



UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence

HM Treasury

January 2021

Response from the Emerging Payments Association

Abstract

This paper sets out the Emerging Payment Association's response to HM Treasury's UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence in January 2021. It contains recommendations on how to ensure the UK's payments industry continues to be progressive, world- leading and secure, by creating the best environment for the growth of businesses touching cryptoassets and varieties of stablecoin including CBDCs.

March 2021

Contents

Introduction

The Emerging Payments Association (EPA) welcomes the opportunity to contribute to HM Treasury's *UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence* published in January 2021 ("HMT Paper"). The community's response contained in this paper reflects views expressed by our members and industry experts recommended by them who have been interviewed and who are referenced. As the EPA's membership includes a wide range of companies from across the payments value chain, and diverse viewpoints across all job roles, this response cannot and does not claim to represent the views of all members fully.

We are grateful to the EPA's members and the experts they have recommended to us, who have contributed to this response which has been drafted based on interviews and collaboration with them by Robert Courtneidge, one of the EPA's longest standing advisors and with the additional support of CoinPayments.

We hope it advances our collective efforts to ensure the UK's payments industry continues to be progressive, world-leading and secure, and effective at serving the needs of everyone who pays and gets paid.

Tony Craddock
Director General
Emerging Payments Association

Author

Robert Courtneidge – Payments Industry Advisor

Contributors

Members of the EPA's Project Regulator

Members of the EPA's Advisory Board

Special thanks to the following who have made valuable contributions:

- Shannon Seitz – Legal Counsel, Western Union
- Nilixa Devlukia – Founder, Payments Solved
- Giedre Mitkute – Associate, Locke Lord
- Peter Howitt – Managing Director, Ince
- Peter Oakes – Founder, Fintech Ireland
- Tony McLaughlin – Managing Director Transaction Banking, Citi
- Jason Butcher - CEO, CoinPayments
- Simone Mazzuca – Director, Wallex TRUST
- Justine Scerri Herrera – Director, MK Fintech Partners

Contents

EPA Responses

The section numbering below corresponds to the numbering of the 'questions for respondents' in the HMT Paper.

Chapter 1

Cryptoassets and the current regulatory landscape

1 Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

The EPA is happy with the current definitions and classifications used. It is also aware that new variants continue to appear which may or may not fit into the existing categories and hence flexibility is required, and new classifications may evolve over time.

2 Do you have views on the proposed new regulated category of 'stable tokens'?

Currently, the FCA guidance distinguishes the following cryptoassets: e-money tokens, security tokens, unregulated tokens including utility tokens and exchange tokens. We note that for the later ("unregulated tokens"), exchange tokens remain on the regulatory radar of the Financial Conduct Authority under the provisions of the Money Laundering Regulations of 2019.

The EPA understands the need to create the new category of 'stable token' which would include stablecoins and CBDCs. However, we need to be adaptable as new variants arise, and as different stable tokens with different rules are established. For example, it is envisaged that CBDCs are likely to be regulated differently to a stablecoin like Tether, which is commercially issued. The EPA believes that conflating CBDCs and Stablecoins is a mistake as their backing and ultimate liability is quite different. In the view of the EPA, CBDCs should be regulated and managed by the Bank of England. In addition, the current classification relies on the purpose for which the token is being used, while the term 'stable token' relies on the features/characteristics the token offers, such as the fact that the token value is pegged to a traditional currency, or the use of distributed ledger technology. Such features should, in the EPA's view, be irrelevant when assessing whether a cryptoasset fits into a regulatory category and is not consistent with current FCA guidance on cryptoassets.

We also note that the definition of "stable token" is different from the definition of stablecoin contained in the Proposal for a regulation of the European Parliament and of the Council on Markets in cryptoassets and amending Directive (EU) 2019/1937 ("MiCA"). Under MiCA, the definition is broader and includes the referencing not only to legal tender but also commodities, cryptoassets and other assets.

To avoid legal divergence, we would recommend aligning the definition of stable token to its definition within MiCA.

Chapter 2

Policy approach

Objectives, principles and UK initiatives

3 Do you have views on the government’s proposed objectives and principles for cryptoassets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

The EPA agrees with the proposed approach of using and adapting where possible existing laws and regulation to work in this new sector of cryptoassets. The technology-neutral basis is welcomed, as is the desire to be proportionate and avoid burdensome regulation.

