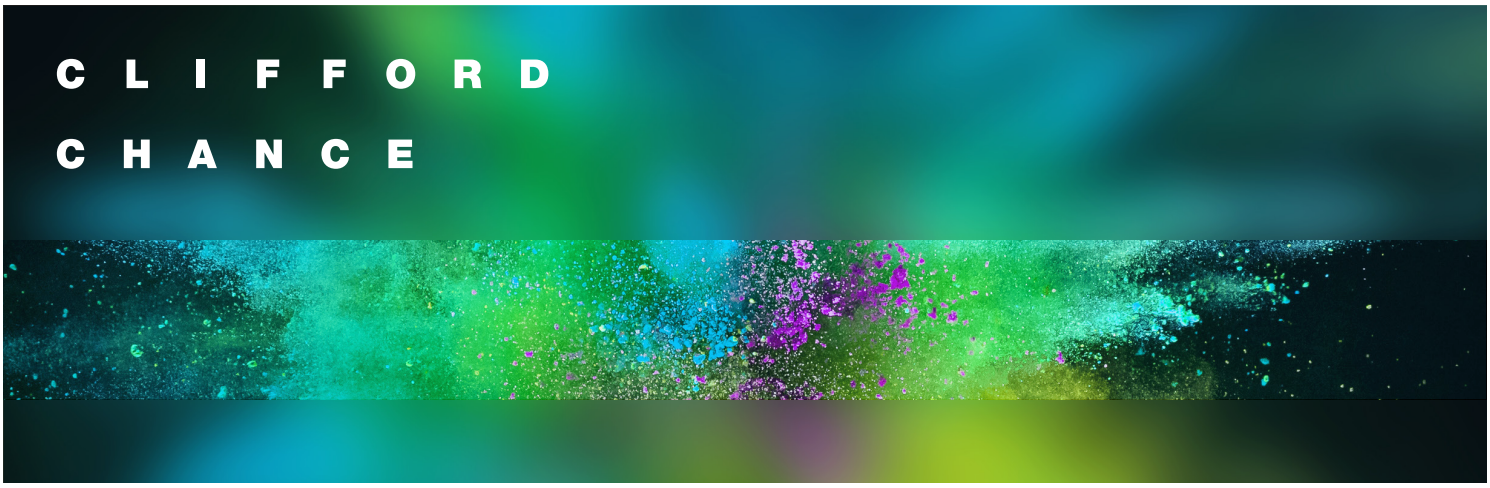

FCA GUIDANCE ON CRYPTOASSETS AND THE SCOPE OF UK REGULATION

The FCA's final Guidance on Cryptoassets clarifies which types of cryptoassets the FCA considers to fall within the existing UK regulatory perimeter. In many ways, the Guidance simply confirms the status quo, as it reiterates the need to carry out a substantive analysis of the characteristics of a particular cryptoasset or token against the pre-existing UK regulatory framework. Indeed, it is not within the FCA's gift to extend the UK regulatory perimeter; that power lies with HM Treasury, which is expected to consult on whether to bring further types of cryptoassets within scope of UK regulation later this year.

Nevertheless, the FCA Guidance does provide a useful insight into the way in which the FCA expects firms to approach this regulatory analysis, as well as some of the FCA's key concerns and areas of focus where firms engage in business relating to both regulated and unregulated cryptoassets. It is likely to be a useful reference guide for firms seeking to structure tokens or cryptoassets in a particular manner and for firms dealing with or providing services in relation to such cryptoassets.

As firms become more familiar with navigating this Guidance, we could see a new era of 'genetically engineered' money – i.e. tokens or cryptoassets that are specifically designed to meet certain functionalities or purposes, whilst fitting within (or falling outside) a particular regulatory categorization. However, the FCA and HM Treasury are sensitive to the potential risks arising from the current complexity of the UK regulatory perimeter. Therefore, HM Treasury's expected consultation later in 2019, on a possible extension of the UK regulatory perimeter to include other types of cryptoassets, may change the regulatory landscape further.

Categorizing cryptoassets

In general, the FCA indicates that a case-by-case analysis is needed to determine the correct regulatory treatment of a particular cryptoasset or token, depending on "*the token's intrinsic structure, the rights attached to the tokens and how they are used in practice*". However, the FCA recognises the benefit of establishing a clear taxonomy for identifying and discussing the regulatory treatment of different broad types or categories of cryptoassets.

