HMT confirms regulatory framework for digital assets

HOT TOPIC

November 2023

Highlights

Summary of HMT's consultation responses on digital assets, confirming the intention to bring a number of cryptoasset and stablecoin activities into the regulatory perimeter for financial services.

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Summary

HM Treasury (HMT) published three papers related to regulated cryptoassets and stablecoins on 30 October 2023, confirming plans to regulate certain digital assets and related activities for the first time to support the growth of the sector.

In its response to the Future financial services regulatory regime for cryptoassets, HMT confirms it will bring forward a new regulatory regime for wider cryptoassets, largely as consulted on earlier in the year. The Government's aim is for the secondary legislation to be laid in 2024, followed by regulatory consultations.

HMT also published an update on its planned approach to regulate fiat-backed stablecoins. The Government commits to bringing forward secondary legislation as soon as possible, by early 2024, to enable the FCA to regulate fiat-backed stablecoins. This forms phase 1 of the plan to regulate cryptoassets.

It also issued a consultation response on managing the failure of systemic 'digital settlement asset' (DSA) firms, including stablecoins.

Background

The Government remains committed to setting up a clear regulatory regime for digital assets, supporting the UK's ambition to become a global hub for starting and scaling cryptoasset businesses. To support this, a number of key developments have taken place during 2023.

The Financial Services and Markets Act 2023 (FSMA 2023) received royal assent on 29 June 2023. It provides the Government with powers to specify cryptoasset activities within the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO), and to designate activities as part of the Designated Activities Regime (DAR).

FSMA 2023 also gives regulators powers to deliver a regulatory regime for the use of 'digital settlement assets' (DSA), e.g. stablecoins, in payments.

The Financial Services and Markets Act 2000 (Financial Promotion) (Amendment) Order 2023 (Financial Promotions SI) came into force in October 2023. It brings financial promotions relating to qualifying cryptoassets within the existing financial promotions regime, as per the FCA's rules.

The Law Commission published its Final Report on Digital Assets, recommending selective reform and development of the private law on digital assets.

HMT will set up a Digital Securities Sandbox (DSS) which will be the first financial market infrastructure sandbox facilitating the testing and adoption of digital securities across financial markets.

The latest papers on cryptoassets and fiat-backed stablecoins are the next step to provide regulatory clarity for the digital assets market in the UK.

Future regulatory regime for cryptoassets

The Government will apply a phased approach to regulating digital assets. The regulation of fiat-backed stablecoins will take priority in phase 1.

The regulation of other activities in relation to cryptoassets, including algorithmic stablecoins, commodity-backed tokens and certain asset-referenced tokens, will be in scope for phase 2.

Phase 1: fiat-backed stablecoins

P1 Activity	Indicative sub-activity
Issuance	Issuance and redemption of a fiat-backed stablecoins
Payment	e.g. execution of payment transactions or remittances involving fiat-backed stablecoins
Safeguarding and/or administration (custody)	Safeguarding and/or administering (or arranging the same) a fiat-backed stablecoin and/or means of access to the fiat-backed stablecoin (custody)

Phase 2: wider cryptoassets

P2 Activity	Indicative sub-activity
Issuance	• Admitting a cryptoasset to a cryptoasset trading venue • Making a public offer of a cryptoasset
Exchange	Operating a cryptoasset trading venue which supports: (i) the exchange of cryptoassets for other cryptoassets, (ii) the exchange of cryptoassets for fiat currency, or (iii) the exchange of cryptoassets for other assets (e.g. commodities)
Investment and risk	• Dealing in cryptoassets as principal or agent • Arranging (bringing about) deals in cryptoassets • Making arrangements with a view to transactions in cryptoassets
Lending, borrowing and leverage	Operating a cryptoasset lending platform
Safeguarding and/or administration (custody)	Safeguarding and/or administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset (custody)

Other digital asset activities

Certain activities, including post-trade exchange as well as investment advisory and portfolio management activities, will be considered in future stages, to the extent not already regulated.

The Government does not intend to capture cryptoassets which are specified investments that are already regulated, including security tokens. Where cryptoassets fall within the scope of already applicable existing regulatory regimes, they will largely continue to be regulated in line with the relevant existing rules and regulations.

Based on the consultation feedback, HMT will accelerate the exploratory work on future regulatory treatment of staking (e.g. a process which incentivises token owners to participate in validating transactions and securing the network, through the use of their tokens). The first steps include developing a clear definition of cryptoasset staking on a PoS blockchain and distinguishing this from riskier activities, establishing a taxonomy of the different PoS staking business models currently in the market, and identifying how to mitigate the associated risks and take advantage of the benefits of a carefully defined, permitted form of staking in the UK. A proposed taxonomy of current staking business models is included in the consultation response.

