THOMSON REUTERS
PRACTICAL LAW™

Lucy Frew's FinTech column: January 2021

by Lucy Frew, Partner, Regulatory & Risk Advisory Practice Group, Walkers

Status: **Published on 14-Jan-2021** | Jurisdiction: **United Kingdom**

This document is published by Practical Law and can be found at: **uk.practicallaw.tr.com/w-029-1933**
Request a free trial and demonstration at: **uk.practicallaw.tr.com/about/freetrial**

Lucy Frew is a Partner in Walkers' Regulatory & Risk Advisory Practice Group.

In this edition of her column, Lucy discusses the UK government's January 2021 consultation on its regulatory approach to cryptoassets and stablecoins and, in this context, considers why the very stability of stablecoins means they are getting more attention from global policymakers than other cryptoassets. Lucy also comments on related regulatory issues addressed in the call for evidence that forms part of the consultation, including the challenges posed by decentralised finance (DeFi), cross-border operations and financial crime.

Introducing the "stable token" and a new regulated regime

At present a large proportion of cryptoassets, including exchange tokens and utility tokens, fall outside the regulatory perimeter (although security tokens and certain types of e-money tokens fall inside, as clarified in 2019 by the FCA in its Guidance on cryptoassets). Currently, stablecoins are most likely to fall within the e-money or unregulated exchange token categories.

In its recent consultation on the regulatory approach to cryptoassets and stablecoins (Consultation), the UK government proposes to bring "stable tokens" very much into the UK regulatory perimeter, under a specific new regime. The new regulated category of stable tokens would refer to tokens that stabilise their value by referencing one or more assets, such as fiat currency or a commodity (that is, those commonly known as stablecoins) and could for that reason more reliably be used as a means of exchange or store of value.

The government considers that requirements for key participants (issuers, systems operators, exchanges and wallets) concerning activities relating to asset-backed stablecoins are necessary and should include FCA authorisation requirements and a raft of ongoing compliance requirements. Examples of such activities given by the government include issuing, creating or destroying stable tokens; managing and providing custody/trust services for reserve assets to ensure stabilisation of the stable token; validation of transactions; facilitating access of participants to the network or underlying infrastructure; transmission of funds; providing custody and administration of a stable token for a third party; and managing tokens on behalf of owners, including the storage of private keys.

For single fiat-linked stable tokens, the FCA authorisation regime will be based on existing payments regulation. For asset-linked stable tokens, the FCA authorisation regime will include specific requirements on the relevant backing asset(s).

In addition to authorisation, proposed compliance requirements include: prudential requirements (including capital and liquidity requirements, accounting and audit requirements); requirements for the maintenance and management of a reserve of safe, quality assets; orderly failure and insolvency requirements; safeguarding of tokens; systems, controls, risk management and governance; reporting and disclosures to regulators and customers; record keeping; conduct requirements; compliance with AML/CTF rules; outsourcing requirements; operational resilience; service reliability and business continuity requirements; and security requirements (including cyber and cloud). Additional requirements may be required in relation to the reserves held for stablecoins where they operate at systemic scale.

Subject to responses to the Consultation, algorithm-based stablecoins will remain outside the authorisation perimeter for now, on the basis that they are less likely to be suitable for transactions. Similarly, exchange tokens (such as BitCoin) that are not stable tokens will also remain outside the authorisation perimeter, as will utility tokens. Although security tokens are currently within the regulatory perimeter, the government proposes to keep them outside the scope of the proposals for stable tokens. However, unregulated tokens are, among other issues, the subject of a Call for Evidence by the government. The government judges that stable tokens are where the risks and opportunities are most urgent now, but future regulation of a potentially wider set of tokens and services will be informed by the Consultation and Call for Evidence.

Moreover, the government proposes that even unregulated tokens will be subject to more stringent regulation in relation to consumer communications via the financial promotion regime and AML/CTF regulation. Indeed, the Consultation is the second government cryptoassets related consultation, with the first being its Cryptoasset promotions consultation (published in July 2020 and closed for feedback).

In terms of what form the new regulatory regime for stablecoins will take, broadly speaking, the proposals envisage that the government will establish a broad framework under FSMA, including the scope of the regulatory perimeter and key objectives which focus on protecting financial stability, market integrity and consumers, and on promoting competition, innovation and the competitiveness. It will be left to regulators to create rules in accordance with the framework. The aim, which is sensible, is to thereby create a flexible regulatory framework that can respond to developments in technology and global standards. Further technical consultations will be issued by UK authorities on specific firm rules.

As always, the devil will be in the detail. The examples given by the government of activities requiring authorisation are wide-ranging. Any compliance requirements will need to be tailored to the relevant activity, as for non-crypto regulated activities, rather than one-size-fits-all.

The Consultation highlights particular challenges relating to the regulation of stablecoins and cryptoassets. As well as some financial regulatory issues (DeFi, location and financial crime) touched on below, the challenges also include broader regulatory issues: for example, in the areas of tax transparency, competition and data protection.

