were exacerbated by limited transparency and disclosures, suboptimal governance models, inadequate consumer and investor protections, and weaknesses in risk management.

**1.8** These issues have been further emphasised by more recent events surrounding the failure of a major crypto exchange, FTX, which has had widespread and ongoing implications for global crypto markets and prices and has contributed to the failure of another crypto trading and lending platform – BlockFi. FTX's failure has underscored important questions around conflicts of interest, market conduct and operational resilience. It has also demonstrated that integrated business models – currently prevalent across the ecosystem – can result in complex and sometimes reinforcing risk profiles. Mitigating these risks will require a combination of robust prudential safeguards, operational risk controls, transparency and data reporting arrangements, measures to manage conflicts of interest, good governance and adequate record keeping. Should cryptoasset markets or entities become or be likely to become systemic, there may be a case to develop additional regulatory requirements or wider oversight commensurate with the risk these markets or entities could pose.

**1.9** There have also been recent investigations and enforcement cases in various jurisdictions: wire fraud and insider trading cases relating to admissions of cryptoassets to trading venues in North

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<sup>1</sup> <https://www.gov.uk/government/publications/individuals-holding-cryptoassets-uptake-and-understanding> ; <https://yougov.co.uk/topics/finance/trackers/how-many-brits-have-bought-cryptocurrency>

<sup>2</sup> <https://www.bankofengland.co.uk/-/media/boe/files/financial-policy-summary-and-record/2022/fpc-summary-and-record-october-2022.pdf>

America; money laundering cases connected with the use of crypto mixing services in Europe; and fraud charges brought against certain actors involved in the operation and collapse of the Terra Luna token in Asia. UK authorities have also taken action – for example, warnings given to illegal crypto ATMs to shut down or face enforcement action,<sup>3</sup> and actions against scams perpetrated by crypto firms that are unregistered with the FCA.<sup>4</sup>

**1.10** The technology underpinning cryptoassets could bring a number of benefits and innovations in the financial system. However, as highlighted by recent episodes, and as set out by the Financial Policy Committee of the Bank of England (FPC),<sup>5</sup> these benefits can only be realised if the activity is undertaken with appropriate knowledge of the risks. This underlines and motivates the need for authorities to develop an enhanced regulatory framework for cryptoassets.

## Overarching policy objectives and principles

**1.11** By seeking to establish a regulatory framework for cryptoassets in the UK, HM Treasury is pursuing four overarching policy objectives:

1. encourage growth, innovation, and competition in the UK
2. enable consumers to make well-informed decisions, with a clear understanding of the risks involved
3. protect UK financial stability
4. protect UK market integrity

**1.12** In addition, and as set out in prior consultation papers, HM Treasury will continue to be guided by a set of core design principles:

- **“Same risk, same regulatory outcome”.** The government will remain technology agnostic while also considering whether the technology, or its use, gives rise to additional risks. Equally, it will be considered where the use of a technology may mitigate risks. This does not mean exactly the same form of regulation, as the features and use of cryptoassets may require a different regulatory method, but the aim is to achieve the same or a very similar regulatory outcome where possible. Subject to consultation, HM Treasury intends to take an activities-based approach to regulation, although there may be cases where specific entities pose or are likely to pose systemic risk and may warrant further regulation.
- **“Proportionate and focused”.** Efforts will be focused on where the risks and opportunities are most urgent or acute. HM Treasury and the financial services regulators should avoid applying disproportionate or overly burdensome regulation to entities, particularly where end users are aware of risks, and

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<sup>3</sup> <https://www.fca.org.uk/news/news-stories/warning-illegal-crypto-atms-operating-uk>

<sup>4</sup> <https://www.fca.org.uk/data/consumer-investments-data-review-april-sept-2021>

<sup>5</sup> [Financial Stability in Focus: Cryptoassets and decentralised finance | Bank of England](#)

where the activities do not give rise to market integrity or financial stability risks.

- **“Agile and flexible”.** The regulatory framework should accommodate evolving markets and products. Future legislation will provide a clear framework in the UK, providing clarity as to the scope of activities to which the regime applies, with detailed rules set by the regulators. This approach is consistent with the Future Regulatory Framework (FRF), which is intended to be established by the Financial Services and Markets Bill 2022 (FS&M Bill). The government judges that this agile approach will enable regulators to adapt to changes in the market and developments in international standards. In addition, and in line with the objective of promoting UK financial stability, the proposed regime will need to evolve if cryptoasset markets pose or are likely to pose financial stability risks. Given the cross-border nature of cryptoassets, the UK encourages cooperation with other jurisdictions and will continue to interact through bilateral engagement and participation in international standard-setting bodies to support harmonisation of treatment as far as is feasible.

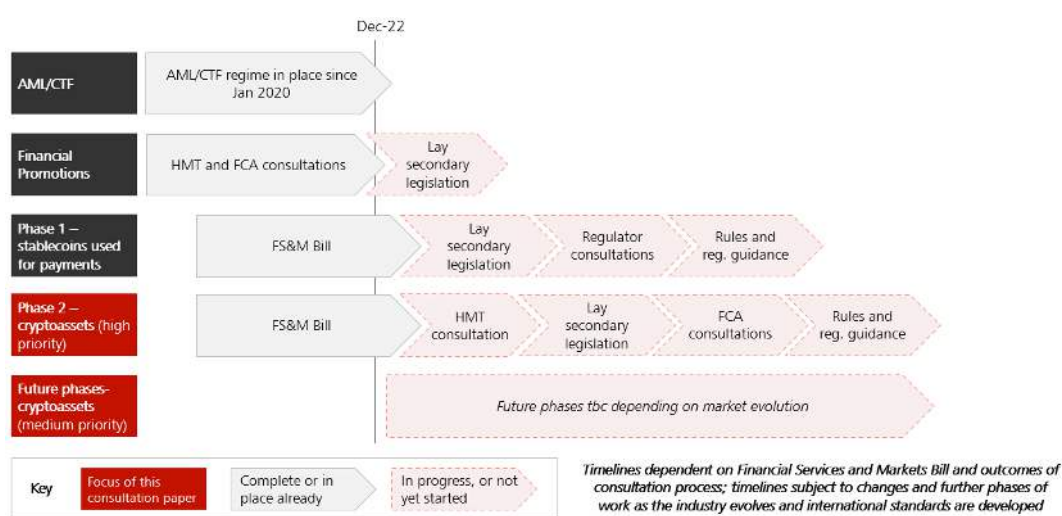
**1.13** Subsequent chapters highlight some of the challenges posed by the global and decentralised nature of cryptoasset markets to delivering these objectives, including where their delivery may be more aspirational due to the absence of international standards and cooperation. For example, Chapter 9 describes how the underlying structure of cryptoasset markets limits the ability of UK authorities to achieve the outcome of offering market integrity or protecting consumers to the same degree as in traditional securities markets.

**1.14** In line with these design principles, HM Treasury intends to continue to pursue a phased approach to regulating cryptoassets, which is prioritised according to the areas of greatest risk and opportunity. These phases are summarised in Figure 1.B. The proposals covered in this consultation represent an important next step in a longer process, with further work anticipated as the sector continues to evolve and authorities gather further information on the industry.

**1.15** The government and financial services regulators are already taking a number of steps to equip the UK regulatory framework to harness this innovation and mitigate the most pressing risks. Since January 2020, an Anti-Money Laundering and Counter Terrorist Finance (AML/CTF) registration regime has been in place for businesses undertaking cryptoasset exchange or custody wallet services in the UK, in order to regulate compliance with the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (“MLR”). The government will shortly introduce legislation to require the regulation of promotions of cryptoassets by the FCA to ensure promotions are clear, fair and not misleading. The government is also currently legislating in the Financial Services and Markets Bill 2022 (FS&M Bill) to introduce a regime that will allow for the regulation of fiat-backed stablecoins which are used for payments, similar to that

for other payment methods (Phase 1) given that these stablecoins have the potential to become widely used as a form of payment. The regime will address issuance and custody activities relating to fiat-backed stablecoins as well as payment-related activities for those fiat-backed stablecoins which are used in payments.<sup>6</sup> The scope of this is expected to cover, at a minimum, GBP and other fiat-backed stablecoins which are issued in the UK. The Bank of England and the Payment Systems Regulator (PSR) will also have a regulatory remit for Digital Settlement Assets (DSAs). These various regimes are covered in more detail in Chapter 3 but are not the focus of this consultation.

**Figure 1.B Phased approach for regulating cryptoassets in the UK**



Source: HM Treasury

**1.16** In Phase 2, the government's intention is to introduce a regime to regulate broader cryptoasset activities, such as the trading of and investment in cryptoassets. Phase 2 will be focused on targeting the activity areas associated with (i) a higher degree of risk from a consumer and overall market perspective and (ii) greater opportunities to support the UK's growth agenda. As a consequence, not all cryptoasset activities are proposed to form part of Phase 2. Chapter 4 sets this out in more detail. In addition, in more nascent areas of the market, the government is actively seeking views to inform future policy development. The government will continue to strategically assess developments in the market to determine future phases of work, taking into consideration the views of industry, consumers, and regulators. As these markets develop and international standards are further implemented, HM Treasury will continue to work to adapt and complete these proposals. This will particularly be the case where current proposals do not achieve the same regulatory outcome as in traditional finance.

<sup>6</sup> Some activities – e.g. custody – will be addressed through Phase 1 for fiat-backed stablecoins and then later (Phase 2) for other types of cryptoassets that come into the perimeter; the same framework is expected to be adopted for all types of cryptoassets as they come into regulation, rather than separate, overlapping regimes

# Chapter 2

## Definition of cryptoassets and legislative approach

### Definition of cryptoassets

2.1 There is no universal definition of a “cryptoasset” or related terms such as a “digital asset” or “virtual asset”, but there is increasing consensus on the basic elements of the definition in UK and overseas legislation, and in global standards. The FS&M Bill includes the following definition of “cryptoasset” for the UK’s financial services regulatory framework, to be introduced into FSMA:

*“‘cryptoasset’ means any cryptographically secured digital representation of value or contractual rights that—  
(a) can be transferred, stored or traded electronically, and  
(b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology).”*

This definition in the FS&M Bill is drawn broadly so as to capture all current types of cryptoasset. The definition underpins the powers HM Treasury has to specify activities within the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (“RAO”), or to designate activities as part of the Designated Activities Regime (“DAR”) being legislated for in the FS&M Bill. It is similar to the definition of “cryptoasset” used in regulation 14A(3)(a) of the MLR, with the principal difference being that the FS&M Bill definition references a wider range of underlying technology. Though the overwhelming majority of cryptoassets currently rely upon DLT, for financial services regulation it is important to encompass potential future changes in the technology underlying cryptoassets in order to mitigate against regulatory arbitrage. The definition is also very similar to the definition of “cryptoasset” in the EU’s Markets in Cryptoassets legislation (“MiCA”), and also shares some features with the definition of “virtual asset” in the FATF’s recommendations.<sup>7</sup> To react to future changes, the definition of “cryptoasset” is accompanied by a power to update it by way of

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<sup>7</sup> FATF (2012-2022), International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation, FATF, Paris, France, [www.fatf-gafi.org/recommendations.html](http://www.fatf-gafi.org/recommendations.html)

secondary legislation. Note that the term “token” is used interchangeably with “cryptoasset” hereafter.

**2.2** The government anticipates that the future financial services regulation of cryptoassets created using HM Treasury’s powers will typically apply to a particular subset of cryptoassets depending on the matter being regulated, and will accordingly use a narrower definition to capture these. For example, Schedule 6 to the FS&M Bill extends the application of the existing scope of Part 5 of the Banking Act 2009 to include payment systems using digital settlement assets. A “digital settlement asset” comprises only those digital assets that can be used for the settlement of payments (it therefore covers other digital assets that can be used for the settlement of payments, as well as cryptoassets used in payments). In addition, the government has confirmed that non-fungible tokens (NFTs) will not be in scope of the cryptoassets financial promotions regime, since NFTs can represent a wide array of different assets which might constitute non-financial services products.<sup>8</sup>

**2.3** Box 2.A below sets out a glossary of commonly used terms for different types of cryptoasset. Importantly though, the government’s intention is that activities will be regulated, rather than the asset itself. Readers should also note that these terms – commonly used in industry, media and public discourse – will not necessarily be aligned to regulatory definitions.

**2.4** Under the proposals being consulted on, **any of the cryptoassets listed in Box 2.A could in the future be subject to financial services regulation where being used for the financial services activities referenced in Chapter 4 (as well as those already in the UK’s regulatory perimeter)**. The proposed regulatory framework for cryptoassets is not intended to impose regulation on any underlying non-financial services activity which a cryptoasset might be used for. If the activity is non-financial in nature this may be covered by other laws or regulations (e.g. fraud cases relating to digital art assets or NFTs).

**2.5** *Regarding investor protections, whilst it is not the government’s intention for FSCS protections to apply to investor losses arising from cryptoasset exposures, it is the responsibility of the PRA and FCA as the UK’s independent financial regulators to set the limits of FSCS protection in respect of regulated activities carried out by authorised firms.*

## Legislative Approach

**2.6** The government intends to include the financial services regulation of cryptoassets within the regulatory framework established by the UK’s Financial Services and Markets Act 2000 (FSMA), taking advantage of the confidence, credibility and regulatory clarity that this existing system affords, and as it is intended to be updated by the FS&M

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<sup>8</sup> <https://www.fca.org.uk/publications/policy-statements/ps19-22-guidance-cryptoassets>



Bill. FSMA is a well-established feature of the UK's legal framework for financial services. The alternative approach of developing a fully bespoke regime outside of the FSMA framework was also considered but discounted on the basis that this would not deliver a level playing field between crypto and traditional financial services firms conducting the same activity (contrary to the "same risk, same regulatory outcome" principle, as set out above). A bespoke regime – built outside of the FSMA framework – is also more likely to create overlapping regulatory regimes and confusion for market participants.

**2.7** Under FSMA, HMT has secondary legislation powers to bring activities into the regulatory perimeter by specifying them in the RAO. The government's intention is to expand the list of "specified investments" in Part III of the RAO to include cryptoassets. An amendment to the RAO power, Section 22(4) of FSMA, made through the FS&M Bill affirms the use of the RAO power for the financial services regulation of cryptoassets. This clarifies that persons (natural or legal) who are carrying out certain activities involving cryptoassets "by way of business" would be performing regulated activities and therefore require authorisation under Part 4A of FSMA. It would also mean that the FCA's general rule making powers would be available, allowing the FCA to design regulatory regimes for newly added activities. In practice this means that the FCA will be given powers to write tailored rules, as opposed to the existing rules automatically applying to cryptoassets. The FCA will need to consider what is appropriate and consult accordingly.

**2.8** HM Treasury has other powers and legislative options available to regulate activities which might not be suitable for regulation under the RAO (e.g. if they are carried out by actors which HM Treasury does not wish to subject to the requirements of the authorisation regime in Part 4A FSMA). In particular, the DAR, a new regime set out in the FS&M Bill, is designed to enable HM Treasury to designate certain activities in order to make regulations relating to the performance of that activity, including prohibiting the activity in its entirety or setting direct requirements.

**2.9** HM Treasury does not currently intend to expand the definition of "financial instrument" in Part 1 of Schedule 2 to the RAO to include presently unregulated cryptoassets. This is due to the limitations of retrofitting an existing regime to a new asset class with unique features and risks. However, in line with the principle of "same risk, same regulatory outcome", HM Treasury will seek to use other legislative and regulatory mechanisms to put in place equivalent or similar safeguards where cryptoassets present similar risks to financial instruments (e.g. market manipulation practices which arise from the fact that cryptoassets are traded in a way which resembles financial instruments).

### **Box 2.A: Glossary of commonly used terms for cryptoassets (not exhaustive)**

**Exchange tokens** are cryptoassets which use a technology such as DLT to support the recording or storage of data and 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 we deliberately avoid this terminology since it draws a potentially unwarranted equivalence with fiat currencies.

**Utility tokens** are cryptoassets which provide digital access to a specific service or application (e.g. digital advertising or digital file storage) and use a technology such as DLT to support the recording or storage of data. 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** are cryptoassets which use a technology such as DLT to support the recording or storage of data and already meet the definition of a specified investment under the RAO and are therefore already subject to regulation.