Flexibility and nimble reactions to changes in Europe and beyond with a goal towards a position of equivalence where possible is seen as a good outcome. Furthermore, ensuring robust consumer protection will instil consumer confidence in dealing with UK fintech firms, especially when consumers are generally wary of cryptoassets due to lack of recourse when targeted by fraudulent parties.

Overarching approach and related UK initiatives

4 Do you agree with the approach outlined, in which the regulatory perimeter, objectives and principles are set by government and HMT, with detailed rules to follow set by the UK’s independent regulators?

By going down this route, provided that the industry is properly and sufficiently consulted throughout with stakeholder meetings and workshops, with sufficient lead times before changes are implemented, the UK should be in a position to ensure proportionate and practical regulation of this complex new area.

In addition, we note the following principle, “Maintaining the current division of UK regulator responsibilities as far as possible and applying the principle of ‘same risk, same regulatory outcome’”. The FCA is the main regulator for cryptoassets businesses falling under the scope of the Money Laundering Regulations of 2019 and with the issuance of the Guidance PS19/22 on cryptoassets. It is important that there are regular discussions between regulators and the industry as outlined above to ensure a consistent practice and understanding, to avoid legal uncertainty for market participants and to continue promoting innovation in the UK payment systems.

5 What are your views on the extent to which the UK’s approach should align to those in other jurisdictions?

It is important with anything new, such as the regulation of cryptoassets, that a proper global approach, with globally aligned standards, is deployed. In the past, different countries have taken an individual approach to this area and have created their own regulations (e.g., Gibraltar, Lithuania, Malta and Singapore). We currently have new EU regulations being created and this is referred to in the consultation: Market in Cryptoassets (MiCA). The EPA believes it would make sense, especially having so recently left the EU, that the UK should look to follow MiCA. We want to have the best regulation but being an island

with independent regulations will not enable the UK to keep its status as world-leading in Fintech. The real value in cryptoassets is their ability to be traded efficiently and the UK should strive to allow trade across borders to happen instantly, with minimal friction and low cost using new technology. Inconsistent regulation across geographic boundaries will only lead to confusion, inefficiencies and unintended regulatory arbitrage opportunities.

Chapter 3

Expanding the regulatory perimeter

The first phase of legislative changes

In the December 2019 Financial Stability Report, the FPC observed that, in the future, digital tokens known as stablecoins might increasingly be used to make payments and that stablecoin-based payment chains pose additional issues for regulation. The FPC set out two expectations for stablecoin-based payment chains:

- 1: Payment chains that use stablecoins should be regulated to standards equivalent to those applied to traditional payment chains. Firms in stablecoin-based systemic payment chains that are critical to their functioning should be regulated accordingly.*
- 2: Where stablecoins are used in systemic payment chains as money-like instruments, they should meet standards equivalent to those expected of commercial bank money in relation to stability of value, robustness of legal claim and the ability to redeem at par in fiat.*

6 Do you agree with the government's assessment of risks and opportunities?

The EPA understands the risks HMT outlines but believes only the second (risk to consumers) is really likely to be of real relevance for the initial regulation of this area.

Concerns over financial stability and market integrity could only come into play if stablecoins became synonymous with fiat currencies in the UK. This is likely to be a long way off even if the growth of stablecoins accelerates massively. This would enable those groups, such as the EPA, working with the regulator to debate and come up with suitable regulations well before this became an issue. With respect to the third risk, competition, stablecoins will take a very long time to become on an equal footing with current payment rails and the offerings available to banks and card businesses today. As such, again, this could easily be dealt with through stakeholder working groups well in advance of it becoming a material concern.

7 Do you have views on the proposed initial scope of UK cryptoasset regulation as summarised above?

Keeping the more difficult exchange tokens and utility tokens out of scope of the initial regulation should make it easier to create regulation in this area. Equally, it does make it less useful for the UK to position itself as a home for the global crypto industry if these tokens are excluded.

Whilst the regulations would be appropriate for centrally managed and issued custodied stablecoins, there has to be a question over whether a decentralised token is capable of

following this form of regulation (e.g. stablecoins backed by a token entirely using smart contracts, in which case there is no issuer custody of those underlying assets within the normal meaning of custody). Further guidance may be needed on good practice for such decentralised stablecoins. The regulator should have the ability to take enforcement action in extreme cases – albeit in a more limited form given it will be against a decentralised autonomous organisation. And the regulator should be able to publish concerns about such stablecoins based on perceived technologically or operational deficiencies. This would allow the regulator to keep an eye over such products and provide good practice guidance without forcing those issuers and products into the centralised regulatory model for which they are simply not suitable. In addition, the regulator could advise on situations where an allegedly decentralised stable token would be treated as one requiring authorisation on the basis that it was not genuinely decentralised.

