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Update — UK Government Launches Consultation and Call for Evidence on a New UK Regulatory Regime for Cryptoassets

The UK Government Has Published a Consultation Paper and Call for Evidence Encompassing Wide Ranging Proposals to Regulate Cryptoassets, Building on the UK's Current Financial Services Regulatory Architecture

SUMMARY

On February 1, 2023, His Majesty's Treasury ("HM Treasury" or the "UK Government") published a consultation paper¹ and call for evidence on proposals for the future regulation of cryptoassets in the UK (the "Consultation"). The Consultation follows the UK Government's commitment, in April 2022², to introduce a new regulatory regime for cryptoassets. The Consultation is open until April 30, 2023.

The UK Government is proposing that the UK's financial services regulatory framework be adapted, where possible, to accommodate cryptoassets instead of introducing a new bespoke regulatory regime specifically for cryptoassets. This is to avoid having potentially duplicative and overlapping regimes and is intended to deliver a "level playing field" between crypto and traditional financial services market participants conducting similar types of financial services activities.

The Consultation proposes to build on the UK's financial services regulatory regime to:

- (1) create a securities regime to regulate public offers of cryptoassets or when a cryptoasset is admitted to a regulated trading venue. This is summarised in section 2. below;
- (2) introduce a number of new regulated activities or a proposed new category of designated activities³ tailored to the cryptoasset market where these activities are the same as, or closely

resemble, regulated activities for traditional financial services market participants under the regulatory perimeter of the Financial Services and Markets Act 2000 (the “FSMA”) or designated activities that currently are not regulated activities under the FSMA under a proposed new parallel licensing regime to be introduced by the Financial Services and Markets Bill (the “FS&M Bill”)⁴ currently being debated in the UK Parliament. The new crypto regulated activities and designated activities are summarised in section 3. below; and

- (3) to amend the UK market abuse regime to reflect particular aspects of cryptoassets and the market for cryptoassets and to bring activities related to cryptoassets within its scope. This is summarised in section 4. below.

It is important to note that the UK Government has stated that the protections given to retail investors under the UK Financial Services Compensation Scheme, which compensates retail investors who suffer financial loss as a result of breach of UK financial services regulation, will not apply to investor losses arising from cryptoasset exposures.

HM Treasury proposes to take a phased approach to introducing the new regulatory regime for cryptoassets. “Phase 1” of the UK proposals for regulating cryptoassets encompasses regulatory initiatives which are already in place or which are currently the subject of draft legislation (and are outlined in the section of this note headed “The UK’s current regulation of cryptoassets” below). “Phase 2” encompasses new proposals which are the subject of the Consultation, although there is no firm timetable for the implementation of Phase 2 other than that the Consultation closes at the end of April 2023.

The UK’s current regulation of cryptoassets and the proposals outlined in the Consultation are summarised below.

THE UK’S CURRENT REGULATION OF CRYPTOASSETS

The current framework: The UK’s current regulation of cryptoassets is a patchwork of initiatives and measures, reflecting the UK Government’s desire to strike a balance between encouraging financial innovation and the need to protect consumers.

These initiatives and measures cover the following activities:

- Offerings of tokens which have the characteristics of traditional debt or equity securities (“security tokens”): these are subject to legal and regulatory requirements governing the public offer/listing of securities in the UK in the same way as traditional debt or equity securities;
- Providers of crypto exchanges and custodian wallet providers⁵ in the UK, who are required to comply with UK anti-money laundering and anti-terrorist finance rules and are also required to register with the UK’s Financial Conduct Authority (the “FCA”);
- Derivative contracts written over cryptoassets, which are prohibited⁶ from being marketed or sold to retail investors in the UK; and
- Financial promotions in relation to certain cryptoassets, which cannot be made in the UK unless made by, or approved by, an authorised person or unless they fall within an exemption; the financial

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promotion rules currently apply only to certain types of cryptoassets such as security tokens and crypto derivatives.

The current UK financial services regulatory architecture under the FSMA requires any person who, by way of business, undertakes a regulated activity in or from the UK to be authorised unless exempt or an exclusion applies. Persons undertaking regulated activities must first obtain authorisation from the relevant regulator, being the Prudential Regulation Authority (the “PRA”) for banks, insurance companies, building societies and large investment firms and the FCA for all other persons. Specific regulated activities are set out in the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (the “RAO”). Currently, therefore, a person undertaking a regulated activity in relation to cryptoassets that already falls within the UK regulatory perimeter, such as arranging deals in security tokens or crypto derivatives, by way of business in or from the UK, is required to be authorised by the FCA.