**Non-Fungible Tokens (NFTs)** are cryptoassets which confer digital ownership rights of a unique asset (e.g. a piece of digital art), using a technology such as DLT to support the recording or storage of data. NFTs do not provide the rights or features associated with a security token and do not function as a means of payment.

**Stablecoins** are 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 regimes.

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



**Commodity-linked tokens** are 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.

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

**Algorithmic tokens** are 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** are 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** are 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.

### **Box 2.B: Questions for respondents**

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

# Chapter 3

## Overview of the current regulatory landscape for cryptoassets

**3.1** This chapter provides a summary of the current financial services regulatory landscape relevant to cryptoasset activities in the UK. Each section also covers how interactions between these regimes and the broader regulatory framework for cryptoassets are expected to be addressed.

### Activities relating to security tokens and other specified investments

**3.2** Certain types of cryptoasset may already fall within the existing FSMA regulatory perimeter set by the RAO, as they qualify as “specified investments”. For instance, security tokens provide rights and obligations akin to shares, debt instruments or other securities, which are specified investments as set out in the RAO. This means that they are already within the regulatory perimeter and that firms carrying on specified activities involving security tokens need to ensure that they have the correct permissions and are following the relevant rules and requirements.

**3.3** For the most part, HM Treasury expects continuation of the current treatment of those cryptoassets that already qualify as “specified investments”, though there may be some amendments over time (e.g. updating custody obligations in the Client Assets Sourcebook for security tokens).

**3.4** Certain types of cryptoasset may also fall within other elements of existing financial services regulation, notably where forming part of (or being the subject matter of) a financial instrument within Part 1 of Schedule 2 to the RAO, e-money under the E-Money Regulations 2011 (EMR 2011) or, where facilitating regulated payment services, the Payment Services Regulations 2017 (PSR 2017). The FCA’s Perimeter Guidance for Cryptoassets (PS 19/22) sets out more detail on the different types of cryptoassets and their interactions with the existing regulatory perimeter.

### AML/CTF Regime

**3.5** In January 2020, following an amendment to the MLR, the FCA became the supervisory authority for cryptoasset exchange providers

and custodian wallet providers ('cryptoasset businesses') in respect of the AML and CTF obligations contained in the MLR.<sup>9</sup> These cryptoasset businesses encompass firms or sole practitioners undertaking activities in the UK in relation to: the exchange, arranging or making arrangements with a view to the exchange of money for cryptoassets, cryptoassets for money, or one cryptoasset for another; the operation of a machine which utilises automated processes to exchange cryptoassets for money or money for cryptoassets; and the safeguarding or safeguarding and administering of cryptoassets or private cryptographic keys in order to hold store and transfer cryptoassets. Consequently, existing cryptoasset businesses have had to be registered and comply with the MLR, requiring them to demonstrate that their controls, policies and procedures are adequate to deal with the money laundering and terrorist financing risks of the cryptoasset market, and requiring any officers, managers and beneficial owners of the business to be fit and proper.

**3.6** To prevent undue disruption to existing cryptoasset businesses, the FCA announced the establishment of a temporary registration regime (TRR). This allowed existing cryptoasset businesses who had applied to be registered with the FCA to continue trading whilst applications were assessed. Since the closure of the TRR on 31 March 2022, cryptoasset businesses are required to be registered by the FCA before they start operating in the UK. This year, HM Treasury further amended the MLR to extend the FATF's "travel rule" to capture cryptoasset activities.<sup>10</sup> This extends information sharing and record keeping requirements that apply to bank transfers to transfers of cryptoassets, to assist in the prevention and detection of money laundering.

**3.7 When the broader cryptoasset regulatory regime being consulted on becomes effective, HM Treasury expects firms undertaking regulated cryptoasset activities to adhere to the same financial crime standards and rules under FSMA that apply to equivalent or similar traditional financial services activities.** This is necessary since the financial crime rules in FSMA are broader than those contained in the MLR, covering anti-bribery and corruption, sanctions, fraud and other aspects of financial crime. It is important for the UK to have a robust gateway to mitigate these risks and maintain high standards and reputational integrity. Under the proposal to introduce certain cryptoasset activities into FSMA, and as with other areas, the FCA would have the powers to write and amend their Handbook rules in relation to financial crime.<sup>11</sup> The FCA will consider whether to update the Senior Management Arrangements, Systems and Controls sourcebook and other financial crime rules to apply to new cryptoasset activities. HMT and FCA will work with industry to

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<sup>9</sup> Regulation 7, Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017/692

<sup>10</sup> Regulation 5, The Money Laundering and Terrorist Financing (Amendment) (No. 2) Regulations 2022.

<sup>11</sup> Relevant FCA Handbook references include - but are not limited to - SYSC 3.2.6, SYSC 6.1.1 SYSC 6.3

ensure crypto firms are made fully aware of the standards required for approval at the FSMA gateway. Further communications will be provided in due course to ensure standards for approval are clearly available to crypto firms operating in the UK.

**3.8** The list of proposed cryptoasset activities (see Chapter 4) seeks to incorporate the full scope of activities that currently require registration under the MLR into the regulatory perimeter of FSMA. Bringing crypto firms within the regulatory perimeter of FSMA and amending the geographical scope to business conducted in or to the UK would, in time, enable authorities to operate a single register and would align the business test for determining activities undertaken in the UK to better protect consumers and support a single authorisation process for firms undertaking cryptoasset activities. HM Treasury and the FCA both have a strong preference for having a single authorisation process in the long term, in order to give businesses and consumers a streamlined process and regulatory clarity. This would also support supervisory and enforcement processes as there may be complexities arising from an enforcement case involving multiple parties, some of whom are MLR-registered and some of whom are FSMA-authorised. This single process may take time to achieve as we bring new legislation into force using a phased approach, in order to navigate any differences in scope in the short term.

**3.9** The introduction of an authorisation regime under FSMA for persons who are carrying out certain activities involving cryptoassets means that crypto firms already registered under the MLR regime and carrying out those activities would be required to also seek authorisation under the new FSMA-based regime. This is because businesses will need to be assessed against a wider range of measures than they have been as part of the MLR registration process. However, in order to smooth this transition, the FCA will adopt a timely and proportionate authorisation process for complete and accurate applications, and will endeavour to avoid duplicative information requests of businesses, taking into account the supervisory history of businesses during the authorisation process. New crypto firms not yet registered under the MLR regime would not need to separately apply for registration under the MLR. All crypto firms in scope of the MLR will still be expected to comply with them, as with current FSMA-authorised businesses that are subject to the MLR.

## Financial Promotions Regime

**3.10** Consumer information ensuring transparent disclosure of the nature of the investment and risks involved is a key plank of the government's proposed framework. In summer 2020, HM Treasury published a consultation on bringing qualifying cryptoassets into the

scope of the financial promotions regime.<sup>12</sup> The consultation response – published in January 2022 – confirmed the government’s plan to introduce legislation to address the significant risk of misleading cryptoasset promotions.<sup>13</sup> HM Treasury is seeking to lay the secondary legislation to extend the financial promotions perimeter in 2023. The FCA consulted on proposed rules for cryptoasset promotions, such as risk warnings and consumer frictions, in January 2022.<sup>14</sup>

## Fiat-backed stablecoins which are used for payment (Phase 1)

**3.11** For the purposes of this consultation, “fiat-backed stablecoins” 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.<sup>15</sup>

**3.12** As part of the FS&M Bill, the government is taking forward legislation to:

- bring Digital Settlement Assets (DSAs) into the regulatory perimeter for systemic payment systems and service providers (to fall under the remit of the Bank of England where they are systemically important)<sup>16</sup>
- enable HM Treasury to bring activities such as the issuance and custody of fiat-backed stablecoins into the regulatory perimeter via statutory instrument (to fall under the remit of the FCA)
- enable HM Treasury to establish via statutory instrument a mechanism for facilitating dual regulation (to fall under the remit of the FCA, the Bank of England and the PSR)

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<sup>12</sup> Cryptoasset promotions: Consultation (July 2020)

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/902891/Cryptoasset\\_promotions\\_consultation.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/902891/Cryptoasset_promotions_consultation.pdf)

<sup>13</sup> Cryptoasset promotions: Consultation response (January 2022)

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1047232/Cryptoasset\\_Financial\\_Promotions\\_Response.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1047232/Cryptoasset_Financial_Promotions_Response.pdf)

<sup>14</sup> Strengthening our financial promotion rules for high risk investments, including cryptoassets (January 2022)

<https://www.fca.org.uk/publication/consultation/cp22-2.pdf>

<sup>15</sup> This does not consider the interaction of the new regulated activity with accepting deposits, which will also need to be considered in Phase 1. It is not the government’s intention to include tokenised deposits (which operate on blockchains and may represent unsecured debt claims) within the scope of regulated activity for Phase 1. This is in addition to cryptoassets that seek to maintain a stable value by way of a purely algorithmic mechanism (see 4.25-4.26). The final phraseology for fiat-backed stablecoins will be developed further in later legal drafting.

<sup>16</sup> The definition of a digital settlement asset is “a digital representation of value or rights, whether or not cryptographically secured that a) can be used for the settlement of payment obligations, b) can be transferred, stored or traded electronically, and c) uses technology supporting the recording or storage of data (including DLT)”. A “digital settlement asset” comprises only those cryptoassets that can be used for the settlement of payments (and in fact covers assets other than cryptoassets that can be used for the settlement of payments too). See clause 22(2), Financial Services and Markets Bill, Bill 181 2022-23 (as amended in Public Bill Committee)

**3.13** The FCA's regime will apply to fiat-backed stablecoins, which is to be defined in the statutory instrument expected to be laid in H1 2023. HM Treasury is intending to regulate activities such as the issuance and custody of fiat-backed stablecoins in Phase 1. At a minimum, GBP and other fiat-backed stablecoins which are issued in the UK are expected to be in scope.

**3.14** In addition, a range of specific amendments will be made to the Electronic Money Regulations (EMRs) and Payment Services Regulations 2017 (PSRs). This is to ensure that the regime can be applied effectively, including when fiat-backed stablecoins are used in retail payments activities. Further details on the government's approach to fiat-backed stablecoins will be set out in due course.

**3.15** Under provisions currently in the FS&M Bill, including provisions which amend the Banking Act 2009 and the Financial Services (Banking Reform) Act 2013, the Bank of England and the PSR will also have a regulatory remit for DSAs, covering systemic payment systems and service providers. There are currently no systemic DSA systems, and this would only be triggered were the system or service provider to meet the relevant criteria and thresholds, and where recognised and/or designated by HM Treasury. In practice, the concept of a DSA could extend to cryptoassets other than fiat-backed stablecoins (e.g. if an unbacked cryptoasset was used for payments and became systemic in nature). This is intended to provide future flexibility and act as a backstop function should any DSA system or service provider scale to pose systemic risks.

**3.16** The intention of this legislation is to focus on the regulation of issuers, custodians and payment service providers for fiat-backed stablecoins, reflecting their specific risks, benefits and potential use cases. It does not capture exchange or trading activities of stablecoins (which are covered in this consultation). Figure 3.A sets this out for clarity. While the stablecoin and broader cryptoasset regimes are being developed according to different timelines, HM Treasury and the regulators are designing both in a consistent and compatible way in order to streamline common processes wherever possible – for example, the admission for trading processes, lending platforms and cryptoasset exchange.

**Figure 3.A Scope of regime for fiat-backed stablecoins vs broader cryptoasset regime**

	<b>Security tokens and other specified investments</b>	<b>Fiat-backed stablecoins<sup>2</sup></b>	<b>All other cryptoassets</b>
<b>Issuance</b>	<b>Already regulated<sup>1</sup></b> (e.g. prospectus rules apply to security tokens)	<b>Stablecoin legislation (phase 1)</b>	<b>Cryptoasset legislation (phase 2)</b> (specifically addressing admission of cryptoassets to a cryptoasset trading venue or a public offer of cryptoassets)
<b>Payment</b>	<b>Already regulated<sup>1</sup></b> (e.g. Payment Services Regulations apply to E-Money)	<b>Stablecoin legislation (phase 1)</b> (+ regulated as systemic DSA if meets criteria) <sup>2</sup>	<b>Not applicable</b> (could theoretically be regulated as systemic DSA if meets criteria) <sup>2</sup>
<b>Exchange / trading</b>	<b>Already regulated<sup>1</sup></b> (e.g. MTF / OTF rules apply to security tokens)	<b>Cryptoasset legislation (phase 2)</b>	
<b>Custody</b>	<b>Already regulated<sup>1</sup></b> (e.g. CASS rules currently apply to security tokens)	<b>Stablecoin legislation (phase 1)</b>	<b>Cryptoasset legislation (phase 2)</b>

<sup>1</sup> unless specific exceptions / exemptions apply

<sup>2</sup> **Any systemic Digital Settlement Asset payment system or service provider** would be subject to regulation by the Bank of England and Payment Services Regulator (PSR)

Source: HM Treasury

### **Box 3.A: Questions for Respondents**

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



# Chapter 4

## Cryptoasset Activities

**4.1** The cryptoasset ecosystem features a complex array of activities and business models, each generating different types of opportunities and risks. Some of these activities resemble “specified activities” (listed under Part II of the RAO) – such as safeguarding and administering investments or operating a Multilateral Trading Facility (MTF). Others have more in common with electronic money-like activities (mostly regulated under the PSR 2017 and EMR 2011), and for the final category of cryptoasset activities – including mining and validation – there is no close analogue to traditional financial services activities.

**4.2** The complexity of cryptoasset activities and the proliferation of new business models creates challenges for policy makers and regulators. It is highly unlikely that a “one size fits all” approach to regulation would work for all types of cryptoasset firms, since different activities present different forms of risk. For this reason, and in line with the principle of “same risk, same regulatory outcome” set out above, HM Treasury intends to create a number of new regulated or designated activities tailored to the cryptoasset market where these activities seek to mirror, or closely resemble, regulated activities performed in traditional financial services. There are also some novel cryptoasset activities for which existing regulatory frameworks would not provide a suitable basis. These various activities are laid out in the following section.

### Proposed scope of regulated cryptoasset activities

**4.3** **Table 4.A below lists a set of illustrative cryptoasset activities that HM Treasury proposes to bring into the regulatory perimeter, and the proposed sequencing.** Where a person (natural or legal) is engaged in these activities by way of business, they are expected to be subject to regulatory obligations which will be legislated for via the RAO, DAR or other legislative means. Further details on HM Treasury’s desired regulatory outcomes for these activities are set out in later chapters.

**4.4** For newly defined RAO activities, firms which are already FSMA-authorized and intend to undertake the activity will generally need to apply for a variation of their permission from the FCA (and the PRA for dual-regulated firms). Regulatory permissions would not be automatically granted for firms which are already authorised.

**4.5** The requirement for a person to be FSMA-authorized only applies to activities that are carried out “in the United Kingdom”. However, determining the location in which an activity is carried out varies according to the nature of that activity. In the case of cryptoasset



activities – which are provided and consumed digitally and are very often not confined to a specific jurisdiction – this is not always straightforward to determine. For the purpose of activities in Phase 2 and subsequent phases, **HM Treasury proposes to capture cryptoasset activities provided in or to the United Kingdom.** This would capture activities provided by UK firms to persons based in the UK or overseas (natural and legal), as well as those provided by overseas firms to UK persons (natural or legal). Whilst this is intended to be the standard approach, HM Treasury recognises that there may be nuances in the application of this for specific activities.

4.6 Such an approach is in line with a number of other areas of the UK’s regulatory perimeter and would likely be necessary since UK consumers can (and frequently do) easily access cryptoasset products and services which are provided by overseas companies. Furthermore, a definition which only captures firms operating in the UK would result in a situation where firms could move offshore to easily evade UK regulations but still serve UK customers. This would create an unlevel playing field for firms based in the UK.