Stability versus volatility

The Consultation considers that many cryptoassets and unregulated exchange tokens still remain highly volatile and cannot be reliably used as a means of payment or store of value and that, as such, their use is limited. However, for some investors, ranging from retail consumers to hedge funds, volatility represents an investment opportunity. In a 2020 Research Note, the FCA reported that the dominant retail use case for cryptoassets is speculative investment, with 47% of UK cryptoasset consumers buying cryptocurrencies "as a gamble that could make or lose money". Bitcoin's price briefly topped $40,000 for the first time in early January 2021, following a year in which according to Coindesk it rose more than 300%.

It is unsurprising, therefore, that on 11 January 2021, the FCA issued a warning to consumers of the risks of investments advertising high returns based on cryptoassets, stating that if consumers invest in these types of product, they should be prepared to lose all their money.

However, the Consultation notes that the cryptocurrency market remains comparatively small in relation to the broader financial services market, with the FCA having estimated the current base of cryptoasset users in the UK to include less than 4% of the population. Moreover, the FCA's research suggests that 89% of UK cryptoasset consumers understood that they were not subject to regulatory protections. In other words, cryptoassets overall are still not seen as having significant impact and requirements relating to marketing and financial crime compliance may suffice.

So, why are stablecoins drawing particular attention from policymakers?

Given stablecoins' stability and benefits as compared to other cryptoassets' volatility and primarily speculative use, it may be seen as surprising that the UK government is proposing to impose significant regulatory requirements on stablecoins, while continuing to leave a large proportion of other cryptoassets outside the regulatory perimeter. The answer to this is threefold.

Growth market

First, while policymakers consider that cryptoassets overall remain relatively limited, the use of stablecoins is rising and, importantly, has massive growth potential. In June 2020, it was reported that there was more value in transactions using stablecoins than in Bitcoin for the first time. The stability offered by stablecoins means that, unlike other cryptocurrencies, they genuinely offer a new way to pay for goods and services or make peer-to-peer transactions.

As well as stablecoins taking an increasing portion of the payments market, even before the current COVID-19 crisis, the payments market itself was growing. Domestic and international e-commerce is increasing. The World Bank has reported that remittances (migrant workers sending money home) have increased by 64% in the last decade to overtake foreign direct investment as the largest source of external financing for low and middle-income countries. Developers claim that stablecoins offer large reductions in the costs of payments, especially cross-border, greater financial inclusion through easier and cheaper access to payment services for the unbanked and better functionality. According to the FSB, the average cost of remittances, for example, stood at around 7% in 2019. Many stablecoins propose to integrate into popular social media or online technology platforms. Given this context, and an estimated 3 billion social media users worldwide, one can see how some stablecoins could quickly reach significant scale: the regulatory outcry when Facebook attempted to launch Libra in 2019 is one high-profile example. The EU's proposed draft Regulation on Markets in Cryptoassets (MiCA), which is designed to provide a comprehensive regulatory framework for digital assets in the EU, notes that:

> "While the crypto-asset market remains modest in size and does not currently pose a threat to financial stability, this may change with the advent of 'global stablecoins', which seek wider adoption by incorporating features aimed at stabilising their value and by exploiting the network effects stemming from the firms promoting these assets".

Lack of regulatory safeguards

The second reason why policy makers focus on stablecoins is that while stablecoins may offer the same functions as money it is not subject to the same safeguards. In order to understand why this is an issue, it is worth a quick look at the pre-existing money landscape.

Money is currently created and issued either by the state as a claim on the state (in the form of banknotes) or electronically by commercial banks as a claim on themselves. According to Sir Jon Cunliffe, 97% of the money we use nowadays, for transacting and storing our wealth, takes the form of electronic claims on banks, referred to as "commercial bank money".

The shift from physical cash to electronic transactions over recent decades has not merely been a shift from paper to electronic form but, far more significantly, from using a form of money issued as a direct claim on the state to money created and issued by commercial banks as a claim on themselves. This happened as a consequence of technological innovation, rather than policy. Put simply, it is not possible to transact in physical state money online over the internet or smartphone and, as a result, cash use is declining fast. For the public and most businesses, the only current option to hold money backed by the state is in the form of physical banknotes.

Perhaps surprisingly, the shift from state to commercial bank money has not been the subject of much public debate. In principle, concerns about whether claims on banks can be met are supposed to be addressed by banks typically being regulated and subject to capital requirements, with some jurisdictions also providing retail deposit guarantee schemes. In practice, the great financial crisis of 2008 showed that controls were not strong enough and, in some cases, states were forced to bail out a certain banks, to ensure credit supply and back up the claims that these banks had issued as money to the public. Since the crisis, major steps have been taken to tighten prudential controls on deposit taking banks, intended to reinforce the reliability of commercial bank money. Currently, stablecoins are not subject to similar safeguards. They operate independently of existing bank to bank and other payment system infrastructure, instead using blockchain and wallets.

Control over the economy

The third reason why stablecoins have attracted policymaker attention relates to control over the economy. While commercial banks now create the bulk of money in the economy, the money supply is still generally controlled by states and central banks through monetary policy. States can increase the supply of money to kick-start growth or reduce it to limit inflation. However, stablecoins are neither state nor commercial bank money and their supply is not controlled by central banks or states. The potential widespread adoption of stablecoins means they are regarded by global policymakers as giving rise to significant implications in terms of monetary and financial stability, the function of credit intermediation and money creation in the economy.