UK financial services regulation generally focusses on regulating activities rather than the underlying assets themselves. Consequently, the UK does not regulate crypto currencies (“exchange tokens”), which is consistent with the approach taken in relation to the regulation of the spot market in fiat currencies (and which is not subject to UK regulation). However, the providers of payment services in relation to fiat currencies and certain types of exchange tokens which fall within the definition of e-money must be authorised by the UK Payment Services Regulator (the “PSR”).

In a similar vein, non-fungible tokens (“NFTs”) are not within the scope of UK financial services regulation. However, the Consultation acknowledges that NFTs have the potential to come within the scope of UK financial services regulation to the extent a person undertakes a regulated activity (or proposed new crypto regulated activity as described in section 3. below) in respect of an NFT.

Other initiatives already in the pipeline or under consideration: The UK Government is currently introducing legislation to regulate financial promotions of cryptoassets that are not already covered by the existing rules on financial promotion; the proposed new rules are designed to ensure promotions relating to cryptoassets are clear, fair and not misleading (and, to be clear, NFTs will not be included in the scope of cryptoassets subject to the new legislation on financial promotions).

The UK Government is also currently legislating 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. This regime will address issuance and custody activities relating to fiat-backed stablecoins as well as payment-related activities for fiat-backed stablecoins that are used in payments. This regime is expected to cover GBP and other fiat-backed stablecoins which are issued in the UK. The Bank of England and the PSR will also have a regulatory remit for digital settlement assets. These various regimes are discussed in the Consultation but are not the focus of the Consultation or this note.

THE UK'S PROPOSALS FOR A NEW REGULATORY REGIME FOR CRYPTOASSETS

1. *Definition of Cryptoasset*

As referred to above, UK financial services regulation generally focusses on the activities undertaken by a person rather than the underlying assets themselves, so while there are definitions of “financial instruments” which encompass a broad range of assets such as shares, bonds, derivatives over shares, bonds and commodities, it is the activities of market participants in relation to those financial instruments which are regulated. This structure necessitates a definition of cryptoasset to which the definitions of “regulated activities” can refer.

The FS&M Bill defines a “cryptoasset” as: *“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 is a deliberately wide, technology neutral definition to capture all current types of cryptoasset and is not limited to crypto using distributed ledger technology. This definition is also used to define new crypto-regulated and designated activities, described in section 3. below.

2. *Proposed new regime governing cryptoasset issuance and disclosure*

2.1 *Issuance activities*

The UK Government proposes to follow a similar approach for cryptoasset issuance and disclosure as would apply to an issuance of traditional debt or equity securities so that the regulatory trigger points would be making a public offer of cryptoassets or admission of a cryptoasset to a UK-regulated trading venue. Currently, a prospectus approved by the FCA is required when there is a public offer of securities or when securities are admitted to trading on a regulated market or other trading venue such as a multilateral trading venue (“MTF”)⁷, in each case subject to exemptions.

The existing UK securities issuance regime is currently subject to proposals for reform (the “UK Securities Reforms”) which are part of the FS&M Bill described above, currently subject to the approval procedures of the UK Parliament. The UK Securities Reforms will introduce a general prohibition on making an offer of securities to the public in the UK, subject to exemptions, including: typical private placement; de minimis; minimum denomination-style exemptions; and specific exemptions for securities which are admitted to trading on a UK-regulated market, on a UK MTF operating a primary market (a “primary MTF”) and where the securities are offered via a “public offer platform” (a new type of regulated electronic offer platform which will, for example, cover certain types of crowdfunding platforms) (a “public offer platform”). The UK Securities Reforms will give the FCA extensive rule-making powers to determine the admission and

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disclosure requirements for admission to trading on a UK-regulated market, primary MTF or public offer platform, as applicable.

2.2 UK regulation of securities offerings/admission to trading

The following issues of cryptoassets are proposed to be subject to cryptoasset public offer/admission to trading regimes:

- (i) Issues and redemptions of a fiat-backed stablecoin: this is currently part of the Phase 1 of the UK Government's regulatory agenda for crypto and further details will be published by the UK Government separately;
- (ii) Admission of a cryptoasset to a UK cryptoasset trading venue: this is part of Phase 2 of the UK Government's regulatory agenda for crypto and further detail is described in chapter 5 of the Consultation; and
- (iii) Making a public offer of a cryptoasset: this is also part of Phase 2 of the UK Government's regulatory agenda for crypto and further detail is described in chapter 5 of the Consultation.

How these will be regulated is described below.