**Figure 4.A Geographic scope of cryptoasset activities carried on “in the United Kingdom”**

		<i>Location of the customer</i>	
		UK	Overseas
<i>Location of the provider</i>	UK	In scope	In scope
	Overseas	In scope	Out of scope

*Subject to exceptions and nuances for specific activities*

Source: HM Treasury

4.7 There may be certain exceptions that the UK government wishes to consider to this approach – for example, to accommodate “reverse solicitation” of cryptoasset activities that are provided from overseas companies. Under this exception, if a UK customer accessed a particular cryptoasset service entirely at their own initiative from an overseas firm and the firm does not otherwise solicit from such customers, then this may not trigger an FSMA-authorisation requirement for that overseas firm in relation to that particular service. However, this would likely be defined in a way to prevent misuse and regulatory arbitrage.

4.8 Whether firms carrying out these activities would be required to have a physical presence in the UK in order to obtain authorisation is under consideration and for the FCA to determine at the point at which firms apply for authorisation. This is expected to be informed by the

FCA's existing framework for international firms and based on the nature and scale of the firm's activities and the risks of harms the activities could cause.<sup>17</sup> In particular, risk of retail, client asset and wholesale harm will be taken into account. Firms operating cryptoasset trading venues would be likely to require subsidiarisation in the UK since they play a critical role in the cryptoasset value chain – from admission to trading (see Chapter 5) through to helping to prevent, detect and disrupt market abuse (see Chapter 9). HM Treasury intends to pursue equivalence type arrangements whereby firms authorised in third countries can provide services in the UK without needing a UK presence, provided they are subject to equivalent standards and there are suitable cooperation mechanisms to help make this work. The government is supportive of pursuing this as soon as practicably possible to help reduce the risk of market fragmentation. The table below contains a list of "economic" or "business model activities", phrased in non-legal language. This will allow respondents to better understand the scope of the regime and is meant for illustrative purposes only. It should be read in the context of the following caveats and clarifications:

- the wording of the activities should not be interpreted as draft legislation or the wording of regulated activities, but rather as an illustration to provide clarity on what sorts of activities HM Treasury intends to regulate (and when)
- the list is not exhaustive and activities with a very similar nature, purpose and risk profile could also be captured in the perimeter (to mitigate against risks of regulatory arbitrage)
- some future activities (beyond Phase 2) may ultimately be left out of the regulatory perimeter in full or in part, pending further consultation and analysis
- some activities – e.g. custody – will be addressed through Phase 1 for fiat-backed stablecoins and then later (under Phase 2) for other types of cryptoassets that come into the perimeter; we expect the same framework will be adopted for all types of cryptoassets as they come into regulation rather than having separate, overlapping regimes
- in addition to the activity-specific requirements set out below, HM Treasury is considering how to ensure that regulators have the necessary information to deliver their objectives, and how this can be obtained in the most cost-effective manner
- the FCA already has powers to implement regulatory requirements for activities relating to security tokens – which meet the definition of a specified investment – but the

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<sup>17</sup> <https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf>

cryptoasset regime being consulted on in this document does not replace or negate these existing powers

- the regulation pertaining to these activities will be subject to exemptions – for instance, only those firms or individuals undertaking these activities by way of business will be regulated – with this being especially relevant to activities like dealing in cryptoassets as principal, or mining and validation

**Table 4.A Proposed scope of cryptoasset activities to be regulated**

Activity category	Sub-activities (indicative, non-exhaustive)	Chapter	Phase
<b>Issuance activities</b>	Issuance and redemption of a fiat-backed stablecoin	Further detail to be set out in due course	Phase 1
	Admitting a cryptoasset to a cryptoasset trading venue	Chapter 5	<b>Phase 2</b>
	Making a public offer of a cryptoasset	Chapter 5	<b>Phase 2</b>
<b>Payment activities</b>	e.g. execution of payment transactions or remittances involving fiat-backed stablecoins	Further detail to be set out in due course	Phase 1
<b>Exchange activities</b>	Operating a cryptoasset trading venue which supports: (i) the exchange of cryptoassets for other cryptoassets (ii) the exchange of cryptoassets for fiat currency (iii) the exchange of cryptoassets for other assets (e.g. commodities)	Chapter 6	<b>Phase 2</b>
	Post-trade activities in cryptoassets (to the extent not already covered)	Chapter 12	Future phases
<b>Investment and risk management activities</b>	Dealing in cryptoassets as principal or agent	Chapter 7	<b>Phase 2</b>
	Arranging (bringing about) deals in cryptoassets		<b>Phase 2</b>
	Making arrangements with a view to transactions in cryptoassets		<b>Phase 2</b>
	Advising (to the extent not already covered) on cryptoassets	Chapter 12	Future phases (or exclude from regulatory perimeter)
	Managing (to the extent not already covered) cryptoassets		

Activity category	Sub-activities (indicative, non-exhaustive)	Chapter	Phase
<b>Lending, borrowing and leverage activities</b>	Operating a cryptoasset lending platform	Chapter 10	<b>Phase 2</b>
<b>Safeguarding and /or administration (custody) activities</b>	Safeguarding or safeguarding and administering (or arranging the same) a fiat-backed stablecoin and/or means of access to the fiat-backed stablecoin <sup>18</sup> (custody)	Further detail to be set out in due course	Phase 1
	Safeguarding or safeguarding and administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset <sup>19</sup> (custody)	Chapter 8	<b>Phase 2</b>
<b>Validation and governance activities</b>	Mining or validating transactions, or operating a node on a blockchain	Chapter 12	Future phases
	Using cryptoassets to run a validator node infrastructure on a proof-of-stake (PoS) network (layer 1 staking)		

## Additional considerations relating to vertically integrated business models

**4.9** In practice many cryptoasset exchanges play a central role in the cryptoasset ecosystem – conducting many more activities than solely operating a trading venue (e.g. custody, post-trade activities, proprietary trading, lending and admission of cryptoassets to a platform). Some venues may also issue their own native cryptoasset or act as intermediaries for the distribution of stablecoins. This is sometimes referred to as “vertical integration” or “agglomeration”. Accordingly, the government expects, as a minimum, that these entities follow rules covering all of these activities – not just those relevant for operating a trading venue. To illustrate, a major cryptoasset exchange would be required to comply with the issuance and disclosure rules for assets that they admit for trading (Chapter 5), the rules relating to the operation of a trading venue (Chapter 6) and certain surveillance and reporting requirements to detect and prevent market abuse (Chapter 9). Additionally, and depending on the sorts of activities they undertake, they would also need to comply with rules for market intermediaries (Chapter 7), cryptoasset custody rules for cryptoassets which they safeguard or safeguard and administer

<sup>18</sup> e.g. a wallet or cryptographic private key

<sup>19</sup> e.g. a wallet or cryptographic private key

(Chapter 8) and rules for operating a cryptoasset lending platform (Chapter 10).

**4.10** Exchanges which combine a number of regulated activities may present conflicts of interest as well as complex and sometimes reinforcing risk profiles, as demonstrated by the recent failure of FTX. This is especially problematic where there is a lack of transparency around organisational structures and balance sheets. Traditional financial institutions that provide multiple services and business lines are subject to comprehensive prudential and conduct regulation which seeks to address the risks of the combined entity, and in some cases particular functions are segregated. For instance, in traditional finance, when different functions or activities happen within a single group, regulation can require separate, independent governance, to ensure that the risks are properly managed and functions are separated in different entities or managed with tight controls and ring-fences. Further consideration will be given to the risks of such combined activities in the cryptoasset sector, and whether and how existing controls on combinations of activity in traditional finance could be applicable.

**4.11** Despite the existence of information on blockchains, there remains considerable opacity in cryptoasset markets, reflecting their often-pseudonymous nature, related inability to monitor aggregated position holdings, and the existence of off-chain activity. Information gathered by exchanges could therefore be of value to the authorities, for both market abuse and systemic risk monitoring purposes.

**4.12** Market participants in traditional finance are required to regularly report market data. However, given the size and structure of cryptoasset markets, the government considers that it would not be proportionate to require such regular reporting at this time. Instead, under the proposed regime venues would be required to keep, and make available at all times, accurate and comprehensive data related to trading on their exchanges. Authorities would retain the ability to propose more regular and wider reporting over time, for example if the size or interconnectedness of the crypto markets were to increase and as international standards in that area progress further.

## Activities relating to asset-referenced tokens

**4.13** In line with the existing perimeter guidance, the government intends to regulate financial services activities, rather than the assets themselves. This is consistent with the existing regulatory approach in traditional financial services, and also reduces risk of regulatory arbitrage through structuring products or instruments in particular ways to circumvent financial services regulation. This section provides further clarity on how this approach will work, since some jurisdictions have taken slightly different approaches and defined separate regimes according to the structure and characteristics of the asset. The government is already taking forward a regime for fiat-backed stablecoins which are used in payments – therefore, tokens used in that way are not considered in this chapter.

**4.14 “Commodity-linked tokens”** 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. Currently, these are a relatively small proportion of the market, representing less than 1% of daily trading volumes and market capitalisation.<sup>20</sup> While commodity-linked tokens have a range of use cases, they are often used by the holder to access the market of the underlying commodity in a way that may be cheaper and more flexible than buying the commodity outright. They could be structured or sold as an NFT representing a unique asset, for example real estate, or as a token referencing a commodity or basket of commodities. They can also be structured and marketed as “stablecoins”, by being pegged to a given commodity. In such a case the commodity/commodities would act as the underlying collateral.

**4.15** The structure of these assets and the ability to buy and sell them on cryptoasset trading venues, among other features, means that they may also share characteristics and pose similar operational, market integrity and consumer risks as ‘unbacked’ crypto tokens – for example, susceptibility to cyber-attacks and risk of consumer losses and fraud.

**4.16** There are already established regulatory structures to accommodate products which provide entry into the market for commodities or other assets (e.g. collective investment schemes, derivatives, or other fund structures). Indeed, where a particular arrangement meets the definition of a collective investment scheme in section 235 of FSMA then persons operating those arrangements will need to be authorised (unless exempt), will be subject to existing regulation, and the tokens themselves will constitute units to which relevant regulation will also likely apply.

**4.17** For these reasons, HM Treasury does not consider a bespoke regulatory regime for commodity-linked tokens to be required. If a commodity-linked token meets the definition of a specified investment, or the arrangements relating to the token meet the definition of a collective investment scheme, it should continue to be regulated accordingly, whether or not distributed ledgers are used in the underlying technology.

**4.18** If there are other commodity-linked tokens which do not meet the definition of a specified investment or financial instrument, but do meet the definition of a cryptoasset, then the **activities relating to these tokens could be adequately catered for through the broader cryptoasset regime** described in this consultation – including financial promotions rules (Chapter 3), disclosure rules for tokens which are admitted to trading or offered to the public (Chapter 5) and market abuse rules (Chapter 9). HM Treasury’s preference is to have a single, consistent framework to govern the trading, exchange, and custody of these tokens. Commodity-linked tokens would not qualify as a

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<sup>20</sup> CoinMarketCap; HM Treasury Analysis.

stablecoin under the proposed regime for fiat-backed stablecoins which only applies to those which are backed by fiat currency.

**4.19 “Crypto-backed tokens”** are those which reference their value in relation to other cryptoassets. Given the volatility of non-backed cryptoassets (such as Bitcoin), crypto-backed tokens may be “over-collateralised”, which means that they are backed with assets which are worth more than their value. For instance, £100 of Bitcoin may be required to collateralise the £50 value of a Bitcoin-backed token to account for fluctuations in the value of the underlying asset. There are several use cases for crypto-backed tokens. For some, they represent a more decentralised version of fiat-backed tokens, since they can be created through the use of smart contracts with no central entity controlling them. Crypto-backed tokens can also be issued to enable a cryptoasset to launch on a different blockchain.

**4.20** As with commodity-linked tokens, crypto-backed tokens can sometimes be marketed as “stablecoins” which are pegged to a currency, with a reserve of cryptoassets forming the collateral. Given that such tokens use unbacked cryptoassets as collateral, they are only as stable as the underlying cryptoasset. Whilst crypto-backed tokens are typically overcollateralised, the value of the unbacked cryptoassets underpinning the token can still vary drastically both inter and intra-day. This volatility could potentially undermine the stability of the crypto-backed token’s price.

**4.21** For these reasons, HM Treasury’s starting point is that **crypto-backed tokens should be regulated in the same way as unbacked cryptoassets** such as Bitcoin. However, depending on the structure and characteristics associated with the tokens, they could meet the definition of a specified investment and/or the arrangements carried on in relation to them could meet the definition of a collective investment scheme, in which case the tokens and activities carried on will likely be subject to regulation. Crypto-backed tokens would not qualify as a stablecoin under the proposed regime for fiat-backed stablecoins, which only applies to those which are backed by fiat currency.

**4.22** Some of the more specific risks relating to asset-referenced tokens – such as risks around the misrepresentation of the backing assets and/or the ability to redeem the tokens – are intended to be addressed through the proposed approach to activities regulation. In particular, the issuance and disclosures regime covered in Chapter 5 will provide a mechanism to protect against false information or major omissions in admission documents which will be required for cryptoassets made available for trading on a UK cryptoasset trading venue.

**4.23** This will be reinforced through the cryptoasset financial promotions regime which will require (amongst other proposals) in-scope promotions to be clear, fair and not misleading. This should reduce the risk of any token marketing itself as stable where this is



potentially not the case.<sup>21</sup> Financial stability risks potentially posed by the widespread adoption of asset-referenced tokens used in payments could be addressed by the regime expected to be put in place through the new concept of a “Digital Settlement Asset” in the Banking Act 2009 being introduced via the FS&M Bill – which could capture such tokens if needed.

## Activities relating to so-called algorithmic stablecoins

**4.24** So-called algorithmic stablecoins are a type of token that aims 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. For example, the recently collapsed TerraUSD token relied on a linked cryptoasset called “Luna”. Algorithmic stablecoins are typically undercollateralised as they don’t require independent assets in reserve. Instead, the model relies on economic incentives for individual users who are able to use any fluctuation in the stablecoin as an arbitrage opportunity.

**4.25** HM Treasury is not proposing to ban algorithmic tokens or to leave them outside the regulatory perimeter – an approach which has been proposed by some jurisdictions. However, given the undercollateralised nature of these tokens, so-called algorithmic stablecoins share characteristics with unbacked cryptoassets. As such, they would not qualify as a stablecoin under the proposed regime for fiat-backed stablecoins - which only applies to those which are backed by fiat currency. Their promise of ‘stability’ could also lead to different risk behaviours by investors. It is not clear that regulating the algorithm itself would provide adequate stability for this class of tokens given that the stability mechanism relies on constant trading by economic actors. For these reasons, **HM Treasury considers that activities relating to so-called algorithmic stablecoins should be subject to the same requirements as for unbacked cryptoassets.** As noted above, cryptoasset financial promotions rules should reduce the risk of firms marketing algorithmic stablecoins as “stable”, “payments instruments” or very similar terms where the use of those terms would be misleading.

## Activities relating to Non-Fungible Tokens (NFTs) and utility tokens

**4.26** An NFT is a digital asset that represents a real-world object, such as a digital only artwork, music, or game. Like other cryptoassets, NFTs use a technology such as DLT to record and verify ownership. Unlike some other cryptoassets, NFTs are not fungible; each NFT is unique and cannot be mutually traded or substituted for another token. There are a

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<sup>21</sup> Per FCA Guidance in COB 4.2.5 (G): a communication or a financial promotion should not describe a feature of a product or service as guaranteed”, “protected” or “secure”, or use a similar term unless that term is capable of being a fair, clear and not misleading description of it



number of risks associated with the NFT market including fraud, market manipulation and money laundering.

**4.27** Utility tokens are cryptoassets which provide digital access to a specific service or application (e.g. digital advertising or digital file storage) and use a technology such as DLT to support the recording or storage of data. 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.

**4.28** As noted in Chapter 2, financial services activities will be regulated, rather than the asset itself. All cryptoassets featured in Box 2.A – including NFTs and utility tokens – would have the potential to be included in the future regulatory perimeter if they were used in one of the activities in Table 4A. If an NFT or utility token is not used in such a way, it would not fall into scope of financial services regulation unless – as a result of the particular structure and characteristics of the NFT or utility token – it constitutes a specified investment and the activities carried on in relation to the token constitute regulated activities that fall within the existing perimeter.

