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Lucy Frew, a Partner in the Regulatory & Risk Advisory Group, Walkers, shares her thoughts with Practical Law subscribers on topical regulatory developments concerning the FinTech sector. In the column for December 2023, Lucy focuses on the UK government's approach to perimeter issues in areas that give rise to questions from clients in practice (such as tokenised investment vehicles, airdrops, third-party custody and staking), which are addressed in the government's October 2023 response to its consultation and call for evidence on the future financial services regulatory regime for cryptoassets.

For Lucy's previous FinTech columns, see Practice note, Lucy Frew's FinTech column.

UK government's response to consultation and call for evidence on the future financial services regulatory regime for cryptoassets

Following a consultation issued in February 2023, the UK government has now confirmed its final proposals for cryptoasset regulation in the UK, in the form of a response and call for evidence on the future financial services regulatory regime for cryptoassets (Response) (see Practice note, Hot topics: UK cryptoassets regulatory developments: Phase 2: UK regulatory approach to cryptoassets).

However, certain questions about the regulatory perimeter in areas that are still at an early stage of evolution have been left unanswered by global policymakers to date. It is useful, therefore, for cryptoasset practitioners worldwide to see the UK government's approach, as it may inform the analysis in jurisdictions that have not yet reached conclusions.

This column focuses on those topics, discussing some key takeaways on where tokenised investment vehicles, cryptoasset issuances and sales, arranging custody, staking, NFTs and DeFi are likely to fall relative to the regulatory perimeter. The terms "cryptoasset" and "virtual asset" are used interchangeably in this column.

Tokenised investment vehicles

A number of sponsors explored a few years ago whether tokenising investment vehicles would be worthwhile or a mere gimmick. At the time, many did not proceed with tokenisation on the basis that tokens would merely represent the traditional equity or debt interests issued by the investment vehicle, rather than replacing them, and add another layer of administration. However, we are seeing a resurgence of interest, as tokenisation is attracting those who wish to provide a liquid product with a secondary market. This is also seen as potentially more accessible to retail or other smaller investors. The question of how tokenised investment vehicles fall to be regulated is therefore a very relevant question at the moment.

The government has confirmed that where asset-referenced tokens meet the definition of a specified investment or a collective investment scheme, regulation will apply under the relevant regulatory framework applicable to that product. If that is not the case, one must consider whether the tokens will be regulated under the wider regime for cryptoassets.

This is very much in line with the Financial Action Task Force's (FATF) view that an asset should not be regulated as both a virtual asset and a financial asset at the same time. According to FATF's guidance for a risk-based approach to virtual assets and virtual asset service providers, the analysis of whether a tokenised interest in an investment vehicle should be regulated as a cryptoasset probably depends on whether it "has inherent value to be traded or transferred and used for payment or investment or, rather, is simply a means of recording or representing ownership of something else", which is in turn a question of the rights attached to the token. Obviously, tokens that do not qualify for regulation as virtual assets may be regarded as securities (commodities, derivatives or fiat currency). The question of whether a tokenised vehicle whose tokens are not virtual assets is subject to regulation may depend on whether it falls within the regulatory regime for pooled investment vehicles in the relevant jurisdiction, including for example whether it is managed on a discretionary basis.

The key point is that vehicles whose tokens are simply a means of recording or representing ownership of their equity or debt interests should not be regulated under virtual assets regimes, but may be regulated under traditional financial services regimes.

Non-fungible tokens (NFTs)

The government's view is that NFTs are generally more akin to collectibles or artwork than financial services products and, therefore, not appropriate for financial services regulation. However, if an NFT is used as a financial instrument or product in practice, it may fall within scope of financial services regulation. For example, the sale of in-game NFT (whether within a specific game or on an external marketplace) would not necessarily be subject to financial services regulation and nor would the exchange on which said NFT is traded (unless it also permits trading of other, regulated, assets). Conversely, it is possible that NFTs that are technically unique but largely indistinguishable from each other, including little or no price differentiation between them, could be considered cryptoassets and regulated as such. An exchange trading in such NFTs would likewise be subject to financial services regulation. This makes sense and is in line with advising clients that fractionalised NFTs are likely to be regarded by regulators as cryptoassets.

Public offers, airdrops and tokens earned via reward mechanisms

It is common in practice for cryptoassets to be distributed as rewards for services or for free via airdrops. The government confirmed that cryptoassets earned via a reward mechanism are unlikely to constitute a public offer as they are awarded in return for a service (staking and validation, mining, or providing liquidity in cryptoassets to receive new tokens in the case of "liquidity mining").

While public offers (such as initial coin offerings (ICO) or other similar issuances) and admission to trading on a platform are being regulated, the government expects to provide exemptions for distributions for free and for offers made only to professional or sophisticated investors.

This is interpretation is a welcome confirmation of industry's current understanding. In terms of distinguishing between a public offer or sale and a private one, an exemption for professional or sophisticated investors (or perhaps pre-identified investors) may be more useful than an arbitrary threshold number of investors.

Arranging custody

It is relatively uncontroversial that cryptoasset custody as a service should be regulated. The question is whether existing frameworks for traditional finance custodians can be applied and adapted to cryptoasset custody activities, as the government proposes albeit with modifications. It notes the differences between traditional versus cryptoasset custody include:

- The various novel technology solutions (for example, hot versus cold storage, multi-signature verification, multi-party computation and the use of smart contracts to hold private keys).
- The conceptual differences around "control" of the asset.
- Scenarios that are unique to cryptoassets (for example, the custody of tokens distributed via smart contracts or airdrops). The lack of recoverability (if the private key is lost, the owner cannot retrieve their cryptoassets) is unique to cryptoassets.