2.3 Issues and admission to trading of cryptoassets

It is proposed that offers of cryptoassets will be subject to a prohibition on the offer of securities to the public in the UK but will be subject to exemptions tailored for the cryptoassets market, namely an exemption where the cryptoassets are admitted to trading on a UK cryptoasset trading venue, subject to the trading venue's admission requirements and overarching FCA-defined principles. The UK Government considers that public offers of cryptoassets (including ICOs where new tokens are created and sold to investors) may meet the definition of a security offering. Where a public offer of cryptoassets meets the definition of a security offering and is considered a security token offering (an "STO"), the new securities issuance regime proposed by the UK Securities Reforms would apply, meaning that, unless the offering was below a *de minimis* monetary threshold, the offer would have to be made through a public offer platform (or a UK regulated market or primary MTF). For public offers of cryptoassets which do not meet the definition of an STO, the UK Government is considering an alternative route to regulate the activity. The proposed designated activities regime to be introduced by the FS&M Bill could be used to prohibit these offers unless they were conducted via a regulated platform (such as a cryptoassets trading venue as described below).

2.4 Cryptoassets admitted to trading on a UK cryptoassets trading venue

For admission of cryptoassets to a UK cryptoasset trading venue, the UK Government is proposing to adapt the primary MTF model from the UK Securities Reforms. It is proposed that the FCA will include overarching principles in their rule book for admission and disclosure requirements which 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 disclosure responsibilities of the issuer if it wished to admit the asset to trading. It is also proposed that trading venues will be given a choice as to whether the admission and disclosure document itself has to comply with the UK rules on financial promotions 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 (which is a public database) maintained by the FCA.

2.5 *Cryptoassets admitted to trading on a primary MTF*

For cryptoassets admitted to trading on a primary MTF, the FCA will be given rulemaking powers to ensure that, in appropriate circumstances, the rulebooks of primary MTFs require an admission document to be published and treated as a prospectus.

2.6 *Will security tokens be able to be admitted to trading on a regulated market?*

The Consultation makes only a brief reference to STOs (and ICOs) being admitted to trading on a UK regulated market. However, until the FCA and the relevant markets develop eligibility rules and disclosure requirements for such issues, it remains to be seen whether in practice an STO would be eligible for admission to trading on a UK regulated market even if a theoretical possibility.

3. *Regulated activities relating to cryptoassets*

HM Treasury is proposing that certain financial services activities relating to cryptoassets, set out below, will be deemed to be regulated activities for the purposes of the FSMA and therefore, will require prior authorisation by the FCA before they can be undertaken by way of business in or to the UK.

3.1 *Payment activities*

It is proposed that the execution of payment transactions and remittances involving fiat-backed stablecoins will be a regulated activity. However, this is currently part of Phase 1 of the timetable for the regulatory reforms, and further detail will be published by the UK Government separately.

3.2 *Exchange activities*

This regulated activity will cover operating a cryptoasset trading venue which supports: (i) the exchange of cryptoassets for other cryptoassets, (ii) the exchange of cryptoassets for fiat currency and (iii) the exchange of cryptoassets for other assets (e.g. commodities). The regulation of this activity is part of Phase 2 of the UK Government's proposals for the regulatory reforms and further detail is described in chapter 6 of the Consultation.

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To the extent not already covered, post-trade activities in cryptoassets (for example, trade reporting) are discussed in more detail in the call for evidence in chapter 12 of the Consultation but are not part of Phase 1 or 2 of the timetable for the UK Government's regulatory reforms.

Persons carrying out these activities would be subject to prudential rules, for example on financial resources, minimum capital, liquidity and other requirements regarding consumer protection, operational resilience and data reporting.

3.3 *Intermediation activities: investment and risk management activities*

It is proposed that the following will be regulated activities:

- dealing in cryptoassets as principal or agent, arranging (bringing about) deals in cryptoassets and making arrangements with a view to transactions in cryptoassets. These are all summarised in more detail in chapter 7 of the Consultation and form part of Phase 2 of the UK Government's proposals for the regulatory reforms; and
- advising on cryptoassets and managing cryptoassets (in each case to the extent not already covered by existing RAO activities). These are summarised in more detail in chapter 12 of the Consultation but do not form part of Phase 1 or 2 of the UK Government's proposals for the regulatory reforms.

There may also be a need for 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). Firms will be subject to conduct and governance rules, rules for best execution, assessing the appropriateness of a particular cryptoasset for a particular client, a duty to act honestly, fairly and in the best interests of clients, and transparency and reporting obligations to clients as well as reporting obligations to the regulator.