#### **Box 4.A: Questions for Respondents**

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.
8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?
9. Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?
10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?
11. Are there any commodity-linked tokens which you consider would not be in scope of existing regulatory frameworks?
12. Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?
13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

# Chapter 5

## Regulatory Outcomes for Cryptoasset Issuance and Disclosures

**5.1** Within traditional financial services the closest parallel to the creation, issuance and distribution of cryptoassets probably exists in the securities markets. In the UK, company shares are governed in the first place by company law (primarily the Companies Act 2006) and financial services securities regulation is applied to transferable securities at the point at which they are offered to the public or admitted to trading on a regulated market. It is a criminal offence to make an offer or request admission to trading of transferable securities without an approved prospectus, although a number of exemptions are available – for example for offers addressed only to wholesale investors or offers which fall below a certain value threshold.

**5.2** For cryptoasset issuance and disclosures, the government proposes to follow a similar approach to that for securities and apply regulation when the asset is admitted to trading on a regulated cryptoasset trading venue and therefore becomes exchangeable for fiat currency, or subject to a public offer. In line with the approach applied to securities, HM Treasury does not intend to directly regulate the “creation” of unbacked cryptoassets under financial services regulation.

**5.3** The actors involved in the “issuance” process for cryptoassets – and the ways in which they subsequently behave once the cryptoassets have been issued – differ significantly from transferable securities such as bonds and equity instruments. Cryptoassets such as Bitcoin do not provide a claim on an identifiable issuer since coins can be created or “minted” according to a protocol which has been coded by computer developers often based in overseas or unknown locations. Even where the creator of the cryptoasset is identifiable, they do not have the same level of control over it as a company does over the securities it issues.

**5.4** The FSB is consulting on the recommendation that “authorities should have the appropriate powers and tools, and adequate resources to regulate, supervise, and oversee crypto-asset activities and markets, including crypto-asset issuers”. However, the paragraph above highlights some of the challenges and limitations of applying existing issuance and disclosure regulations which were developed for traditional financial markets. Other jurisdictions are taking a range of approaches to tackle this. In terms of public offers of cryptoassets

(roughly equivalent to an Initial Public Offering (IPO)) some countries have developed bespoke frameworks to govern Initial Coin Offerings (ICOs), whilst others deliberately do not on the basis that most ICOs would meet the criteria for being a security offering, and therefore are within existing laws. In terms of cryptoassets which are admitted to trading on an exchange or trading venue, some jurisdictions require approval by the relevant regulator to designate the cryptoasset as an “accepted asset”, or to confirm that it does not represent a security. There is also precedent for Self-Regulatory Organisations (SROs) in this space, for example the Japan Security Token Offering Association (JSTOA) is an SRO with a mandate to ensure security token offerings (STOs) comply with local securities laws.

## High level regulatory outcomes

**5.5 The 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.** The following list sets out the regulatory outcomes the government is seeking:

- a minimum standard of information regarding a cryptoasset should be available so investors are able to make informed investment decisions; this should be subject to a ‘necessary information test’, striking a balance between the interests of the investor and avoiding a disproportionate burden on the issuer or trading venue
- appropriate liability and compensation should be available for untrue or misleading statements made in disclosure / admission documents
- an appropriate level of due diligence should be performed over the content of disclosure / admission documents
- an appropriate level of investor protection should be offered around marketing materials and advertisements, and trading venues should have in place rules governing marketing materials / product appropriateness
- there should be controls or procedures to prevent a harmful offer from being made (e.g. to detect fraud)

## Proposed regulatory approach

**5.6** The proposed approach would generally follow the principles of the intended reform of the UK prospectus regime – the Public Offer and Admissions to Trading Regime.<sup>22</sup>

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<sup>22</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1123008/Po  
licy\\_Note\\_Admissions\\_to\\_Trading\\_and\\_Public\\_Offer\\_Regime\\_Illustrative\\_Statutory\\_Instrument.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1123008/Policy_Note_Admissions_to_Trading_and_Public_Offer_Regime_Illustrative_Statutory_Instrument.pdf)

**5.7** Under the intended reforms there will be a general prohibition on public offerings of securities, subject to certain exemptions. These include (i) where the securities are admitted to trading on a UK Regulated Market (ii) where the securities are admitted to trading on MTFs operating primary markets and (iii) securities offered via a “public offer platform” (a new bespoke permission for platforms facilitating public offers of unlisted securities, such as crowdfunding platforms). In addition, certain exemptions are intended to be available according to the type or scope of public offer, including offers below a de minimis monetary threshold, offers made only to “qualified investors” and offers made to fewer than 150 persons.

**5.8** For securities admitted to trading on a Regulated Market, the FCA will set detailed rules, including on whether a prospectus is required and what it should contain. For securities admitted to trading on an MTF, the FCA would be given rulemaking powers to ensure that, in appropriate circumstances, the rulebooks of MTFs operating as primary markets require an admission document to be published and treated as a prospectus. Those admission documents will therefore also be subject to the statutory compensation remedy for prospectuses.

**5.9** Outside of admissions to trading on a regulated market or MTF, the government intends to continue to allow companies to offer securities to the public where certain conditions apply regarding the size of the offer. An alternative route will also be available, through which offers can be made to the public via a new regulated activity covering the operation of an electronic platform for the public offering of securities (such as a crowdfunding platform). In this case, a prospectus will not be required, but the FCA will determine the detailed requirements for such platforms including the levels of due diligence and disclosure required on offers made through them.

**5.10** For cryptoassets, two regulatory trigger points have been considered:

1. Admitting (or seeking the admission of) a cryptoasset to a cryptoasset trading venue
2. Making a public offer of cryptoassets (including ICOs)

**5.11 For admission of cryptoassets to a UK cryptoasset trading venue, the government is proposing to adapt the MTF model from the intended reform of the UK prospectus regime.** The FCA would include principles in their rule book for admission and disclosure requirements that cryptoasset trading venues would then be responsible for administering. Cryptoasset trading venues would be responsible for writing more detailed content requirements for admission and disclosure documents as well as performing due diligence on the entity admitting the cryptoasset. Where there is no issuer (e.g. Bitcoin), the trading venue would be required to take on the responsibilities of the issuer if they wish to admit the asset to trading. The venue would be given a choice as to whether the admission and disclosure document itself has to comply with financial promotions

rules, or whether it has to be accompanied by a separate document for this purpose. All admission and disclosure documents would then be stored on the National Storage Mechanism (NSM), maintained by the FCA.<sup>23</sup>

**5.12 The government considers public offers of cryptoassets – including ICOs where a fund raiser creates new tokens and sells them to investors – may meet the definition of a security offering.**

The presence of a token per se does not fundamentally change the nature of a capital raising event from a regulatory perspective. **For public offers of cryptoassets which meet the definition of a security offering and are considered an STO, the intended Public Offers and Admissions to Trading Regime could be an adequate regulatory framework to capture this activity.** Accordingly, public offers of cryptoassets which are deemed to be security token offerings which were less than the de minimis monetary threshold in the reformed regime would be exempt. Those that were larger, would need to go through a public offer platform (or a Regulated Market or a primary MTF) and would not require a prospectus; instead, due diligence would be done via the platform according to the platform's rules.

**5.13** For public offers of cryptoassets which do not meet the definition of a security token offering, the government is considering an alternative route to regulate the activity. **The DAR – or similar legislative mechanism – could be used to prohibit these offers unless they were conducted via a regulated platform.** Again, due diligence would need to be performed by the platform according to its rules.

**5.14** The FCA will also consider whether ongoing disclosures should be required subsequent to cryptoassets being admitted to a trading venue in order to ensure a minimum standard of information is available to investors.

**5.15** The proposed features of the regime are summarised in Table 5.A below:

**Table 5.A. Proposed design features for cryptoasset issuance and disclosures regime**

<b>Basis for the regime</b>	<ul style="list-style-type: none"><li>• A mix of provisions from existing MTF and public offer platform disclosure regimes</li><li>• Specific characteristics and risks of cryptoasset issuance will need to be accommodated (e.g. disclosing details of the underlying technology)</li></ul>
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<sup>23</sup> <https://www.fca.org.uk/markets/primary-markets/regulatory-disclosures/national-storage-mechanism>

<b>Definition / regulatory trigger point</b>	<ul style="list-style-type: none"> <li>• Admitting (or seeking admission of) a cryptoasset to a cryptoasset trading venue,<sup>24</sup> which will be in accordance with the venue's admission requirements and subject to overarching FCA-defined principles set out in their rulebook</li> <li>• Making a public offer of a cryptoasset (including ICOs), which would need to be done via a regulated platform</li> </ul>
<b>Responsibility for defining content requirements and vetting disclosure / admission document content</b>	<ul style="list-style-type: none"> <li>• The venue will write detailed requirements for disclosure documents required for admission, in accordance with principles established in the FCA's rulebook</li> <li>• The government does not expect these admission disclosure documents to take the same shape and form as a traditional prospectus given specific characteristics and investor profiles of cryptoassets</li> <li>• Venues should be required to reject the admission of cryptoassets should they consider that it may result in investor detriment</li> </ul>
<b>Responsibility for preparing the disclosure / admission document content</b>	<ul style="list-style-type: none"> <li>• The issuer or the trading venue would prepare the admission documents, should they be willing to take on all the associated responsibilities, including consideration within their prudential requirements</li> <li>• The FCA will also consider whether ongoing disclosures should be required subsequent to a cryptoasset being admitted to a venue, in order to ensure a minimum standard of information is available to investors; this could cover information such as code audits, or planned changes to the way a cryptoasset functions (e.g. the recent Ethereum "merge")</li> </ul>
<b>Liability for disclosure / admission document content</b>	<ul style="list-style-type: none"> <li>• Liability would be applied to the preparer of the document, which could be the issuer or the trading venue</li> <li>• Clear liability should be attached to the preparer of the document</li> <li>• A necessary information test (see below) would be used to determine liability outcomes - for example where an investor had suffered loss as a result of the preparer of the disclosure / admission document omitting necessary information.</li> </ul>

<sup>24</sup> See Chapter 6 for description of a cryptoasset trading venue

	<ul style="list-style-type: none"> <li>• Liability standards are likely to be based on the “negligence standard” currently applicable to the contents of a prospectus under the existing prospectus regime (Section 90, Schedule 10 FSMA) or the “recklessness standard” currently applicable to information published via a recognised information service under the existing prospectus regime (Section 90A, Schedule 10A FSMA), or some hybrid of the two according to the type of disclosure (e.g. distinguishing between certain types of forward-looking information)</li> <li>• Some prudential requirements are likely to be necessary for issuers to ensure they are able to absorb losses arising from liability (either through adequate financial resources or professional indemnity arrangements)</li> </ul>
<b>Proposed necessary information test for cryptoasset disclosure / admission documents</b>	<ul style="list-style-type: none"> <li>• We provisionally consider that disclosure documents (which could be required for either an offer to the public, where not already required by existing law, or for admission onto a trading venue) could require the following as necessary information material for an investor making an informed assessment of the cryptoasset: <ul style="list-style-type: none"> <li>– the features, prospects and risks of the cryptoassets</li> <li>– the rights and obligations attached to the cryptoassets (if any)</li> <li>– an outline of the underlying technology (including protocol and consensus mechanism)</li> <li>– if applicable, the person seeking admission to trading on a cryptoasset trading venue</li> </ul> </li> <li>• Information may vary depending on the following: i) the type and design of the cryptoasset; or ii) if, or as applicable, the nature and circumstances of the person making the public offer or seeking admission to trading on a cryptoasset trading venue</li> </ul>
<b>Admission document storage and re-use</b>	<ul style="list-style-type: none"> <li>• All admission and disclosure documents should be stored on the NSM, maintained by the FCA</li> <li>• Venues would be required to search the NSM before new admissions and ensure information is consistent with other documents lodged</li> <li>• Venues would be able to accept other regulated trading venues’ disclosure / admission documents if they chose</li> </ul>

**Marketing,  
disclosures, and  
promotions**

- Venues should have in place rules governing the accuracy and fairness of marketing materials / advertisements.
- Where marketing materials / advertisements are available to retail investors, they will need to comply with the financial promotion regime. Exceptions likely to apply (e.g. for disclosures relating to cryptoassets which are only offered to qualified investors)

**Box 5.A: Questions for Respondents**

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?
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?
16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?
17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?
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?



# Chapter 6

## Regulatory Outcomes for Operating a Cryptoasset Trading Venue

**6.1** Cryptoasset trading venues (often referred to as “exchanges”) are still at a relatively early stage of development when compared to traditional financial market infrastructures. Many of the risks associated with cryptoasset trading are comparable to those of traditional exchanges, including operational disruptions and fraudulent or market abusive trading. However, the proliferation of cryptoasset trading venues across the globe has heightened challenges around monitoring trading venue activity (e.g. for AML purposes) and protecting consumers. Lack of regulation to support market integrity and increased fragmentation of liquidity across venues and jurisdictions is also creating more opportunities for market manipulation. The FSB have identified a range of other risks associated with cryptoasset trading venue activities, including counterparty credit, market, exchange rate and operational risks.

**6.2** Most jurisdictions with existing regulatory frameworks for cryptoassets have sought to address these challenges by defining persons who are operating a cryptoasset trading venue or offering exchange-like services as cryptoasset service providers (CASPs), or a similarly termed designation.<sup>25</sup> CASPs are then subject to a range of obligations including authorisation or licensing rules, prudential requirements, operational resilience rules and conduct and consumer protection rules. This provides regulators with the appropriate powers and tools to regulate, supervise, and oversee cryptoasset activities and markets, including cryptoasset trading venues and other CASPs.

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<sup>25</sup> Also known by various other terms depending on the jurisdiction – e.g. Virtual Asset Service Providers (VASPs), Digital Payment Token (DPT) service providers, Crypto Asset Exchange Service Providers (CAESPs), Crypto Asset Secondary Service Providers (CASSPrs)

## High Regulatory Outcomes

**6.3** The following list sets out the regulatory outcomes the government is seeking to achieve through a cryptoasset trading venues regime:

- there should be orderly, open and resilient conditions for trading on cryptoasset trading venues
- venues should have transparent and fair access and operating rules
- persons operating cryptoasset trading venues should have the people, processes, systems and controls to facilitate fair, orderly and efficient trading, and address conflicts of interest
- persons operating cryptoasset trading venues should have the systems and processes for ensuring accurate market data (both on- and off-chain) is available in real time where appropriate

## Proposed Regulatory Approach

**6.4** **HM Treasury is proposing to establish a regulatory framework which is based on existing RAO activities of regulated trading venues – including the operation of an MTF.** Accordingly, persons carrying out these activities would be subject to prudential rules and various other requirements including consumer protection, operational resilience, and data reporting. This is set out in further detail below.