In general, activities in connection with non-fungible tokens (NFT) or utility tokens do not fall under financial services regulation, unless used for regulated financial services activities in markets, as an instrument or a product.

The Government does not intend to regulate mining as a regulated activity at this stage. Mining, in and of itself, does not constitute a financial services activity.

Authorisation process

The Government will expand the list of ‘specified investments’ in Part III of the RAO. Firms will generally be required to be authorised by the FCA under Part 4A of FSMA, if they are undertaking one of the regulated activities and are providing a service in or to the UK.

Once the cryptoasset regime is in place, firms undertaking regulated activities must adhere to the same financial crime standards and rules under FSMA which apply to equivalent or similar traditional financial services activities.

Firms already registered with the FCA under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs) will also need to seek authorisation from the FCA, under the wider FSMA-based regime.

Those categories of cryptoasset which already fall within the existing regulatory perimeter (e.g. e-money ’specified investments’ and ’financial instruments’ in Part 1 of Schedule 2 to the RAO) will continue to be regulated under those regimes.

Firms which have an existing authorisation under Part 4A of FSMA (e.g. multilateral trading facilities) can apply for a Variation of Permission (VoP). Similarly, firms which have established FSMA authorised status for regulated activities relating to fiat-backed stablecoins (phase 1) can apply for a VoP, if seeking to undertake additional regulated cryptoasset activities, regulated in phase 2.

Location

Firms dealing directly with UK retail consumers must be authorised in the UK, irrespective of where they are located.

The FCA will later determine physical location requirements, in line with existing practices. In certain market access cases, UK firms operating a regulated cryptoasset trading venue in an overseas jurisdiction may be able to apply for authorisation for a UK branch extension of their overseas entity.

The Government does not intend to expand the overseas persons exclusion to cover cryptoassets.

Vertically integrated business models

Vertically integrated businesses will be required to follow the relevant regulatory rules for each regulated activity undertaken. This refers trading venues which also conduct other activities, including custody, post-trade activities, proprietary trading, lending and admission of cryptoassets to a platform, issue their own native cryptoasset or act as intermediaries for the distribution of stablecoins.

The legislation will not explicitly prohibit certain business models or corporate structures. However, firms will be required to evidence that conflicts of interest and risks to market integrity are appropriately managed within their specific business models as they seek authorisation. The ultimate decision-making power sits with the FCA and the requirements will be addressed in detailed FCA rules.

Issuance and disclosures

The Government will establish an issuance and disclosures regime for cryptoassets in the UK, Prospectus Regime: the Public Offers and Admissions to Trading Regime (POATR), tailored to cryptoassets.

The regime will include two regulatory trigger points: admitting (or seeking the admission of) a cryptoasset to a cryptoasset trading venue, and making a public offer of cryptoassets (including initial coin offerings).

For admission to a trading venue, venues are responsible for writing detailed and publicly available disclosure documents, in accordance with principles established in the FCA's rulebook. To support consistency, the Government is in principle supportive of venues establishing an industry association to coordinate the effort with the FCA's oversight.

For tokens made available through a public offer, disclosure requirements and exemptions will likely be similar to those proposed in the draft POATR.

Disclosure / admission requirements will apply only to tokens which are made available to the UK public. Certain exceptions will apply, including offers made for no consideration or where the value of consideration is below a certain threshold, offers made to a limited number of persons or only to professional investors, and tokens acquired solely through a consensus protocol reward mechanism. Specific requirements may also vary between venues catering to retail consumers versus those only admitting institutional investors.

Trading venues

The new regulatory framework for trading venues will be based on existing RAO activities of regulated trading venues, including the operation of an MTF.

Firms will be subject to prudential rules and various other requirements, including consumer protection, operational resilience and data reporting.

The Government will not explicitly endorse or prohibit specific business models or execution protocols in legislation, but expects firms to evidence that conflicts of interest and risks to market integrity are appropriately managed within their specific business models as they seek authorisation. Specific requirements may differ between retail / wholesale trading venues and firms undertaking activities on either primary or secondary markets.

The same insolvency provisions, under Part 24 FSMA, will apply as the FCA has set for FSMA authorised firms and payment/e-money firms.

Intermediation activities

The Government will define a set of new regulated activities relating to the intermediation of cryptoassets, drawing from analogous activities in the existing regulatory perimeter.

Issuance and market abuse regimes must be activated for tokens bought and sold by UK investors. Firms will be required to log a disclosure / admission document on the NSM by a trading venue, prior to any intermediary being able to deal or arrange deals in a given token. This is similar to the requirement for a trading venue to search the NSM before a new admission to ensure disclosure / admission documents are in place.

Certain requirements (e.g. disclosures, appropriateness checks) may differ for intermediaries when dealing with eligible counterparties, mirroring the existing conduct regimes.