3.4 *Lending, borrowing and leverage activities*

This proposed regulated activity relating to cryptoassets will encompass operating a cryptoasset lending platform. This activity includes facilitating collateralised and uncollateralised borrowing of cryptoassets or borrowing of fiat currency with collateral provided in cryptoassets. This part of the proposal is subject to Phase 2 of the UK Government's proposals for the regulatory reforms and is described in more detail in chapter 10 of the Consultation.

Firms providing lending services relating to crypto will be subject to prudential requirements such as a requirement to have sufficient financial resources to meet their liabilities as they fall due. The thresholds are to be set by the FCA and will include, for example, minimum capital requirements, liquidity requirements needed to mitigate credit risk, market risk, liquidity risk and non-financial risks and addressing both the potential for harm from ongoing operations and the ability to wind-down in an orderly manner. Firms will also be required to have in place robust governance and risk management processes. Conduct of business

requirements will also apply and will cover client disclosures (especially in relation to collateral requirements and margin calls), the need for clear contractual terms and certainty of ownership of legal and beneficial title. Firms will be subject to requirements relating to operational resilience and, in particular, persons operating a cryptoasset lending platform should have adequate people, processes, systems and controls to mitigate operational resilience risks. Any outsourcing and third-party arrangements should require appropriate due diligence, ongoing oversight and formal documentation.

3.5 *Safeguarding and/or administration (custody) activities*

This proposed regulated activity relating to cryptoassets will encompass the following activities:

- safeguarding or safeguarding and administering (or arranging) a fiat-backed stablecoin and/or means of access to the fiat-backed stablecoin. This is part of Phase 1 of the timetable for the regulatory reforms and further detail will be set out by the UK Government in a separate proposal (and are not included in the Consultation); and
- safeguarding or safeguarding and administering (or arranging) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset. This is part of Phase 2 of the UK Government's proposals for the regulatory reforms and is described in more detail in chapter 8 of the Consultation.

The current custody provisions in the FCA Handbook will 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 so that if a custodian were to become insolvent, assets are returned to investors promptly and as whole as possible. The custody requirements are expected to encompass: arrangements to safeguard investors' rights to their cryptoassets (e.g. restrict commingling of investors' assets and the firm's own assets); organisational arrangements to minimise risk of loss or diminution of investors' assets; a requirement to maintain accurate books and records of investors' holdings; and controls and governance over safeguarding arrangements of investors' holdings. Firms carrying out these activities will also be subject to prudential rules, for example relating to financial resources (minimum capital and liquidity), and requirements relating to operational resilience, resolution and insolvency.

3.6 *Territorial Scope of the new regulated activities relating to cryptoassets*

UK financial services regulation currently encompasses activities carried on "in or from the UK", which can be broadly summarised as being provided from a UK presence such as a UK establishment (although there are circumstances where the territorial scope is given an extended meaning for certain cross-border activities). The Consultation recognises that activities relating to cryptoassets, which are consumed digitally, are often not confined to a specific jurisdiction. The Consultation therefore proposes to capture cryptoasset activities provided in or to the UK. This will capture activities provided by UK firms to legal and natural persons based in the UK or overseas and those provided by overseas firms to natural and legal UK persons.

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However, HM Treasury also recognises that there may be nuances in the application of the territorial scope for specific activities (in particular the regulation of crypto trading activities as mentioned below).

The Consultation recognises that there could be a “reverse solicitation” exception for cryptoasset activities provided from overseas companies, so that if a UK customer accessed entirely on its own initiative a particular cryptoasset service from an overseas firm and that overseas firm did not otherwise solicit investment business from such customer, then this might not give rise to a requirement to be authorised by the FCA. However, such an exception would likely be defined in a way to prevent misuse and regulatory arbitrage.

The Consultation also proposes that the UK introduce an “equivalence regime” for firms authorised in third countries who will be able to provide services in the UK, provided they are subject to equivalent standards and where there are suitable cooperation mechanisms between regulators to help make this work.

The Consultation states that the territorial scope for the new cryptoassets regulated activities will be determined according to whether firms are incorporated in the UK and whether services are being provided to UK persons. Any requirements on physical location will be determined by the FCA. However, firms operating cryptoasset trading venues would likely require subsidiarisation in the UK given their critical role in the cryptoasset value chain.