**Table 6.A. Proposed design features for cryptoasset trading regime**

<b>Definition / regulatory trigger point</b>	<ul style="list-style-type: none"><li>• Operating a cryptoasset trading venue</li></ul>
<b>Basis for the regime</b>	<ul style="list-style-type: none"><li>• To be based on existing RAO activities of regulated trading venues, including the operation of an MTF</li><li>• Specific characteristics and risks of cryptoasset trading activities will need to be accommodated (e.g. cyber security risks or risks arising from conflicts of interests which are specific to the cryptoasset industry)</li></ul>
<b>Authorisation rules</b>	<ul style="list-style-type: none"><li>• Authorisation will be required since operating a cryptoasset trading venue will become a regulated activity under the RAO</li><li>• Applications should include details of operations, services and business plans, description of organisational and governance arrangements, description of controls and risk management</li></ul>

	processes, cybersecurity, outsourcing arrangements and financial resources
<b>Location requirement</b>	<ul style="list-style-type: none"> <li>• Scope will be set by whether: i) firms are incorporated in the UK; and ii) services are being provided to UK persons (natural or legal)</li> <li>• Requirements on physical location to be determined by the FCA. It is expected that this will be informed by the FCA's existing framework for international firms (see Chapter 4 for further detail)<sup>26</sup>.</li> <li>• Firms operating cryptoasset trading venues would likely require subsidiarisation in the UK given their critical role in the cryptoasset value chain</li> </ul>
<b>Prudential requirements</b>	<ul style="list-style-type: none"> <li>• Persons operating trading venues should have sufficient financial resources to conduct business in a prudent manner</li> <li>• Thresholds to be set by the FCA – e.g. minimum capital, liquidity and other relevant prudential requirements addressing both the potential for harm from on-going operations and the ability to wind-down in an orderly manner</li> </ul>
<b>Consumer protection and governance requirements</b>	<ul style="list-style-type: none"> <li>• Venues should have fair, open and transparent access rules and fee schedules</li> <li>• Conflicts of interest should be appropriately identified and managed. Separate entities may be required should conflicts prove unmanageable</li> <li>• Persons operating trading venues should have robust governance arrangements</li> <li>• There should be adequate procedures for handling customer complaints</li> </ul>
<b>Operational resilience requirements</b>	<ul style="list-style-type: none"> <li>• Persons operating trading venues should have the people, processes, systems, controls and arrangements to ensure that their trading systems are resilient, including under conditions of market stress</li> <li>• Outsourcing arrangements should require appropriate due diligence, ongoing oversight and formal documentation</li> </ul>

<sup>26</sup> <https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf>

	<ul style="list-style-type: none"> <li>Trading systems should be subject to effective business continuity, disaster recovery arrangements and cyber security protections</li> </ul>
<b>Data reporting</b>	<ul style="list-style-type: none"> <li>Cryptoasset trading venues should have the capability to make accurate and complete information readily accessible for both the on- and off-chain transactions which they facilitate</li> <li>This should include the need to have systems in place for sharing information, such as order book data, with other trading venues that admit the same cryptoasset to trading for market abuse monitoring purposes (see Chapter 9)</li> <li>Specific requirements to be set by the FCA, which are likely to require order book data and transaction information (e.g. type of cryptoasset, price, time stamp, wallet information) and information concerning management of large positions (e.g. size of holdings and holder information for large positions) – as well as market abuse reporting (see Chapter 9)</li> <li>This could potentially be done through arrangements with specialist blockchain surveillance providers as an alternative to using or developing in-house capabilities</li> <li>Authorities would retain the ability to propose more regular and wider reporting over time</li> </ul>
<b>Resolution and Insolvency</b>	<ul style="list-style-type: none"> <li>Insolvency powers under Part 24 of FSMA should apply, enabling the FCA to participate in insolvency proceedings governed by the Insolvency Act</li> <li>The government will consider whether a bespoke resolution regime should be developed in time (e.g. new special administration regime)</li> </ul>

### **Box 6.A: Questions for respondents**

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

# Chapter 7

## Regulatory Outcomes for Cryptoasset Intermediation Activities

**7.1** As with traditional financial markets, cryptoasset intermediaries play an important role in the ecosystem. Dealers and liquidity providers make markets in cryptoassets, helping to increase order book depth and narrow spreads. Some firms facilitate cryptoasset trading by arranging transactions which take place “off-exchange” (i.e. not on a centralised order book). Agency brokers help execute trades on behalf of investors and other market participants. Specialist cryptoasset firms and some large traditional financial services firms operate in this space.

**7.2** The FSB have highlighted a number of risks that can arise from these activities, including those arising from conflicts of interest and, in the case of some business models, credit and liquidity risks.<sup>27</sup> Most jurisdictions with established regulatory frameworks for cryptoassets have sought to bring these types of activities into the regulatory perimeter in some way, often through adapting securities legislation.

**7.3** The activities of these market intermediaries have much in common with 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. For these already regulated activities, the FCA’s Senior Management Arrangements, Systems and Controls (SYSC) sourcebook contains requirements on management bodies, systems and controls and conflicts of interest, while MIFIDPRU is the FCA handbook which sets out relevant prudential rules. Conduct of business requirements regulating the way firms interact with their clients, including rules on acting in clients’ best interests, communicating with clients, and the execution of client orders are contained in various articles of MiFID II (including Articles 24 to 30) and in the FCA’s Conduct of Business Sourcebook (COBS).

### High level regulatory outcomes

**7.4** The regulatory outcomes the government is seeking to achieve through a cryptoasset market intermediaries regime include the following:

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<sup>27</sup> <https://www.fsb.org/wp-content/uploads/P111022-3.pdf>

- there should be fair and transparent conditions for any trades executed for, or on behalf of, a third party
- trades should be executed in a way that serves the best interest of the client
- persons offering cryptoasset market intermediation should have effective controls and arrangements to manage conflicts of interest
- persons offering cryptoasset market intermediation should have sufficient financial resources to conduct business in a prudent manner
- persons operating cryptoasset trading venues should have systems and processes to be able to detect market abuse and submit suspicious transaction and order reports (STORs)

## Proposed regulatory approach

**7.5 The 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.** The government does not consider that there are many major differences required to existing requirements for investment firms but there may need to be additional rules or guidance to address specific risks and characteristics of cryptoasset market intermediation activities (e.g. to address conflicts of interest that arise from more vertically integrated cryptoasset business models, or specific controls or resilience requirements). The proposed design features of the regime are set out in further detail in Table 7.A below.

**Table 7.A Proposed Design Features for Cryptoasset Market Intermediation Regime**

<b>Definition / regulatory trigger point<sup>28</sup></b>	<ul style="list-style-type: none"> <li>• Dealing in cryptoassets as principal or agent</li> <li>• Arranging (bringing about) deals in cryptoassets</li> <li>• Making arrangements with a view to transactions in cryptoassets</li> </ul>
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<sup>28</sup> For analogous activities in the existing regulatory perimeter, readers should refer to i) Article 14 of the RAO (“Buying, selling, subscribing for or underwriting....as principal); ii) Article 21 of the RAO (“Buying, selling, subscribing for or underwriting....as agent); iii) Article 25(1) of the RAO (“Making arrangements for another person (whether as principal or agent) to buy, sell, subscribe for or underwrite...”); and iv) Article 25 (2) of the RAO (“Making arrangements with a view to a person who participates in the arrangements buying, selling, subscribing for or underwriting...(whether as principal or agent)...)”)

<b>Basis for the regime</b>	<ul style="list-style-type: none"> <li>• MiFID derived rules applying to similar “investment services and activities” – e.g. dealing on own account, (Annex I, Section A (3) of MiFID), execution of orders on behalf of clients (Annex I, Section A (2) of MiFID) and reception and transmission of orders in relation to one or more financial instruments (Annex I, Section A (1) of MiFID)</li> </ul>
<b>Authorisation rules</b>	<ul style="list-style-type: none"> <li>• Authorisation will be required since the above listed activities will become regulated activities under the RAO</li> <li>• Applications should include details of operations, services and business plans, description of organisational and governance arrangements, description of controls and risk management processes, cybersecurity, outsourcing arrangements, and financial resources</li> </ul>
<b>Location requirements</b>	<ul style="list-style-type: none"> <li>• Scope will be set by whether: i) firms are incorporated in the UK; ii) services are being provided to UK persons (natural or legal)</li> <li>• Requirements on physical location to be determined by the FCA. It is expected that this will be informed by the FCA's existing framework for international firms (see Chapter 4 for more details)<sup>29</sup></li> </ul>
<b>Consumer protection and governance requirements</b>	<ul style="list-style-type: none"> <li>• Persons offering cryptoasset intermediation services should act honestly and fairly, and in the best interests of their clients</li> <li>• Conflicts of interest should be appropriately identified and managed</li> <li>• All reasonable steps should be made to obtain the best possible result for the client when executing a client order</li> <li>• Firms should assess cryptoassets as appropriate for the consumer before an application or order to purchase can be made</li> <li>• Trading arrangements should be transparent to clients - e.g. liquidity sourcing and execution methods, related parties, fees and price methodology</li> </ul>
<b>Data reporting</b>	<ul style="list-style-type: none"> <li>• Persons professionally intermediating orders should have the systems and controls to be able to detect market abuse and submit STORs to the relevant trading venue (see Chapter 9)</li> </ul>

<sup>29</sup> <https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf>

	<ul style="list-style-type: none"> <li>• Authorities would retain the ability to put in place further reporting requirements in future, including regular and wider reporting over time</li> </ul>
<b>Prudential requirements</b>	<ul style="list-style-type: none"> <li>• Persons offering cryptoasset intermediation services should have sufficient financial resources to conduct business in a prudent manner</li> <li>• Thresholds to be set by the FCA – e.g. minimum capital, liquidity and other relevant prudential requirements addressing both the potential for harm from on-going operations and the ability to wind-down in an orderly manner</li> </ul>
<b>Operational resilience requirements</b>	<ul style="list-style-type: none"> <li>• Persons offering cryptoasset intermediation services should have adequate people, processes, systems, and controls to mitigate operational resilience risks</li> <li>• Outsourcing arrangements should require appropriate due diligence, ongoing oversight, and formal documentation</li> </ul>
<b>Resolution and insolvency</b>	<ul style="list-style-type: none"> <li>• Insolvency powers under Part 24 of FSMA should apply, enabling the FCA to participate in insolvency proceedings governed by the Insolvency Act</li> <li>• The government will consider whether a bespoke resolution regime should be developed in time (e.g. new special administration regime)</li> </ul>

### **Box 7.A: Questions for respondents**

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



# Chapter 8

## Regulatory outcomes for cryptoasset custody

**8.1** In financial services, the term custody broadly refers to a firm holding an asset on behalf of another. In traditional financial models, investors rely on a custodian to access global markets and secure their assets to reduce risk of theft or loss. In the UK, there is an established custody regulatory framework for traditional finance which is primarily set through Article 40 of the RAO and the FCA's Client Assets Sourcebook (CASS). These requirements aim to protect investors' custody assets while a firm is a going concern such that, if and when the custodian becomes insolvent, those assets are returned to investors promptly and as whole as possible.

**8.2** Custody represents one of the key aspects of the cryptoasset lifecycle in terms of providing investors access to, and safe storage of, their assets. Custody of cryptoassets is conceptually similar to traditional finance as the custodian holds itself out as being responsible for safekeeping a cryptoasset on behalf of another. However, in contrast to traditional finance custody, information is recorded on DLT (often pseudonymously) and the custodian generally holds a 'private key'<sup>30</sup> that allows access and usage of the cryptoasset. Custody providers can use a range of technology solutions to secure the assets and private keys – for example, cold (offline) storage or multi-signature hot (online) wallets, as well as techniques such as multi-party computation.<sup>31</sup> They can also undertake off-chain transactions outside of the blockchain network. Therefore, the digital nature of the asset means that cryptoasset custody operates differently from traditional finance custody arrangements in some important ways. The irreversible, immutable nature of cryptoasset transactions also means that protecting against unauthorised access to these private keys is especially important.

**8.3** Currently there is no regime for cryptoasset custody in the UK and industry feedback has highlighted that there is a wide variance of cryptoasset custody business models and practices. If a cryptoasset custodian were to fail today, the lack of a clear regulatory framework results in uncertainty that would likely cause harm by delay and cost to

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<sup>30</sup> A private key is a string of alphanumeric characters – similar to a password – which is used to perform functions like signing and authorising a cryptoasset transaction

<sup>31</sup> Multi-party computation enables multiple parties – each with their own private data – to evaluate a computation without ever revealing any of the private data held by each party

investors in obtaining their assets back. More significantly, without clear and tailored regulatory standards to which firms are required to adhere, cryptoassets may not be safeguarded adequately, leading to risk of losses should the firm enter insolvency (either as a consequence of the assets being treated as assets of the firm or due to loss, fraud or operational errors). In addition to the harm to investors, an outcome that results in uncertainty in insolvency could also impact confidence in the market.

**8.4** Related work underway by the Law Commission, exploring whether English and Welsh law needs to be adapted to accommodate digital assets, has considered different custody arrangements and the legal obligations that they may give rise to. Future recommendations from this work will be considered in developing the regime.

**8.5** Liability standards for custodians are also under consideration by the authorities. The government is exploring taking a proportionate approach which may not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control.

**8.6** As noted in Chapter 4, custody requirements will be addressed through phase 1 for fiat-backed stablecoins and under Phase 2 for other types of cryptoassets that come into the regulatory perimeter. The government expects the same custody requirements will be adopted for all types of cryptoassets as they come into regulation. For cryptoassets that already meet the definition of a specified investment (security tokens), the existing regulatory framework that currently applies will be replaced by the new custody regime. The FCA expect to run a separate consultation on this.

## High level regulatory outcomes

**8.7** The following list sets out the regulatory outcomes the government is seeking to achieve through a cryptoasset custody regime:

1. custodians should ensure adequate arrangements to safeguard investors' rights to their cryptoassets when it is responsible for them such that, if and when the custodian becomes insolvent, those assets are returned to investors promptly and as whole as possible
2. custodians should have sufficient financial resources to conduct business, wind down and, where applicable, fail without causing significant harm to consumers and market participants
3. custodians should establish clear processes for redress in the event that cryptoassets held in custody are lost
4. custodians should maintain adequate systems, controls and governance arrangements to help minimise risk of misuse or loss to investors' cryptoassets

5. authorities would retain the ability to put in place more comprehensive reporting requirements in future, including regular and wider reporting over time

## Proposed regulatory approach

**8.8 The 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.** Key design features are set out in further detail in the table below.

**Table 8.A. Proposed Design Features for Cryptoasset Custody Regime**

<b>Definition / regulatory trigger point</b>	<ul style="list-style-type: none"> <li>• Safeguarding, or safeguarding and administering (or arranging the safeguarding or safeguarding and administering) of a cryptoasset other than a fiat-backed stablecoin and / or means of access to a cryptoasset (e.g. a wallet or cryptographic private key)</li> <li>• This activity would be broader than the closest equivalent regulated activity (Article 40 of the RAO) as it would capture firms that only safeguard (but not administer) assets (e.g. firms that solely safeguard cryptographic private keys which provide access to cryptoassets). The government considers those arrangements in the cryptoassets market to pose the same risks of harm as firms that safeguard and administer assets. This broader definition is also consistent with the definition of cryptoasset custodians in the Money Laundering and Terrorist Financing (Amendment) Regulations 2019</li> </ul>
<b>Basis for the regime</b>	<ul style="list-style-type: none"> <li>• Existing frameworks for traditional finance custodians under Article 40 of the RAO, making suitable modifications to accommodate unique cryptoasset features, or putting in place new provisions where appropriate (e.g. specific controls and safeguards for the safekeeping of private keys)</li> </ul>
<b>Authorisation / licensing rules</b>	<ul style="list-style-type: none"> <li>• Authorisation will be required since the activities described above are expected to become regulated activities</li> <li>• Applications should include details of operations, services and business plan, description of organisational and governance arrangements, description of controls and risk management</li> </ul>

	processes, cybersecurity, outsourcing arrangements, and financial resources
<b>Location requirements</b>	<ul style="list-style-type: none"> <li>• Scope will be set by whether: i) firms are incorporated in the UK; or ii) services are being provided to UK persons (natural or legal)</li> <li>• Requirements on physical location to be determined by the FCA. It is expected that this will be informed by the FCA's existing framework for international firms (see Chapter 4 for more details)<sup>32</sup></li> </ul>
<b>Custody / safeguarding / client assets rules (CASS)</b>	<ul style="list-style-type: none"> <li>• Existing custody provisions in the Client Assets Sourcebook (CASS) to be used as a basis to design bespoke custody requirements for cryptoassets. These provisions aim to protect investors' rights to their assets while a firm is a going concern such that, if and when a custodian becomes insolvent, assets are returned to investors promptly and as whole as possible. Core components of the custody provisions are expected to be the following: <ul style="list-style-type: none"> <li>– adequate arrangements to safeguard investors' rights to their cryptoassets (e.g. restrict commingling of investors' assets and the firm's own assets)</li> <li>– adequate organisational arrangements to minimise risk of loss or diminution of investors' custody assets</li> <li>– accurate books and records of investors' custody assets holdings</li> <li>– adequate controls and governance over safeguarding arrangements of investors' custody assets holdings</li> </ul> </li> </ul>
<b>Prudential requirements</b>	<ul style="list-style-type: none"> <li>• Persons offering cryptoasset custody should have sufficient financial resources to conduct business in a prudent manner</li> <li>• Thresholds to be set by the FCA – e.g. minimum capital, liquidity and other relevant prudential requirements addressing both the potential for harm from on-going operations and the ability to wind-down in an orderly manner</li> <li>• Analogous regimes will be considered as a starting point for policy development)</li> </ul>

<sup>32</sup> <https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf>

<b>Consumer protection and governance requirements</b>	<ul style="list-style-type: none"> <li>• Availability of FSCS protection for claims against failed authorised cryptoasset custodians under consideration and to be determined by FCA</li> <li>• Persons offering cryptoasset custody should have robust governance arrangements</li> <li>• Conduct of business requirements (e.g. client disclosures, clear contractual terms) should be met by persons offering cryptoasset custody</li> </ul>
<b>Operational resilience requirements</b>	<ul style="list-style-type: none"> <li>• Persons offering cryptoasset custody should have adequate people, processes, systems, and controls to mitigate operational resilience risks related to custody, such as inaccurate record-keeping, loss or malfunction of means of access to cryptoassets, and / or mismanagement or misuse of cryptoassets</li> <li>• Outsourcing (including sub-custodian) arrangements should require appropriate due diligence, ongoing oversight and formal documentation</li> </ul>
<b>Resolution and insolvency</b>	<ul style="list-style-type: none"> <li>• Insolvency powers under Part 24 of FSMA should apply, enabling the FCA to participate in insolvency proceedings governed by the Insolvency Act</li> <li>• The government will consider whether a bespoke resolution regime should be developed (e.g., new special administration regime)</li> </ul>

### **Box 8.A: Questions for Respondents**

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?