The UK Consultation reflects moves by other worldwide policy makers, including the EU's MiCA and the US Stablecoin Tethering and Bank Licensing Enforcement (STABLE) Act proposed in December 2020.

Could central bank issued digital currency be the answer?

A number of central banks are considering the possibility of issuing an electronic form of central bank digital currency (CBDC) that can be used by households and businesses for payments.

According to Sir John Cunliffe:

> "The potential benefits to financial stability could include more access to and utility of central bank money, including greater public access to a risk free asset enhancing a resilient payments infrastructure. There could also be positive benefits to monetary policy, such as more direct control of the monetary transmission mechanism".

However, according to Andy Haldane, there are legitimate concerns that a widely used digital currency, whether public (such as CBDC) or private (such as stablecoins), could generate systemic risks – for example, due to large, unstable flows of funds from commercial banks deposits into private sector stablecoins or CBDC, especially at times of stress. He has also raised concerns that rapid growth of, in effect, "narrow banking" institutions could crowd out funding, and ultimately credit provision, by the banking system over the medium-term. They may also affect the transmission of interest rates to the economy.

Regulation of DeFi

Many cryptoassets and stablecoins operate using decentralised Finance (DeFi) models. Rather than being operated by a specific entity, these models use smart contracts to automate transactions and facilitate peer-to-peer transactions on a permission-less network. Thus, unlike banks or other traditional financial institutions, there is no legal or natural person who can readily be held accountable for service failures or regulatory breaches. Unsurprisingly, policymakers see issues with this scenario and are moving to require that stablecoin activities involve an authorised operator – potentially, as in the case of the proposed US Stable Bill, a bank. The enforcement of such requirements may be easier said than done, especially given the cross-border and geographically mobile nature of such activities. Locating and then prosecuting anyone within one jurisdiction would not be an easy task. It has been suggested that regulatory compliance might be built into decentralised applications' code. However, this would require regulators to place a level of trust and power with DeFi developers that is unlikely to be acceptable to regulators. Recognising the increasing role of DeFi, the UK government is keeping developments in this area under review.

Location requirements

Following on from the above, due to the digital, decentralised and cross-border nature of stable tokens, the government and UK authorities are considering whether firms actively marketing to UK consumers should be required to have a UK establishment and be authorised in the UK. Options include: requiring UK presence and UK authorisation for stable token issuers, system operators and service providers when marketed in the UK; defining the activity conducted in the UK and determining whether UK authorisation is required as a result; or no location requirements at all. The government and UK authorities are also considering the case for location requirements for systemic stable token arrangements. However, when regulatory standards are created in one country, platforms may gravitate to countries with less strict ones. While easier said than done, it is important to regulate in a way that is workable for industry as well as effective. Consumers may choose to use transact with token issuers, system operators and service providers in less regulated jurisdictions where lower compliance costs may result in lower-cost services.

Financial crime compliance

Financial institutions are required to undertake know-your-client procedures to ensure compliance with AML and CTF rules and targeted financial sanctions. Such rules are predicated on the presence of a gatekeeper institution with the resources, economies of scale, expertise and incentives to comply. However, this can be difficult to enforce in peer-to-peer or DeFi situations. Further, identities of counterparties may be concealed.

It remains to be seen how authorities would regard potential solutions. For example, tokens' smart contracts may be programmed to require checks on sellers and purchasers before execution. This is an area where an underlying globally digital ID may be necessary. There are rightly concerns about the privacy and security implications of digital IDs. But the truth of the matter is that anyone who communicates or transacts digitally – which is almost everyone - already has multiple digital identities, often poorly protected. A single, unique digital ID would enable the permissioned sharing of specific data, reinforcing personal security and giving consumers much greater control than now over their identities and data. This is an area where the FATF's March 2020 Guidance on Digital ID and Risk Based Approach for Virtual Assets may not go far enough, as it does not address challenges presented by DeFi and focuses on digital ID for individuals but not entities. There are also practical issues for compliance with the travel rule, which relates to information required to accompany transfers, in the context of cryptoassets, which have given rise to widely reported industry concerns.

Final thoughts

Comments on the Consultation are due by 21 March 2021.

The UK is still in fact finding mode and, while this consultation of stakeholders is very much to be welcomed, it has taken the UK some time to produce following the initial work of the Cryptoassets Taskforce in 2018. In the past, the UK has often been at the forefront of proposals relating to innovation in the financial sector, but this consultation follows behind proposals for regulation of stablecoins from both the EU and US.

To a longer timetable, the government will consider the case for bringing a broader set of cryptoasset market actors or tokens into an authorisation regime. The Consultation represents an important opportunity for stakeholders to agree or challenge the government's assessment of the risks and opportunities and proposed initial scope of cryptoasset regulation.

Devising an appropriate regime for stablecoins is not straightforward and requires a combination of specialist expertise covering economics, technology, data security and financial crime. It will be very interesting to see how this area develops, especially as policymakers need to move quickly to stay abreast of developments.