The FCA identifies three main categories of cryptoassets in its Guidance, comprising two types of regulated cryptoassets and a residual category of unregulated cryptoassets:

- ***Security tokens*** are cryptoassets with characteristics that mean they provide rights and obligations akin to specified investments under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**), other than e-money.
- ***E-money tokens*** are cryptoassets that meet the definition of electronic money (or e-money) under the Electronic Money Regulations 2011 (**EMR**). Both security tokens and e-money tokens fall within the UK regulatory perimeter.
- ***Unregulated tokens*** are cryptoassets that are neither security tokens nor e-money tokens and so fall outside the UK regulatory perimeter. This category includes cryptoassets that the FCA refers to as "exchange tokens" (i.e. cryptocurrencies) as well as "utility tokens" and other types of unregulated cryptoassets.

These categories differ slightly from those that the FCA identified in its consultation on the draft Guidelines earlier in 2019. In particular, the FCA has now identified e-money tokens as a separate category (whereas it previously suggested some types of utility tokens or other tokens could include e-money). The revised taxonomy therefore seems an improvement in terms of aiding clarity on which types of cryptoassets fall within the regulatory perimeter.

Of course, the regulatory treatment of cryptoassets depends on their substantive characteristics rather than how they are labelled. Therefore, a so-called "utility token" could be regulated to the extent that it meets the definition of a security token or an e-money token. The FCA also notes that tokens can move between categories during their lifecycle, for example, depending on how they are used in practice at a particular point in time.

Security tokens and specified investments

The FCA Guidance defines security tokens as cryptoassets with characteristics that mean they provide rights and obligations akin to specified investments under the RAO, other than e-money.

The reference to "specified investments" means that this category is broader than just cryptoassets that meet the definition of "security" under Article 3 RAO (a sub-set of specified investments) and/or cryptoassets that are MiFID financial instruments. Instead, this category includes any cryptoasset that falls within scope of the UK regulatory perimeter, other than e-money tokens. Therefore, referring to these types of cryptoassets as "security tokens" could be counterintuitive in some cases.

However, in practice, we expect that many security tokens are likely to be "securities" as defined in the RAO. These include shares and other types of equity securities, debt securities, units in a collective investment scheme, rights under a stakeholder or personal pension scheme and emission allowances. The FCA Guidance sets out a non-exhaustive list of factors that are indicative of a security token, including any contractual entitlement holders may have to share in profits or exercise control or voting rights in relation to the issuer's activities.

The FCA Guidance also notes that additional regulatory requirements, such as the requirement to publish a prospectus, may apply in respect of cryptoassets that are transferable securities.

Application to stablecoins

The FCA does not identify stablecoins as a separate category of cryptoassets in its Guidance, noting that stablecoins could fall within any of the three categories identified above, depending on how they are structured and used.

A stablecoin is a type of cryptocurrency for which mechanisms are established to minimize price fluctuations and 'stabilize' its value. For example, stablecoins might be backed by financial assets (such as fiat currency), physical assets (such as gold) or other cryptoassets. Alternatively, a stablecoin's value may be algorithmically stabilized, for example through selling or 'burning' coins to control supply (as Facebook has proposed for the Libra coin). Stablecoins may also have a fixed redemption value or variable redemption value, for example based on the value of underlying reserve assets.

Given the wide variety of structures and arrangements that stablecoins may use, the FCA concluded that it was not appropriate to create a single classification in its taxonomy for stablecoins. However, it does give some examples of when stablecoins might qualify as e-money tokens, security tokens or fall outside scope of regulation.

For example, the FCA explains that a gold-backed stablecoin that gives holders a right to or interest in the gold, or rights to payments from income or profits generated from holding, buying or selling of gold, may in some cases be a unit in a collective investment scheme or a debt security.

Other types of stablecoins might qualify as e-money tokens. In general, stablecoins are likely to qualify as electronically stored monetary value that are issued for the purpose of making payment transactions. However, in order to meet the other limbs of the definition of e-money, a stablecoin would also need to represent a claim on the issuer (and so a decentralised structure with no issuer would not qualify), be issued upon receipt of funds and be accepted by persons other than the issuer.

The FCA notes that 'bank' or 'settlement' tokens used by financial institutions to facilitate efficient settlement would not qualify as e-money tokens, if they can only be used within that financial institution issuer and/or if they are not used for the purpose of making payment transactions. The FCA would therefore treat such tokens as unregulated, unless they confer rights on holders that are akin to another type of specified investment.

Definition of e-money

"electronic money" means electronically (including magnetically) stored monetary value as represented by a claim on the electronic money issuer which—

(a) is issued on receipt of funds for the purpose of making payment transactions;

(b) is accepted by a person other than the electronic money issuer; and

(c) is not excluded by regulation 3 of the EMR.