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

# Chapter 9

## General Market Abuse Requirements

**9.1** In traditional financial services, the UK has a market abuse regime (MAR) which applies to i) financial instruments that are admitted (or requested to be admitted) to trading on a regulated UK, Gibraltar or EU trading venue and ii) other financial instruments (e.g. derivatives) whose price depends on those instruments. MAR defines and prohibits insider dealing, unlawful disclosure of inside information and market manipulation. All persons, regardless of where they are based, are subject to the prohibitions on market abuse.

**9.2** MAR places various obligations on market participants to prevent and detect market abuse. For example, issuers must maintain lists of persons who have access to inside information (insider lists) and must disclose inside information which concerns the issuer as soon as possible, although delayed disclosure is permissible if certain conditions are met. Trading venues must maintain effective arrangements, systems, and procedures to prevent and detect market abuse. Persons professionally arranging or executing transactions must also have in place arrangements, systems, and procedures to detect and report Suspicious Transaction and Order Report (STORs) and notify these to the FCA without delay. A suspicious transaction or order is one where there are 'reasonable grounds' to suspect it might be market abuse. In addition to requirements under UK MAR, authorised firms must also have policies and procedures for countering the risk that the firm might be used to further financial crime, including market abuse (see FCA Financial Crime Guide).<sup>33</sup>

**9.3** The table in Annex B sets out core elements of the behaviours that constitute the three offences under the retained EU law version of the Market Abuse Regulation (596/2014) (UK MAR).<sup>34</sup>

**9.4** While the technology and the channels used to conduct market abuse may be different in cryptoasset markets compared to traditional markets, the types of activities and behaviours are similar. There is

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<sup>33</sup> <https://www.handbook.fca.org.uk/handbook/FCG.pdf>

<sup>34</sup> Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC (Text with EEA relevance) (Retained EU Legislation)

significant evidence in cryptoasset markets of “pump and dump”<sup>35</sup> and “trash and cash”<sup>36</sup> schemes which resemble price manipulation strategies carried out on equity instruments. Other market manipulation behaviours which have been reported include “wash trading” and “spoofing”, among other trading techniques which seek to give false market signals or distort pricing to the advantage of the orchestrator. In addition to market manipulation, there are parallels to the activities of insider dealing or acting on non-public information, which are prohibited in securities markets. For example, there is evidence of “front-running” ahead of coin listings on cryptoasset exchanges, whereby a number of market participants have traded at favourable prices immediately before a coin listing (where the timing information of that coin listing was not available to the general public). Novel abusive behaviours may also be possible in cryptoasset markets.

**9.5** One of the key challenges which policy makers and regulators face is that some of the existing market abuse regulations are based around concepts and market structures which manifest themselves differently in cryptoasset markets versus traditional securities markets. For example, some of the requirements under the existing market abuse regulations are orientated around the concept of a traditional issuer. In traditional securities markets the issuer is often the main holder and creator of inside information which is reflected in the structure and design of the market abuse regulations. However, this concept does not translate easily to cryptoassets, since there may not be a clearly identifiable issuer, or the issuer may be an individual rather than a corporate entity. In these circumstances it may be challenging to place obligations on the “issuer” to control inside information. Further, as price movements in cryptoasset markets are often linked to supply and demand rather than the fundamental nature of the cryptoasset, inside information may be more likely to be held or created by entities other than the issuer – e.g. miners, validators and oracles.<sup>37</sup> Manipulation from the “true” value of the cryptoasset may therefore be harder to detect.

**9.6** Another difference versus traditional markets is that the cryptoasset market currently has a higher proportion of direct retail participation. This creates a gap in the surveillance of market abuse as there may not be intermediaries who have obligations to detect and prevent market abuse. It is likely to be challenging to impose similar obligations on direct retail market participants.

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<sup>35</sup> “Pump and dump” schemes take place when the operator(s) of the scheme artificially inflate the price of an asset using false and misleading information in order to sell assets at a higher price (“pumping”). The operators of the scheme then sell the overvalued assets (“dumping”) before the price collapses

<sup>36</sup> “Trash and cash” schemes are the inverse of “pump and dump” schemes; the operator of the scheme disseminates false, misleading or damaging information about the asset (“trashing”) causing the market price to fall artificially. The scheme operators then buy the assets at undervalued prices (“cashing”)

<sup>37</sup> Oracles connect blockchains to external systems, allowing smart contracts to be executed according to instructions and data held in legacy systems; they are a way of connecting traditional systems to decentralised infrastructures

**9.7** The highly globalised, fragmented, and borderless nature of cryptoasset markets makes the cross-border challenges of identifying and controlling market abuse behaviours materially more difficult than, for example, in more localised equity and fixed income markets where there are clear ‘main’ markets where the majority of trading is concentrated. Cryptoasset trading venues are globally accessible by retail and institutional market participants, and there is little geographic nexus between the trading venue, the entity who issued the cryptoasset and those trading the cryptoasset. At present there are thousands of tokens being traded within and across hundreds of cryptoasset trading venues domiciled in dozens of different countries. There is trading across the globe that contributes to price formation, with limited ability currently to exchange information globally. This global market makes it difficult for any single jurisdiction to effectively address the risks of market abuse. There is, at present, no agreement between international regulators on how to divide up the oversight or how to enable this in practical terms, although work is being undertaken in international forums to enable cooperation as regimes are developed.

**9.8** Despite these challenges, HM Treasury believes there is a strong case for including a market abuse regime in the proposed crypto regulatory framework. A well-functioning and efficient financial market requires market integrity. Market abuse regulation seeks to foster confidence in markets, balancing the benefits of market integrity against the cost of obligations on market participants, as well as their efficacy.

**9.9** The underlying technology used in cryptoasset market structures also offers some potential advantages. For example, the transparency of the blockchain may make it easier to identify instances of market abuse. There may be scope for collaboration between firms, regulators, and enforcement agencies to develop Regulatory Technology (RegTech) solutions to help detect, prevent and disrupt market abuse<sup>38</sup>. However, there are currently notable limitations to this since transactions on centralised exchanges happen off-chain, and much of the on-chain data can be difficult to cleanse and interpret, though capabilities may improve over time.

## High level regulatory outcomes

**9.10** Given the challenges and limitations identified above, the government considers that the following are a sensible and realistic set of initial outcomes:

- market participants should have a shared understanding of what constitutes unfair and abusive practices

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<sup>38</sup> For example, real time surveillance systems for trading venues, systems to share information across trading venues where the same cryptoasset is admitted to trading on multiple venues, and blockchain analytics technologies



- market participants should understand their obligations to prevent, detect and take action against these practices
- abusive practices can be sanctioned
- markets should be structured to prevent market abuse, and to make it easier to detect and take action against abuse when it does occur
- there should be a proportionate regime, with an appropriate balance between the benefits to consumers arising from market integrity versus the cost of obligations on market participants

**9.11** In pursuit of several of the objectives above, a key consideration is the appropriate balance of responsibilities between the FCA and cryptoasset trading venues. HM Treasury is very interested to hear views from industry on this. The proposed model would place the primary responsibility on the trading venues for preventing, detecting and disrupting market abuse. Trading venues would be expected to establish “who” the offenders are, to establish information sharing arrangements with other venues that admit the same cryptoassets, and to have an effective regime for disrupting market abuse such as the ability to publicly blacklist offenders.

**9.12** This model could create greater scope for firms to develop innovative technological approaches to detecting market abuse behaviours enabled by crypto innovation. The FCA would then be responsible for supervising trading venues and other regulated entities (i.e. intermediaries) to ensure they have the appropriate systems and controls to prevent, detect and disrupt market abuse.

**9.13** The above represents a pragmatic approach which recognises the practical challenges and limits of regulating a highly cross-border industry. This regime would not achieve the outcome of offering market integrity or protecting consumers to the same degree as in traditional markets for financial instruments, and therefore represents an area where the objective of “same risk, same regulatory outcome” is not considered to be achievable – at least in the foreseeable future. Longer term, with international standards and cooperation in place on surveillance, reporting and market abuse safeguards more broadly, HM Treasury is seeking to additionally achieve the following outcomes:

- aspirationally, market prices should reflect genuine forces of supply and demand and should not be manipulated
- market participants should be able to trade in a fair and orderly environment
- market participants should have the same opportunities to access information

**9.14** Until the point at which international standards and coordination are in place between the majority of jurisdictions where the major

exchanges are domiciled, these objectives will be difficult to achieve and enforce. For example, price manipulation on an overseas exchange could impact the price of a cryptoasset on a UK exchange. Even in the long run, it is unclear whether the same outcomes for market integrity and consumer protection that exist in traditional securities markets could realistically be achieved. Cryptoasset markets are more globalised with no clear UK nexus, and some crypto exchanges may choose to continue operating in offshore jurisdictions which do not impose equivalent market abuse rules and safeguards – e.g. market surveillance and enforcement mechanisms. These exchanges would be breaking the law if they were offering services to UK customers without authorisation in the UK – but customers could still continue to access them. Consumers and market participants will need to be made aware of these limitations to ensure well-informed trading decisions and to avoid the perception that the same levels of market integrity exist in cryptoasset markets vs securities markets (“halo effect”).

**9.15** Despite these challenges, HM Treasury considers there is significant value in taking steps to enable authorities and venues to deter, prevent and sanction much of the most egregious market abuse behaviour. This would be preferable to the alternative of not having a market abuse regime. Over time market abuse prevention and enforcement capabilities could be enhanced through the adoption of new technologies and international coordination and by introducing criminal offences.

## Proposed regulatory approach

**9.16** The government is proposing a cryptoassets market abuse regime based on elements of the MAR 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. The main design features are detailed in the table below.

**Table 9.A. Proposed design features for cryptoasset market abuse regime**

<b>Regulatory trigger point</b>	<ul style="list-style-type: none"> <li>Requesting the admission of a cryptoasset to a UK cryptoasset trading venue. This applies regardless of the location of the market abuse activity (which could take place within the UK or overseas)</li> </ul>
<b>Basis for the regime</b>	<ul style="list-style-type: none"> <li>Based on UK MAR, though it is important to note that the government does not expect to be able to achieve the same outcomes as MAR (at least in the foreseeable future)</li> </ul>

<b>Scope of offences</b>	<ul style="list-style-type: none"> <li>• Civil offences of market abuse would be similar as for traditional markets, covering insider dealing, market manipulation and unlawful disclosure of inside information. All persons would be subject to these prohibitions regardless of where they are based</li> </ul>
<b>Enforcement mechanism</b>	<ul style="list-style-type: none"> <li>• The primary means of taking action against breaches of these offences would be trading venues disrupting occurrences of this activity</li> <li>• This assumes a definition of a “market” to encompass a “marketplace” rather than the entire market in a particular asset</li> <li>• This would place the onus upon trading venues to establish “who” offenders are and information sharing arrangements with other venues that admit the same cryptoassets, to have an effective regime for disrupting the activity of offenders</li> </ul>
<b>Obligations for trading venues</b>	<ul style="list-style-type: none"> <li>• Cryptoasset trading venues should establish systems and controls to prevent, detect and disrupt market abuse</li> <li>• Venues will be responsible for determining the appropriate systems, controls and methods of disruption subject to FCA supervision. Indicatively, this could include Know Your Customer (KYC) requirements, public blacklists, order book surveillance, STORs, information sharing between trading venues, use of blockchain analytics and providing the means for ongoing disclosures of information to the market</li> <li>• Trading venues would be required to investigate suspected abuse on their markets and to sanction individuals, for example through the use of public blacklists</li> </ul>
<b>Obligations for other market participants</b>	<ul style="list-style-type: none"> <li>• Persons professionally arranging or executing transactions should establish systems and controls to prevent and detect market abuse, subject to FCA supervision. This could include preventing misuse of information relating to client orders and obligations to submit STORs to the relevant trading venue</li> <li>• The government is proposing that all regulated firms undertaking cryptoasset activities would be required to disclose inside information and maintain insider lists. HM Treasury welcomes views on this since this may be difficult to apply to cryptoasset markets, and would be a departure from MAR, under which only issuers are required to do so.</li> </ul>

### **Box 9.A: Questions for Respondents**

25. Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?
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)?
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?
28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?
29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?
30. Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?

# Chapter 10

## Regulatory outcomes for operating a cryptoasset lending platform

**10.1** Lending and borrowing makes up a significant amount of activity in the cryptoasset and DeFi market (see Chapter 11). Dedicated lending platforms offer a variety of business models, some of which have similarities to traditional activities such as: collateralised lending; peer-to-peer lending; securities lending (e.g. exchanges providing margin loans); investment management; and unsecured credit products. There are also novel business models, including those where customers contribute to a platform's liquidity pool in return for variable yield, usually retaining legal title of their assets. Cryptoasset lending and borrowing can look like a mix of these, though in most cases there is a platform – either centralised or decentralised – sitting between those lending and borrowing.

**10.2** The lending model exemplified in the case of the failed platform Celsius highlights several of the regulatory challenges and prudential risks associated with cryptoasset lending. Celsius took the transfer of legal title to cryptoassets from predominantly retail customers to then lend and invest in predominantly wholesale businesses. This particular model of cryptoasset borrowing and lending combines features of risky wholesale investment with guarantees on interest repayments to retail customers, where poor risk management can generate high losses for platforms and consumers. In the case of Celsius, retail investors were treated as unsecured creditors in insolvency.

**10.3** Lending to institutional borrowers can involve significant amounts of credit risk. In traditional finance this risk is mitigated through prudential assessments of counterparty credit quality, prudent collateral risk-management practices, and regulatory capital requirements. Credit risk is heightened when a lender is exposed to the debt of multiple institutional borrowers who have highly correlated risk profiles, which is often the case in cryptoasset markets. Furthermore, current practices around collateralisation, rehypothecation, leverage and maturity transformation are opaque, increasing the risks associated with counterparty defaults.

**10.4** There are also significant liquidity risks associated with operating a lending platform, which are similar to those witnessed in the case of FTX. Cryptoasset platforms engaged in lending activities have often

held high proportions of illiquid or 'less liquid' assets on their balance sheets, which has made it difficult to meet liabilities in periods of stress. This risk is exacerbated when lending platforms incur obligations denominated in one cryptoasset while investing or lending in another. Celsius and FTX are both examples of crypto firms which have experienced significant liquidity mismatches.

**10.5** Cryptoasset lending and borrowing activities conducted by lending platforms typically fall outside the current regulatory perimeter.<sup>39</sup> This means that most of the safeguards in place for traditional lending and borrowing activities are unavailable to users of similar cryptoasset products and services. Instead, cryptoasset loans often manage risk through high levels of collateralisation and automated margin calls. Customers should be made aware of risks where traditional safeguards are not in place for cryptoasset lending and borrowing activities.