Custody

The Government will legislate to define a new regulated activity for custody covering the safeguarding, safeguarding and administration or arranging of safeguarding or safeguarding and administration, of a cryptoasset. Existing frameworks for traditional finance custodians under Article 40 of the RAO will be used as a basis for the regime.

The activity of providing self-hosted wallet technology to a consumer is not expected to fall under the scope of custody. Regulators will continue to keep this under review.

Arrangements with third parties, either to provide the custody or some of the underlying technology or infrastructure, will be in scope. Custody liability will be proportionate, in line with the approach for traditional finance custody.

Security tokens which meet the definition of an existing specified investment will largely be regulated in line with existing rules and regulations (e.g. issuance, reporting and prudential rules). Custody of security tokens will fall under the new legislation.

Market abuse

The new market abuse regime for cryptoassets will be based on elements of the Market Abuse Regulation (MAR) regime. The market abuse offences will apply to all persons committing market abuse on cryptoassets which are admitted (or requested to be admitted) to trading on a UK cryptoasset trading venue and apply regardless of where the person is based or where the trading takes place. Trading venues would be expected to establish who the offenders are, to establish information sharing arrangements with other venues which admit the same cryptoassets, and to have an effective regime for disrupting market abuse such as the ability to publicly blacklist offenders.

Treasury will continue to work closely with the FCA, industry and other external stakeholders to help shape the structure and function of an industry-led market abuse information sharing platform.

Regulated firms will be expected to have policies and procedures in place to identify price sensitive information, put controls around this, and to release that information to the public domain as soon as possible. The requirement extends beyond trading platforms to, for instance, cryptoasset intermediaries.

Firms will also need to consider the Financial Promotions SI which applies to cryptoasset financial promotions capable of having an effect in the UK, regardless of where in the world the promotion originates and the medium it takes.

Lending platforms

The new regime for cryptoasset lending firms will incorporate a bespoke set of rules, ongoing monitoring arrangements and the creation of a newly defined regulated activity of 'operating a cryptoasset lending platform'. Lending platforms will be required to put in place adequate risk warnings, financial resourcing and clear contractual terms of ownership. More stringent requirements will apply to retail consumer lending arrangements, which are the immediate regulatory priority.

To mitigate the risk of wholesale cryptoasset and securities lending resulting in the build-up of systemic risk, some requirements, similar to those found in the UK Securities Financing Transactions Regulation (SFTR), may be applied in the future phases.

Decentralised finance (DeFi)

The Government recognises that DeFi may play an important role in financial services, as the cryptoasset sector becomes larger and blockchain-based solutions continue to be adopted by financial markets. However, Treasury recognises that it would be premature and ineffective to regulate DeFi activities at this stage. Authorities continue their ongoing regulatory engagement with international standard-setters, authorities in other jurisdictions and industry to inform a future domestic framework.

Fiat-backed stablecoins

The stablecoins update outlines the Government's intention to prioritise the creation of FCA-regulated activities under the RAO for the issuance and custody of fiat-backed stablecoins issued in the UK, as well as the regulation of payment services relating to certain fiat-backed stablecoins when used in a UK payment chain under the Payment Services Regulations 2017.

To progress the regulation of fiat-backed stablecoins in phase 1, HMT commits to bringing forward secondary legislation as soon as possible, and by early 2024, to enable the FCA to consult and implement the regulatory regime.

Issuance

The FCA's regime will apply to all issuers located in the UK. The FCA will specify the expectations for backing assets, redemption rights and capital requirements.

The FCA will require that the assets backing the stablecoins are held in a statutory trust, whereby the terms of the trust will be set out in FCA rules. This includes when backing assets could be paid out of the trust and how they would be distributed in a firm failure.

Custody

The FCA's rules will follow the existing custody framework, with modification where necessary for specific features of cryptoassets. The FCA's regime will not capture the custody of fiat-backed stablecoins outside the UK. For both issuance and custody, the FCA intends to apply standard corporate insolvency procedures.

Payments

HMT will amend Payment Services Regulations 2017 to bring fiat-backed stablecoins in payment chains into regulation. This regime will capture payment transactions involving UK consumers, where at least one end of the transaction is in the UK, or UK firms facilitating payment transactions, regardless of whether the transaction takes place in the UK.

The Government will accommodate overseas fiat-backed stablecoins in UK payments for goods and services in the real economy. The authorities will engage with industry to understand possible options to do this, including where an FCA authorised arranger of the payment can be made responsible for ensuring overseas stablecoins meet the FCA standards.

HMT will introduce an obligation on the payment arranger to report transaction data of stablecoins to the FCA and Bank of England (BoE), in order to support their determination of whether a stablecoin is systemic.