(Article 2 EMR)

(Not quite) unregulated tokens

By definition, unregulated tokens fall outside the UK regulatory perimeter. However, the FCA Guidance highlights that some regulatory rules may nevertheless apply to firms carrying on activities relating to unregulated cryptoassets.

Facilitating regulated payment services

Firstly, unregulated tokens such as exchange tokens (i.e. cryptocurrencies) or unregulated stablecoins may be used to facilitate provision of regulated payment services, for example, in the context of international money

remittance. The transfer of unregulated tokens itself would not amount to a regulated payment service, as the Payment Services Regulations 2017 (**PSR**) regulate payment services relating to "funds", which are defined as banknotes, coins. scriptural money and e-money. However, each side of the remittance may be regulated under the PSR (to the extent such activity is carried on in the UK by way of business). In general, firms will therefore need to consider not only how a cryptoasset is characterised but also whether the way in which the firm is using a cryptoasset might involve the firm providing regulated payment services.

Cryptocurrency derivatives

The FCA Guidance notes that firms can gain exposure to unregulated tokens, such as exchange tokens, through financial instruments such as fund units and derivatives referencing those tokens. These financial instruments are likely to fall within the UK regulatory perimeter (even though they reference unregulated cryptoassets) but will not generally themselves be cryptoassets.

Senior Managers Regime, Principles for Business and financial promotions

The FCA Guidance highlights the need for authorised firms to consider the extent to which regulatory rules and principles apply even in relation to unregulated areas of their business, such as activities relating to unregulated tokens. In particular, the conduct rules under the Senior Managers and Certification Regime (**SMCR**) may apply to the activities of relevant individuals in firms that are subject to those rules.

High level Principles for Business 3, 4 and 11 in the FCA Handbook also apply generally to unregulated activities of authorised firms (although for Principle 3 this is limited to unregulated activities which may have a negative impact on the integrity of the UK financial system or the ability of the firm to meet the suitability Threshold Condition). These principles require firms to take reasonable care to organise and control its affairs responsibly and effectively with adequate risk management systems, maintain adequate financial resources and to deal with the FCA in an open and cooperative way and to disclose to the FCA anything of which it would reasonably expect notice.

Finally, the FCA indicates in its guidance that it expects authorised firms to "*apply the financial promotion rules and communicate financial promotions for products and services, whether regulated or unregulated, in a way which is clear, fair and not misleading*". Firms must also make clear whether their financial promotions relate to regulated or unregulated products and activities. In particular, the FCA stresses that firms must not suggest that their authorisation extends to unregulated cryptoassets.

Anti-money laundering

The FCA Guidance notes that HM Treasury intends to bring entities carrying on certain cryptoasset activities within scope of anti-money laundering regulation, as part of the UK's implementation of the EU Fifth Anti-Money Laundering Directive (**5AMLD**). This includes cryptoasset exchanges and wallet providers for all types of cryptoassets, whether regulated or not. The UK has proposed going beyond the scope of 5AMLD in certain respects.

However, the FCA notes that the anti-money laundering regime is separate to the general UK regulatory perimeter and so this extension of the anti-money laundering regime to entities carrying activities relating to unregulated cryptoassets will not bring those cryptoassets within the perimeter.

Reviewing the regulatory perimeter

The FCA indicates that its Guidance will inform further work in this area, including a consultation by HM Treasury on whether further regulation of cryptoassets is required.

In its first annual Perimeter Report, the FCA highlighted particular challenges in analysing whether cryptoassets fall within the regulatory perimeter, for example due to the fact that they can display different characteristics during their lifespan. The FCA also questioned whether the existing perimeter is fit form purpose to manage the potential harm that cryptoassets pose. In this regard, the FCA has issued various warnings on the risks posed by unregulated cryptoassets and is consulting on a potential ban on the sale to retail customers of derivatives and other products referencing unregulated cryptoassets.

However, the power to change the regulatory perimeter itself lies with HM Treasury and not with the FCA. On this issue, the Treasury Committee has recently published a report recommending that the FCA should be given formal powers to recommend to the Treasury changes to the perimeter of regulation, citing cryptoassets as a current grey area that would benefit from further consideration. Therefore, if the Treasury Committee gets its way, the FCA may end up consulting on possible changes to the perimeter it might then recommend to HM Treasury, rather than leaving this solely to HM Treasury.

Meanwhile, the FCA continues to indicate that it is for the Treasury to consult on possible changes to the regulatory perimeter. Therefore, it is unclear whether further work in this area could be delayed while this question as to whether the FCA or Treasury should take the initiative in consulting on potential changes to the regulatory perimeter is resolved. This question may also feed into the Treasury's call for evidence on the future of the UK's regulatory framework for financial services.

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