One area where we see questions coming up in practice is around use by virtual asset service providers of third-party custodians. A basic regulatory principle in most jurisdictions is that a business that contracts with a customer to provide a regulated service (such as custody) must be licensed or authorised to provide that service, even if it delegates the performance of that service to a third party. It is not unusual for cryptoasset businesses to arrange for a customer's cryptoassets to be held by a third-party service custodian. For example, customers of A may send cryptoassets to A's omnibus account with custodian B. While the UK has an "arranging" limb to the regulated activity of providing custody, this is not the case in some other jurisdictions, where the question of whether an entity is providing custody is more binary. A business that arranges for a customer's cryptoassets to be held by a third-party custodian may itself be subject to regulation as a custodian, unless there is a direct contractual relationship between the customer and the third-party custodian that clearly defines responsibilities and liabilities.

The government says that the FCA will consider detailed rules for third-party arrangements, including whether to apply similar rules to those that apply to traditional finance custodians. This is an area which will no doubt be tested by the courts in the coming years.

Lending and staking

The government asked whether regulatory treatment should differentiate between lending (where title of the asset is transferred) versus staking or supplying liquidity (where title of the asset is not transferred). Most respondents considered that staking should not be regulated alongside cryptoasset lending and should also not fall within the framework for regulating collective investment schemes. Many respondents defined staking as a technological process that should not be regulated under financial regulation noting that risks in cryptoassets lending (rehypothecation, counterparty credit risk and information asymmetries) were not apparent in staking.

The government proposes a definition of staking as "the process where a given amount of native cryptoassets are locked up (staked) on smart contracts in a proof of stake (PoS) consensus mechanism blockchain (on-chain), in order to activate validator nodes (computers) which collaboratively validate subsequent transactions and achieve consensus on the network's current state. It goes on to explain that rewards, consisting of newly minted native tokens and/or a portion of transaction fees on the blockchain, are then subsequently allocated to the network participants staking their cryptoassets and to the validator node operators. The government is of the view that any activities, services, or products marketed as "staking", but that do not directly facilitate a validation process on a PoS blockchain, should not currently be considered staking. At present, the government considers that the specific process of operating a validator node using on-chain staked cryptoassets would generally constitute a technical function essential to the operational activities and security of a PoS blockchain, rather than a financial services activity.

The government also proposes to establish a taxonomy of the different PoS staking business models currently in the market, broadly as follows.

- Solo staking: participants stake their own cryptoassets and operate validator nodes independently.
- Delegated staking: participants stake their own cryptoassets, but directly delegate the validation node operation to a third party on the blockchain.
- Decentralised pooled staking: decentralised intermediaries (for example, smart contracts) "pool" cryptoassets of multiple participants to stake and operate validator nodes or delegate this to a third party.
- Centralised pooled staking: centralised crypto intermediaries (like exchanges) "pool" cryptoassets of multiple participles to stake and operate validator nodes or delegate this to a third party.

The government recognises that many of the activities performed by intermediaries in the two pooled staking categories, such as taking custody of and/or pooling cryptoassets and issuing liquid tokens present risks for consumers that need to be addressed. However, there is potentially a case for these activities to be appropriately captured by other regimes, including marketing, custody, lending, and intermediation, without needing further regulation.

The government is also signalling an intent to carve out certain manifestations of staking within the taxonomy outlined above from the regulatory framework for collective investment schemes.

The government is mindful of various live or recently closed consultations potentially relevant, which should not be prejudged.

So, while the government has confirmed that it does not intend to ban staking, its exploratory work outlined above means that stakeholders (apologies!) should watch this space.

DeFi

The government's approach of holding off on DeFi regulation to enable a more internationally co-ordinated approach, as the market was relatively small and at an early stage of development, was supported by most respondents.

The government had consulted on what indicators should be used to measure and verify decentralisation of the underlying technology or governance of a DeFi protocol. Most respondents agreed that decentralisation should be seen as a process, spectrum or progression rather than a static choice between centralisation and decentralisation. Voting rights/ governance token distribution was raised by nearly all respondents as a metric that could be used to measure decentralisation. At least one respondent added that, although decentralisation was a spectrum, if a single body within the DeFi chain holds 50% or more of voting rights this should not be considered decentralised. Another respondent cited 60% as the threshold figure. Respondents added that it was also important to account for the nature of the control of the governance tokens (that is, the extent to which token-holders vote on the direction of the organisation or more immaterial matters). Distribution of nodes was also raised as a metric for measurement of decentralisation, if a small number of nodes control the majority of the network's processing power, it would indicate a more centralised protocol. The government explained that other respondents also raised "code openness" (the transparency and accessibility of the code) as a measure. Also, one respondent highlighted that reliance on self-executing smart contracts, non-custodial arrangements (no intermediary has access to client assets) and self-governance were pillars of DeFi arrangements, suggesting that the lack of this therefore would indicate a centralised entity.

The government had also consulted on what might be appropriate regulatory hooks for DeFi, in recognition of the difficulty or impossibility of regulating a true DeFi protocol itself. A significant proportion of the responses agreed with the consultation: that regulating on and off-ramps, especially exchanges, would be the most suitable regulatory hook for DeFi. Another approach suggested was to focus on the elements of the cryptoassets ecosystem that enable DeFi such as stablecoin issuers, centralised crypto exchanges, hosted wallet service providers, and market makers. All of the above are ultimately likely to be regulated in any case, so this may be a distinction without a difference. At any rate, this continues to be an evolving and fascinating area.

Conclusion

The above covers some questions that are live perimeter issues, not only in the UK but globally. It is reassuring to see that the UK government is seeking to provide more certainly without rushing to regulate areas that are still at an early stage of evolution.