Bank of England and PSR regimes

HMT provides further detail on the BoE and Payment Systems Regulator's (PSR) regime for the regulation of systemic DSA payment systems and service providers. HMT will retain the decision-making power for designating DSA payment systems and service providers as systemic and/or subject to PSR regulation. Further detail on the BoE's regime for regulating systemic DSA payment systems and service providers will be set out in the BoE's discussion paper in due course.

Where an FCA authorised fiat-backed stablecoin is recognised as systemic, the BoE will act as the lead prudential regulator and the FCA as the conduct lead, as per the existing approach between the FCA and PRA for investment firms.

Managing the failure of systemic 'digital settlement asset' (DSA) firms

HMT's consultation response relates only to systemic DSA firms. The policy intent is to establish a legal framework for managing the financial stability risks posed by the failure of a systemic DSA firm, and for ensuring the return or transfer of customer funds and custody assets.

HMT confirms four policy proposal steps to deliver these objectives:

1) Use the Financial Market Infrastructure Special Administration Regime (FMI SAR), with amendments, as the primary regime for systemic DSA firms that are not banks.

2) Introduce an additional objective for the FMI SAR, applicable to systemic DSA firms only, focused on the return or transfer of customer funds and custody assets, and make new rules to ensure this new objective can be applied effectively.

3) Give the BoE the power to direct administrators.

4) Require the BoE, as the lead prudential supervisor of systemic DSA firms, to consult with the FCA prior to seeking an administration order or directing administrators in respect of firms subject to regulatory requirements imposed by both the BoE and FCA.

HMT will continue with its proposal to appoint the FMI SAR as the primary legal regime, given the need to have an existing framework which can be applied in the near-term. HMT states that it may consider whether a bespoke legal framework would be appropriate in the future, as well as whether bespoke insolvency arrangements should be developed for non-systemic firms.

The BoE may use its powers under Part 5 of the Banking Act 2009 to require a systemic DSA firm operating in the UK to establish a UK presence.

The Government will lay regulations which implement the policy proposals, namely appointing the FMI SAR, with necessary amendments, as the primary regime for systemic DSA firms which are not banks, establishing an additional objective for the FMI SAR focused on the return or transfer of customer funds and custody assets, providing the BoE with the power to direct administrators as to the prioritisation of objectives, and include a requirement to consult the FCA where applicable.

HMT will make secondary legislation outlining the rules and processes by which return of customer funds and custody assets will be handled. This will build, where appropriate, on the existing frameworks for Payments & Electronic Money firms (PESAR) and Investment Banks (IBSAR).

The BoE will later publish a discussion paper, followed by a consultation paper on the proposed regulatory regime for systemic DSA firms.

What do firms need to do?

The breadth and scope of the requirements means that firms with diverse business models will be impacted by them. However in general increased regulatory clarity in the UK for cryptoassets and related activities will be welcomed by the digital assets industry.

Comprehensive and clear rules provide certainty for existing crypto firms and may encourage more established firms to enter or grow their digital asset businesses.

The FCA's recent statistics highlight that the majority of the prospective crypto firms have so far been unable to comply with the existing cryptoasset AML/CTF regime, which is required for registration with the FCA. Once the new regime is implemented, the expectations for authorised firms are raised to the level of traditional financial services firms. New and currently registered crypto firms will need to need to be able to demonstrate their maturity and ability to comply with the more stringent rules and regulations.

Existing digital asset firms and prospective new market entrants should begin to assess their current systems, operations and practices early, to identify potential gaps against the new requirements, some of which will become clearer after regulatory consultations at a later stage of the process. This is particularly important for firms with a global footprint and may be required to establish a new regulated entity in the UK.

The lack of harmonised global regulatory standards also means that many specific requirements will differ between jurisdictions, for example compared to the frameworks established in the EU, Asia and Middle East. Firms will need to navigate these, to continue to be able to reach provide services to their customers.

For more information on global digital assets regulation, including detailed jurisdiction-specific insights, please refer to Navigating the Global Crypto Landscape with PwC: 2024 Outlook, published in December 2023.

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Next steps

For fiat-backed stablecoins, the Government commits to bringing forward secondary legislation as soon as possible, by early 2024, to enable the FCA to regulate fiat-backed stablecoins. This forms phase 1 of the plan to regulate cryptoassets.

For wider cryptoassets (phase 2), the Government's aim is for the secondary legislation to be laid in 2024, followed by regulatory consultations.

Authorities have previously confirmed that the BoE will shortly publish a Discussion Paper exploring the proposed regulatory model for systemic stablecoins (used for payments). The paper will be published alongside related publications from the FCA on the regime for non-systemic stablecoin issuers and custodians and from the PRA on risks which arise for deposit-takers from innovations in new forms of digital money and money-like instruments.