**10.6** Most jurisdictions which have already established regulatory frameworks for cryptoassets have not explicitly brought lending and borrowing activities into the regulatory perimeter. However, some have signalled intent to regulate the sector given growing risks while others have proposed business model restrictions, such as prohibiting cryptoasset service providers from hypothecating the cryptoassets of retail customers and requiring explicit consent and specific risk disclosures for any lending out of wholesale customer assets.

**10.7** HM Treasury believes there is a strong case for developing a cryptoasset lending and borrowing regime as a priority Phase 2 activity. Given that credit risk has been a significant driver of cryptoasset market turbulence and firm failure, it is important that platforms taking part in lending and borrowing activities have sufficient financial resources to manage counterparty credit risk and ensure they can meet liabilities as they fall due.

**10.8** A regime for cryptoasset lending platforms should also consider the need for firms to have effective risk management of collateral, including appropriate collateral valuation; contingency plans for the failure of participants' largest market counterparties; and the management of collateral following default.

**10.9** The government's proposal, set out below, requires platforms to disclose important information to customers, such as the terms of legal ownership, collateral, and margin calls. However, given the wide range of lending business models and unique challenges described in this chapter, the proposed approach does not pursue all of the same outcomes delivered by different traditional lending and borrowing regulations, such as FSCS protection, affordability assessments and forbearance periods. The government will continue to monitor

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<sup>39</sup> Depending on the specific characteristics of a particular model, some cryptoasset lending and borrowing services may fall within existing regulated activities, for example where the arrangements meet the definition of a collective investment scheme, or where captured by other parts of this consultation paper

developments in lending markets and assess the need for any further regulatory action.

## High level regulatory outcomes

**10.10** Through the creation of a newly defined regulated activity – ‘operating a cryptoasset lending platform’ – the government considers that the following are a sensible and realistic set of initial outcomes:

- lending platforms should have adequate risk warnings for consumers lending to said platform (e.g. that the consumer could lose all their money, clarity on lack of FSCS protection)
- lending platforms should have adequate financial resources – capital and liquidity – and wind down arrangements to carry out their business
- lending platforms should have clear contractual terms on ownership and, if applicable, ringfencing of retail funds in case of insolvency

**10.11** Furthermore, it is important that authorities are able to monitor the build-up of risk present in collateralised lending transactions. HM Treasury is therefore of the view that disclosure requirements derived from those applied to Securities Financing Transactions (e.g. counterparty and transactions details, collateral composition, rehypothecation, substitution of collateral at the end of the day and haircuts applied) could help improve transparency associated with the use of collateral in cryptoassets financing activities. The government is seeking views on whether such a disclosure regime would be necessary, or whether transparency could be enhanced by other means. In any event, it is likely that specifying the requirements and scope of the disclosure requirements for these transactions will happen after Phase 2.

## Proposed regulatory approach

**10.12** **For the regulation of cryptoasset lending and borrowing activities the government is proposing to apply and adapt existing RAO activities, while making suitable modifications to accommodate unique cryptoasset features.** Key design features are set out in further detail in the table below.

**Table 10.A. proposed design features for cryptoasset lending and borrowing regime**

<b>Regulatory trigger point</b>	<ul style="list-style-type: none"> <li>• Operating a cryptoasset lending platform (this would include facilitating collateralised and uncollateralised borrowing of cryptoassets or borrowing of fiat currency with collateral provided in cryptoassets)</li> </ul>
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<b>Basis for the regime</b>	<ul style="list-style-type: none"> <li>Adapt existing RAO activities e.g. arranging deals in investments, dealing as principal and operating an electronic system in relation to lending</li> </ul>
<b>Authorisation rules</b>	<ul style="list-style-type: none"> <li>Authorisation will be required since “operating a cryptoasset lending platform” will become a regulated activity under the RAO.</li> <li>Applications should include details of operations, services, business plans, and organisational and governance arrangements. Applications should also set out persons who are lending assets, persons who are borrowing assets, any loans received or provided, legal title of assets including collateral, liquidity, capital and risk management practices and how liabilities are met in both crypto and fiat at any point in time</li> </ul>
<b>Location requirements</b>	<ul style="list-style-type: none"> <li>Scope will be set by whether: i) firms are incorporated in the UK; ii) services are being provided to UK persons (natural or legal)</li> <li>Requirements on physical location to be determined by the FCA. It is expected that this will be informed by the FCA’s existing framework for international firms (see Chapter 4 for more details)<sup>40</sup></li> </ul>
<b>Prudential requirements</b>	<ul style="list-style-type: none"> <li>Persons operating a cryptoasset lending platform should have sufficient financial resources to meet their liabilities as they fall due</li> <li>Thresholds to be set by the FCA – e.g. minimum capital requirements, liquidity requirements needed to mitigate credit risk, market risk, liquidity risk and non-financial risks – addressing both the potential for harm from ongoing operations and the ability to wind-down in an orderly manner</li> <li>Entities will need to monitor and manage liquidity and funding risks across different time horizons and stress scenarios</li> </ul>
<b>Consumer protection and governance requirements</b>	<ul style="list-style-type: none"> <li>Persons operating a cryptoasset lending platform should have robust governance arrangements and risk management processes in place</li> <li>Conduct of business requirements (e.g. client disclosures, risk warnings, clear contractual terms including ownership of legal and beneficial title) should apply</li> </ul>

<sup>40</sup> <https://www.fca.org.uk/publication/corporate/approach-to-international-firms.pdf>



	<ul style="list-style-type: none"> <li>• Clear terms and disclosures should exist in terms of collateral requirements and margin calls, including the circumstances under which these are enacted</li> </ul>
<b>Operational resilience requirements</b>	<ul style="list-style-type: none"> <li>• Systems and controls requirements, such as operational resilience, should apply to cryptoasset lending and borrowing platforms. Persons operating a cryptoasset lending platform should have adequate people, processes, systems and controls to mitigate operational resilience risks</li> <li>• Outsourcing and third-party arrangements should require appropriate due diligence, ongoing oversight, and formal documentation</li> </ul>
<b>Resolution and insolvency</b>	<ul style="list-style-type: none"> <li>• Insolvency powers under Part 24 of FSMA should apply, enabling the FCA to participate in insolvency proceedings governed by the Insolvency Act</li> <li>• The government will consider whether a bespoke resolution regime should be developed in time (e.g. new special administration regime)</li> </ul>

#### **Box 10.A: Questions for Respondents**

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

# Chapter 11

## Call for Evidence: Decentralised Finance (DeFi)

### Context and regulatory challenges

**11.1** 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. Programmers and developers use the coding language of a blockchain to create “smart contracts”. These represent open sourced, codified sets of rules which automatically execute and record transactions on the blockchain when certain parameters are met. Once deployed, smart contracts are immutable, enabling peer-to-peer (or “peer-to-contract”) transactions without centralised decision making from intermediaries. The functionalities of different smart contracts are typically combined and offered to end users through decentralised apps (“dApps”).

**11.2** DeFi services currently form a small proportion of the cryptoasset financial services market, but recent years have seen a marked increase in retail adoption of DeFi, alongside growing institutional involvement. 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. This means that the typical systems of financial services regulation – which usually rely on the authorisation and supervision of individuals and firms undertaking specified activities – may be difficult to apply.

**11.3** There is a long list of actors involved in DeFi product chains, from limited companies and coders creating or editing protocols and code, to Decentralised Autonomous Organisations (DAOs) and governance token holders, who in many cases may not be undertaking financial services activities by way of business.

**11.4** Various international organisations, including the BIS, FSB, IOSCO and the IMF, have identified a number of risks arising from the growth of DeFi. In particular, where governance of these protocols lacks transparency and accountability, there may be increased risk to consumers, market integrity and financial stability. While not

exhaustive, other risks may arise from: a lack of operational resilience to cyber-attacks and scams; increased dependencies between traditional and decentralised financial systems; and the lack of backstops in periods of market stress. At the same time, the innovative nature of programmable transactions could also increase efficiency and competition in the financial services industry, leading to consumer benefits such as reduced costs of service.

**11.5 HM Treasury is of the view that the regulatory outcomes and objectives described in the preceding chapters should apply to cryptoasset activities regardless of the underlying technology, infrastructure, or governance mechanisms. However, due to the challenges outlined above, including the rapidly evolving nature of the sector, the way this is achieved may well differ and take longer to clarify.** The work of international organisations is especially important in this area (again noting the highly borderless nature of DeFi organisations) and we are not intending to front run this by developing a prescriptive framework for the UK that would need to be fundamentally re-shaped once international approaches and standards crystalise. With this in mind, HM Treasury is considering a range of approaches and seeking views.

**11.6** One option for regulating DeFi is to define a set of DeFi-specific activities – e.g. “establishing or operating a protocol” – as regulated activities under the RAO (or DAR). The persons carrying out those activities would then require authorisation, and the FCA could design a bespoke regime around these regulated activities.

**11.7** There is a spectrum of decentralisation amongst current DeFi offerings. In some cases, governance of a protocol is conducted via on-chain voting, whereby an individual’s voting rights are determined by their holdings of the protocol’s governance token. Therefore, individuals who have a significant share of those tokens can dominate the outcome of the votes. Often, a large proportion of governance tokens are retained by the protocol’s founding team and investors. Some DeFi protocol teams also retain emergency powers to unilaterally make changes to the protocol when they deem necessary. Centralised business models which brand and market themselves as DeFi in order to circumvent regulatory obligations should be subject to the same treatment as centralised organisations. Regulators should be able to apply rules to persons who maintain significant control or influence over a DeFi arrangement or protocol providing cryptoasset services and activities. To illustrate this point further, the objective is not to regulate the activity of developing software, but if software developers go on to maintain, run and operate systems used for regulated financial activities (e.g. exchange, lending) then they should be subject to financial services regulation. Parallels can be drawn with algorithmic trading activity in traditional financial markets; software developers write code (algorithms) which may submit, match and execute orders. However, there are ways to regulate this and control the risks – e.g. enforceable rules around algorithmic trading systems and controls.

**11.8** Some parts of the value chain may not be practical to regulate, for example the underlying protocol if that has become truly open-sourced and decentralised over time. The approach to regulation was discussed at the FCA's cryptoasset sprint in May 2022,<sup>41</sup> with one suggestion being to focus regulatory responsibility for mitigating risks on centralised on and off ramps like exchanges. Interface providers and other actors facilitating consumer access to DeFi (e.g. aggregators and other consumer "front ends") could be another viable hook. Even though these interface providers do not necessarily provide the underlying services or protocols they could be required to demonstrate or check whether certain standards or rules have been met, before facilitating access to a decentralised application or service. These standards could include technical standards – such as conducting regular, independent code audits and IT security tests, as well as standards around information disclosures requiring clear, non-technical descriptions of the services provided and associated risks, third party service provider oversight, and governance standards covering best practices around voting and review periods and vesting schedules.

**11.9** Longer term, establishing clarity of the legal structure of DAOs will be important in helping to determine how regulation could be applied to these structures. The Law Commission has already carried out work, concluding that smart contracts may in many circumstances be binding in English law. Following a recent request from HM Treasury, in November the Law Commission published its call for evidence to develop recommendations on the legal status of DAOs. Both these developments are likely to lead to greater legal certainty for consumers and markets, as well as provide potential insights for regulation. There is also cross-governmental work taking place on artificial intelligence and autonomous code which is likely to have a relevant read-across for DeFi. Shorter term, there may be interim measures such as using recommendations and guidelines to encourage best practices of the sort mentioned in the paragraph above.

**11.10** Overall, HM Treasury is looking for a proportionate, innovation-friendly approach, which recognises distinct opportunities offered by new business models and encourages a thriving and well-regulated UK DeFi industry. However, the government also wishes to deliver similar regulatory outcomes across centralised financial services activities and their DeFi equivalents, thereby preventing risks of regulatory arbitrage. We welcome further views from industry and other stakeholders on how to balance these objectives.

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<sup>41</sup> <https://www.fca.org.uk/firms/cryptoassets/cryptosprint>

### **Box 11.A: Questions for Respondents**

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?
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?
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?
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)?
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)?
41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?
42. What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

# Chapter 12

## Call for Evidence: Other Cryptoasset Activities

### Cryptoasset investment advice and portfolio management

**12.1** At present, cryptoasset investment advice and discretionary portfolio management services are relatively limited and geared towards institutional and High Net Worth client segments, presenting relatively little immediate risk of financial harms to retail consumers. To date there is little evidence of UK firms offering cryptoasset-focused investment advice, and minimal examples of cryptoassets being placed in wealth and asset management propositions. However, as with other types of financial advice and portfolio management, these activities have potential to generate risks from conflicts of interest, fraud and loss of customer assets. And the extent to which these (or similar) services could expand and be provided to retail clients in future is unclear.

**12.2** These activities could be considered as analogous to the current regulated activities of “advising on investments” and “managing investments” (See Article 53 of the RAO and Article 37 of the RAO). The government is therefore considering whether there is a case for bringing these activities into the regulatory perimeter.

**12.3** Despite parallels to existing investment advice activities, there are important differences. The UK’s current investment advice regime requires regulated advisors to be experienced, competent and qualified, and for them to assess that an investment is suitable before making a recommendation. However, the price and value of an unbacked cryptoasset is driven by speculative investment decisions, rather than market fundamentals which can be objectively assessed. This is in contrast to traditional financial assets; even for high-risk investments such as illiquid securities, advisors at least have experience and qualifications to conduct due diligence on the corporate issuer (e.g. through assessing projected growth plans). It would be very difficult to require an investment advisor to meet these criteria for cryptoasset investment advice.

### Post-trade activities in cryptoasset transactions

**12.4** Some of the functions currently performed by cryptoasset exchanges in relation to cryptoassets go beyond solely trading venue activities and can include FMI activities such as settlement. This looks very different to traditional securities settlement, as it is typically performed on a blockchain rather than on a central securities

depository. However, the underlying functions of a central securities depository are still being performed – namely maintaining and updating a record of ownership of the security, and processing transfers of ownership of dematerialised securities. Risks therefore remain to market functioning from a loss of those records, or the loss of integrity due to disputed records. The benefits of regulating settlement include mitigating the risk of settlement failures and ensuring clarity of ownership. As with conventional FMIs, where settlement is captured under existing legislation, future regulations of cryptoasset settlement activity undertaken by cryptoasset exchanges may be required where the activity is deemed to be systemic and proportionate to the scale of the risk to financial stability.

**12.5** Clearing – the handling of counterparty credit risk of both parties to a transaction – may also need to be a regulated cryptoasset activity. Although the types of clearing services provided by central counterparties (CCPs) in the traditional financial sector are not being provided widely by cryptoasset exchanges today, the government considers it important to future-proof regulations and bring them in line with those for conventional securities if cryptoasset exchanges were to undertake clearing activity in the future. This would likely follow similar requirements to those that exist under European Market Infrastructure Regulation (EMIR). For example, authorities may need to require firms undertaking clearing activities to establish adequate safeguards to mitigate counterparty credit risk during the post-trade settlement process, such as the creation of a default fund.

**12.6** Rather than setting out initial proposals in this consultation, our regulatory outcomes for the settlement of cryptoassets will be shaped from what the government learns from the FMI Sandbox initiative. While cryptoasset are outside of scope, the sandbox will enable firms to experiment with DLT, to provide the services that underpin financial markets. Accepted firms will be able to set up an FMI that utilises new technology within the sandbox, while being subject to modified legislative requirements (where the existing requirements act as a barrier to using new technology). These modified requirements could be made permanent if testing is successful.

## Crypto mining and validation

**12.7** The UK makes up a very small percentage of global mining power – 0.23% of global bitcoin mining is conducted in the UK.<sup>42</sup> Instead, it is geographically concentrated in certain countries such as the US, China, and Russia. The decentralised nature of certain cryptoassets also means that authorities may have greater difficulties in enforcing how and where cryptoassets are mined. Another challenge is that attempting to enforce regulation at protocol level may simply push mining / validation and certain software development activity abroad

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<sup>42</sup> <https://chainbulletin.com/bitcoin-mining-map/> - Crypto mining hash rate map

by increasing costs and regulatory obligations – particularly in the absence of international agreements.