3.7 Vertically integrated business models

Cryptoasset exchanges which operate “vertically integrated” or “agglomerated” models which involve more than just the operation of a trading venue, will be expected to follow rules covering all of the activities performed by the trading venue. These additional activities could involve: custody, post-trade activities, proprietary trading, lending and admission of cryptoassets to a platform, the issuance of their own native cryptoasset, or intermediation for stablecoin distribution. For example, a cryptoasset exchange would be required to comply with the issuance and disclosure rules for assets that they admit to trading, the rules relating to the operation of a trading venue, surveillance and reporting requirements to detect and prevent market abuse (discussed below), the rules for market intermediaries, custody rules and rules for operating a cryptoasset lending platform, where the venue carries these additional activities.

4. Market Abuse

The UK Government is proposing that there should be a market abuse regime for cryptoassets based on elements of the UK’s existing Market Abuse Regulation (“MAR”) for financial instruments. The Consultation proposes that offences against market abuse would apply to all persons committing market abuse in relation to a cryptoasset that is requested to be admitted to trading on a UK cryptoasset trading venue. As with MAR, the provisions relating to cryptoassets would have extraterritorial effect and will apply regardless of where the person is based or where the trading takes place. Note, the MAR already applies to UK regulated

markets and MTFs so should cover cryptoassets admitted to trading on a UK regulated market or a primary MTF.

The key point is that, given that for cryptoassets there is often no issuer on whom regulatory obligations to control market abuse can be pinned, it is proposed that the obligations to detect, deter, and disrupt market abusive behaviours will fall on certain market participants.

The offences covered by the market abuse regime for cryptoassets will be the civil offences of insider dealing, market manipulation and unlawful disclosure of inside information and will have extraterritorial effect as described above.

The Consultation proposes that the cryptoasset trading venues themselves be primarily responsible for ensuring compliance with the market abuse rules. Cryptoasset trading venues will be required to establish systems and controls to prevent, detect and disrupt market abuse. This could include Know Your Customer (KYC) requirements, public blacklists, order book surveillance, suspicious transaction reports (“STORs”), information sharing between trading venues, use of blockchain analytics and providing the means for ongoing disclosures of information to the market. Trading venues would be required to investigate suspected abuse on their markets and to sanction individuals, for example through the use of public blacklists.

Other market participants, such as 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. The UK Government is also proposing that all regulated firms undertaking cryptoasset activities would be required to disclose inside information (similar to the current obligation on issuers to disclose inside information as soon as possible to ensure an orderly market in their securities (subject to exceptions)) and to maintain insider lists.

5. *Future Developments*

The Consultation also includes a discussion and call for evidence on issues relating to decentralised finance (“DeFi”), on other crypto-related activities, such as crypto investment advice and portfolio management, and on sustainability issues raised by crypto, such as the environmental impact of mining activities and whether this impact should be subject to a disclosure regime. The results of this call for evidence may lead to further proposals for regulation in these areas. For example, the Consultation raises the possibility of regulating DeFi-specific activities of “establishing or operating a protocol” which would require authorisation from the FCA and possibly a bespoke regulatory regime for such activities.

CONCLUSION

The Consultation provides a direction of travel for the UK regulation of cryptoassets and sets out, at a high level, proposals for a potential regulatory framework. The actual rules governing the Phase 2 regulation of cryptoassets in the UK will be the subject of detailed primary legislation made by the UK Parliament and detailed secondary rules made by the FCA. While the Consultation states as a general aim that the new UK regime for regulation of cryptoassets should be based on the UK's existing regulatory architecture, some of the existing rules will need to be modified, amended or augmented in order to capture particular aspects of cryptoassets and their underlying technology. The actual destination for the new UK regime for the regulation of cryptoassets, therefore, depends on the final text of the detailed legislation and rules.

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ENDNOTES

- 1 [TR Privacy edits Future financial services regulatory regime for cryptoassets vP.pdf \(publishing.service.gov.uk\)](#).
- 2 [Keynote Speech by John Glen, Economic Secretary to the Treasury, at the Innovate Finance Global Summit - GOV.UK \(www.gov.uk\)](#).
- 3 “Designated Activities” are a proposed new category of activities which cover certain activities relating to financial markets that are typically carried out by non-financial institutions as well as financial services firms. Unless exempt, a person carrying on a designated activity will be obliged to comply with requirements specified by HM Treasury and the FCA (but they will not be required to obtain authorisation as a condition of carrying on the activity).
- 4 [Financial Services and Markets Bill - Parliamentary Bills - UK Parliament](#).
- 5 [Cryptoassets: AML / CTF regime | FCA](#).
- 6 [FCA bans the sale of crypto-derivatives to retail consumers | FCA](#).
- 7 MTFs are set up normally by regulated exchanges who set out the disclosure requirements (where a prospectus is not required) and ongoing obligations for issuers on MTFs run by them. (For this reason, these markets are also called “exchange regulated markets”.)

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