**12.8** Given the reasons outlined above, there **may not be justification to regulate the activity of mining in and of itself**. The environmental impacts associated with mining especially of the Proof-of-Work (PoW) consensus mechanism are discussed in the following section.<sup>43</sup> However, the 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.

**12.9** There may be an argument for capturing staking activities within the regulatory perimeter, to the extent that they are currently outside the perimeter; some models – depending on their specific characteristics – may already fall within the perimeter, for example where the staking arrangements meet the definition of a collective investment scheme. Staking services have been targeted at UK consumers and may increase following the transition to Proof of Stake (PoS)<sup>44</sup> by Ethereum. However, given the lack of data on the amount of staking that takes place in the UK, it may be sensible to initially seek data on staking to enable us to gather a fuller picture (to the extent this is feasible given the often-decentralised nature of staking pools).

#### **Box 12.A Questions for Respondents**

43. Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.
44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?
45. Should staking (excluding “layer 1 staking”) be considered alongside cryptoasset lending as an activity to be regulated in phase 2?
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)?

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<sup>43</sup> PoW is a consensus mechanism that features complex problems for miners to solve using high-powered computers through trial and error. When the first miner authenticates the block or “solves the puzzle”, the digital currency is then added to the blockchain. In return, the miner also receives compensation.

<sup>44</sup> PoS is consensus mechanism in which, to validate blocks, miners need to put up stake with coins of their own. The choice for who validates each transaction is random using an algorithm which is weighted based on the amount of stake and the validation experience of the miner. After a miner verifies a block, the miner receives cryptocurrency for their fee along with their original stake.



# Chapter 13

## Call for evidence: Sustainability

### Context and regulatory challenges

**13.1** As noted in Chapter 12, the Proof of Work (PoW) consensus mechanisms can have a high environmental impact. This is mainly due to the energy usage of the computing task, which becomes more intensive as time progresses. Mining rig facilities allow computing for PoW at scale, although it is challenging to estimate energy usage with accuracy, given the need to make assumptions around issues like hardware specifications, indirect energy impacts and regional energy mixes. For illustrative purposes, 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.<sup>45, 46</sup> Some estimates have Bitcoin's energy consumption even higher.

**13.2** PoS blockchains may also use computers or servers located in data centres, which use electricity for cooling and data storage. However, the energy consumption and carbon footprint for PoS still remains much lower than PoW. Following the switch of the Ethereum blockchain from PoW to PoS (in a process known as "the Merge"), estimations of Ethereum's TWh of electricity used per year fell from 77.77 to 0.01 TWh.<sup>47</sup>

**13.3** The government reiterates its firm commitment to making the UK a competitive location for sustainable finance. Elsewhere in the financial services sector, there are various sustainability-related reporting requirements that apply to other types of firms. The FCA note that listed issuers and other entities in scope of requirements under MAR and the Prospectus Regulation may need to consider ESG-related risks and opportunities when determining what to disclose under the various disclosure regimes.<sup>48</sup> Furthermore, premium listed companies, issuers of standard listed shares and global depositary receipts, asset managers, life insurers, and FCA-regulated pension providers have mandatory climate-related disclosure requirements aligned with the

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<sup>45</sup> <https://cbeci.org/> Cambridge Centre for Alternative Finance Bitcoin Live Bitcoin Network Power

<sup>46</sup> <https://www.eia.gov/international/data/world/electricity/electricity-consumption>

<sup>47</sup> <https://digiconomist.net/ethereum-energy-consumption>

<sup>48</sup> <https://www.fca.org.uk/publication/primary-market/tn-801-1.pdf>

Task Force on Climate-related Financial Disclosures' (TCFD) recommendations.

**13.4** Given parallels between cryptoassets and securities markets, applying similar ESG-related reporting requirements may be a proportionate way of achieving our “same risk, same regulatory outcome” principle. However, given the nature of cryptoassets, this may be more challenging. The way that consumers interact with the product and intermediaries is different to securities markets, not least because of decentralisation. Additionally, unlike in other parts of the sector, there is currently no agreed upon set of indicators or metrics for measuring the environmental impact of cryptoassets.

**13.5** Therefore, the 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. It would also be useful to know if there are particular indicators or metrics that can be used to calculate these environmental impacts and whether these are interoperable with other recognised sustainability disclosure standards such as those developed by the Taskforce on Climate Related Financial Disclosures (TCFD) or IFRS Foundation's International Sustainability Standards Board (ISSB).

#### **Box 13.A: Questions for Respondents**

47. When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?
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)?
49. What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?
50. How interoperable would such indicators be with other recognised sustainability disclosure standards?
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?
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?

# Chapter 14

## Responding to this Consultation

### Responding to this consultation and call for evidence

**14.1** This consultation will close on 30-April 2023. The government is inviting stakeholders to provide responses to the questions set out above and to share any other views on the proposed approach to regulating cryptoassets.

**14.2** Responses are welcome from all stakeholders, including cryptoasset firms, technology firms, financial institutions, other businesses impacted by cryptoasset regulation, trade associations, representative bodies, academics, legal firms, and consumer groups.

### How to submit responses

**14.3** Please send responses to [cryptoasset.consultation@hmtreasury.gov.uk](mailto:cryptoasset.consultation@hmtreasury.gov.uk) or post to:

Future regulatory regime for cryptoassets – consultation  
Payments and Fintech  
HM Treasury  
1 Horse Guards Road  
SW1A 2HQ

### HM Treasury Consultation: Future financial services regulatory regime for cryptoassets - Processing of Personal Data

**14.4** This section sets out how we will use your personal data and explains your relevant rights under the UK General Data Protection Regulation (UK GDPR). For the purposes of the UK GDPR, HM Treasury is the data controller for any personal data you provide in response to this consultation.

### Data subjects

**14.5** The personal data we will collect relates to individuals responding to this consultation. These responses will come from a wide group of stakeholders with knowledge of a particular issue.

### The personal data we collect

**14.6** The personal data will be collected through email submissions and are likely to include respondents' names, email addresses, their job titles, and employers as well as their opinions.

## How we will use the personal data

14.7 This personal data will only be processed for the purpose of obtaining opinions about government policies, proposals, or an issue of public interest.

14.8 Processing of this personal data is necessary to help us understand who has responded to this consultation and, in some cases, contact respondents to discuss their response.

14.9 HM Treasury will not include any personal data when publishing its response to this consultation.

## Lawful basis for processing the personal data

14.10 The lawful basis we are relying on to process the personal data is Article 6(1)(e) of the UK GDPR; the processing is necessary for the performance of a task we are carrying out in the public interest. This task is consulting on the development of departmental policies or proposals to help us to develop good effective policies.

## Who will have access to the personal data

14.11 The personal data will only be made available to those with a legitimate need to see it as part of consultation process.

14.12 We sometimes conduct consultations in partnership with other agencies and government departments and, when we do this, it will be apparent from the consultation itself. For these joint consultations, personal data received in responses will be shared with these partner organisations in order for them to also understand who responded to the consultation.

14.13 As the personal data is stored on our IT infrastructure, it will be accessible to our IT service providers. They will only process this personal data for our purposes and in fulfilment with the contractual obligations they have with us.

## How long we hold the personal data for

14.14 We will retain the personal data until work on the consultation is complete.

## Your data protection rights

14.15 You have the right to:

- request information about how we process your personal data and request a copy of it
- object to the processing of your personal data
- request that any inaccuracies in your personal data are rectified without delay
- request that your personal data are erased if there is no longer a justification for them to be processed

- complain to the Information Commissioner's Office if you are unhappy with the way in which we have processed your personal data

## How to submit a data subject access request (DSAR)

**14.16** To request access to your personal data that HM Treasury holds, contact:

The Information Rights Unit  
HM Treasury  
1 Horse Guards Road  
London  
SW1A 2HQ

[dsar@hmtreasury.gov.uk](mailto:dsar@hmtreasury.gov.uk)

## Complaints

**14.17** If you have concerns about our use of your personal data, please contact the Treasury's Data Protection Officer (DPO) in the first instance at [privacy@hmtreasury.gov.uk](mailto:privacy@hmtreasury.gov.uk)

**14.18** If we are unable to address your concerns to your satisfaction, you can make a complaint to the Information Commissioner at [casework@ico.org.uk](mailto:casework@ico.org.uk) or via this website: <https://ico.org.uk/make-a-complaint>.

## Next steps

**14.19** This consultation sets out a proposed policy approach to bringing cryptoasset activities into the UK regulatory perimeter. The government will carefully consider the responses received and use these to inform a response. If taken forward, further technical consultations will be issued by UK authorities on specific firm rules.

**14.20** As part of this consultation, the government will also undertake a programme of stakeholder engagement. This will maximise opportunities for stakeholders to share their views with the government.

**14.21** A Crypto Engagement Group, chaired by the Economic Secretary to the Treasury, will continue to run on a regular basis over the course of 2023. This group will ensure that key industry participants can offer insights and support the government in establishing a clear regulatory framework that supports innovation and protects consumers.

# 1.: Glossary of Terms

Acronym	Definition	Acronym	Definition
<b>AML</b>	Anti-Money Laundering	<b>HMRC</b>	His Majesty's Revenue and Customs
<b>BIS</b>	Bank for International Settlements	<b>HMT</b>	His Majesty's Treasury
<b>CASP</b>	Crypto Asset Service Provider	<b>ICC</b>	International Chamber of Commerce
<b>CASS</b>	(the FCA's) Client Assets Sourcebook	<b>ICO</b>	Initial Coin Offering
<b>CeFi</b>	Centralised Finance	<b>IME</b>	Investment Manager Exemption
<b>CIS</b>	Collective Investment Scheme	<b>IMF</b>	International Monetary Fund
<b>CLI</b>	Climate Ledger Initiative	<b>IOSCO</b>	International Organization of Securities Commissions
<b>COBS</b>	(the FCA's) Conduct of Business Sourcebook	<b>IPO</b>	Initial Public Offering
<b>COMP</b>	FCA's compensation rules	<b>KYC</b>	Know Your Customer
<b>CPMI</b>	Committee on Payments and Market Infrastructures	<b>MAR</b>	Market Abuse Regulation
<b>CTF</b>	Counter-Terrorist Financing	<b>MiCA</b>	(The EU's) Markets In Crypto-Assets
<b>DAO</b>	Decentralised Autonomous Organisation	<b>MiFID II</b>	Markets in Financial Instruments Directive II
<b>dApps</b>	Decentralised Applications	<b>MIFIDPRU</b>	FCA handbook on prudential rules for certain investment firms
<b>DAR</b>	Designated Activities Regime	<b>MLRs</b>	Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017
<b>DCMS</b>	Department for Digital, Culture, Media & Sport	<b>MTF</b>	Multilateral Trading Facility
<b>DeFi</b>	Decentralised Finance	<b>NFT</b>	Non-Fungible Tokens
<b>DLT</b>	Distributed Ledger Technology	<b>NSM</b>	National Storage Mechanism
<b>DSA</b>	Digital Settlement Asset	<b>PoS</b>	Proof of Stake

Acronym	Definition
<b>EMR 2011</b>	E-Money Regulations 2011
<b>EMIR</b>	The European Market Infrastructure Regulation
<b>ESG</b>	Environmental, Social, and Governance
<b>FATF</b>	Financial Action Task Force
<b>FCA</b>	Financial Conduct Authority
<b>FMI</b>	Financial Market Infrastructure
<b>FMI Sandbox</b>	Financial Market Infrastructure Sandbox
<b>FOS</b>	Financial Ombudsman Service
<b>FPC</b>	Financial Policy Committee (of the Bank of England)
<b>FRF</b>	Future Regulatory Framework
<b>FS&amp;M Bill</b>	Financial Services and Markets Bill 2022
<b>FSB</b>	Financial Stability Board
<b>FSCS</b>	Financial Services Compensation Scheme
<b>FSMA</b>	Financial Services and Markets Act 2000

Acronym	Definition
<b>PoW</b>	Proof of Work
<b>PRA</b>	Prudential Regulation Authority
<b>PS 19/22</b>	The FCA's Perimeter Guidance for Cryptoassets
<b>PSR</b>	Payment Systems Regulator
<b>PSR 2017</b>	Payment Services Regulations 2017
<b>RAO</b>	Financial Services and Markets Act 2000 (Regulated Activities) Order 2001
<b>RegTech</b>	Regulatory Technology
<b>SRO</b>	Self-Regulatory Organization
<b>STO</b>	Security Token Offering
<b>STOR</b>	Suspicious Transaction and Order Report
<b>SYSC</b>	Senior Management Arrangements, Systems and Controls
<b>TCFD</b>	Task Force on Climate-Related Financial Disclosures
<b>TRR</b>	Temporary Registration Regime (for cryptoasset businesses)
<b>WTO</b>	World Trade Organisation

## 2.: Market abuse offences under UK MAR

<b>Insider Dealing (Article 8)</b>	<p>Insider dealing arises where a person possesses inside information and uses that information by acquiring or disposing of, for its own account or for the account of a third party, directly or indirectly, financial instruments to which that information relates.</p> <p>The use of inside information by cancelling or amending an order concerning a financial instrument to which the information relates, where the order was placed before the person concerned possessed the inside information, shall also be considered to be insider dealing.</p> <p>Recommending or inducing another person to engage in insider dealing also amounts to insider dealing where the person using the recommendation or inducements knows or ought to know that it is based upon inside information.</p>
<b>Unlawful disclosure of inside information (Article 10)</b>	<p>Unlawful disclosure of inside information arises where a person possesses inside information and discloses that information to any other person, except where the disclosure is made in the normal exercise of an employment, a profession or duties.</p> <p>The onward disclosure of recommendations or inducements to engage in insider dealing also amounts to unlawful disclosure of inside information where the person using the recommendation or inducements knows or ought to know that it is based upon inside information.</p>
<b>Market manipulation (Article 12)</b>	<p>Market manipulation comprises the following activities:</p> <ul style="list-style-type: none"> <li>a) entering into a transaction, placing an order to trade or any other behaviour which: <ul style="list-style-type: none"> <li>i. gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument; or</li> <li>ii. secures, or is likely to secure, the price of one or several financial instruments, at an abnormal or artificial level;</li> </ul> </li> </ul> <p>unless the person entering into a transaction, placing an order to trade or engaging in any other behaviour establishes that such transaction, order</p>



	<p>or behaviour has been carried out for legitimate reasons, and conform with an accepted market practice</p> <p>b) entering into a transaction, placing an order to trade or any other activity or behaviour which affects or is likely to affect the price of one or several financial instruments, which employs a fictitious device or any other form of deception or contrivance</p> <p>c) disseminating information through the media, including the internet, or by any other means, which gives, or is likely to give, false or misleading signals as to the supply of, demand for, or price of, a financial instrument, or secures, or is likely to secure, the price of one or several financial instruments, at an abnormal or artificial level, including the dissemination of rumours, where the person who made the dissemination knew, or ought to have known, that the information was false or misleading</p> <p>d) transmitting false or misleading information or providing false or misleading inputs in relation to a benchmark where the person who made the transmission or provided the input knew or ought to have known that it was false or misleading, or any other behaviour which manipulates the calculation of a benchmark</p> <p>MAR also sets out various behaviours that, inter alia, are considered to be market manipulation.</p>
<p><b>Inside information (Article 7)</b></p>	<p>Inside information is information:</p> <ul style="list-style-type: none"> <li>• of a precise nature</li> <li>• which has not been made public</li> <li>• which relates, directly or indirectly, to one or more issuers or to one or more financial instruments</li> <li>• which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments</li> </ul> <p>For persons charged with the execution of orders concerning financial instruments, it also means information conveyed by a client and relating to the client's pending orders in financial instruments, which is of a precise nature, relating, directly or indirectly, to one or more issuers or to one or more financial instruments, and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments.</p>

### **HM Treasury contacts**

This document can be downloaded from [www.gov.uk](http://www.gov.uk)

If you require this information in an alternative format or have general enquiries about HM Treasury and its work, contact:

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1 Horse Guards Road  
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