It makes a lot of sense to bring in the financial promotions regime under the Regulated Activities Order in order to cover unregulated exchange and utility tokens (which would include algorithm-based stablecoins). This will help to protect consumers in respect of these highly volatile forms of cryptoasset. The appropriate regulatory approach must always aim to be, and be stated to be, as technologically neutral as possible and not engage in blanket regulation using very wide terms such as ‘cryptoassets’ but instead have clear and defined terms.

8 Do you agree that this approach best balances the government’s stated objectives and principles?

In order to meet these identified risks, the government proposes that stablecoins should be subject to a suitable regulatory regime that covers both the issuers of the stablecoins and firms providing services in relation to them, either directly or indirectly to consumers.

It is suggested that the degree of regulation should match the size of the business in the same way that banking regulation applies (e.g., stage 1, payment institution, stage 2, electronic money institution, stage 3, financial/credit institution). In respect of other cryptoassets, these will be under continuous observation and potentially further regulation can be applied if it appears necessary.

The EPA is in general agreement with this approach but believes constant review and ongoing workshops with the industry are the only way in which to ensure the right regulation is developed, deployed and maintained. In creating the regulatory regime, care should be taken to make sure that the regulations are not duplicative or divergent to existing regulations and contemplated services. In other words, money transfers where the user provides fiat to a money transfer operator who provides the fiat to the crypto provider/broker should be regulated under existing payment regulations applicable to money transmission).

Scope of regulation and requirements

- Tokens in scope**
- Stable token payment systems**
- Systemic stable token payment systems**

9 Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

To clarify the paper sees the following:

Actors - three key actors involved in stable tokens are: the issuers of the tokens, the exchanges accepting the tokens and the wallet providers holding the tokens.

Activities - areas of regulation for stable tokens are: issuing, creating or destroying tokens (asset- or fiat-backed), management/custody of the assets/fiat funds backing the tokens, execution, validation and settlement of transactions using tokens, access services to the actors (set out above), custody services for tokens, and exchanging tokens for fiat money and vice versa. Whilst much of these activities are already covered by existing payment regulation in the UK, the storing and custody of the private key for the tokens are not.

Requirements

- Authorisation
- Prudential requirements
- Orderly failure and insolvency
- Systems, controls, risk management and governance
- Reporting (including notifications requirements, e.g. if value of reserve falls below par) and record keeping
- Conduct requirements
- Outsourcing requirements
- Security requirements
- Financial crime requirements

Additional requirements specific to the issuing, creation and destroying of in scope tokens:

- Requirements for the maintenance and management of a reserve of assets
- Operational resilience, service reliability

Additional requirements specific to providing custody and admin of token for a third party, executing transactions in tokens and exchange between fiat and token:

- Safeguarding of customer funds / custody of client assets
- Safeguarding the stable token and key

The FCA would be the main regulator unless systemic.

As currently envisaged the following activities would not require authorisation:

- Value stabilisation and reserve management
- Validation of transactions
- Access
- Transmission of funds

The EPA believes that these requirements could form the basis of good regulation in the area of stable tokens. They are based on the well-established principles from electronic money and payment services which have evolved over more than two decades and are known requirements which should work immediately.

10 Do you agree that the government should primarily use existing payments regulations as the basis of the requirements for a new stable token regime, applying enhanced requirements where appropriate on the basis of mitigating relevant risks? What other existing legislation and specific requirements should also be considered?

See 9 above.

In respect of other relevant legislation, that depends on the uses of the tokens. Typically, all relevant consumer protection laws and regulations applicable to payment and banking business should equally apply to stable tokens (e.g. if credit is being offered or interest on loans these should all follow existing UK laws).

11 Do you agree with the high-level requirements outlined? Do you consider that any additional requirements are needed?

In respect of the high-level requirements set out in our response to 9 above, we believe that these requirements, being in line with existing regulation on payment systems, will be workable and will help the industry, provided that there is proper and timely consultation on the detail and implementation is held with the industry.

We do, however, have some specific queries:

- “requirements for the maintenance and management of a reserve of assets”: Does the government foresee if they will require firms to maintain segregated reserves for stable tokens and unregulated tokens in the future (should such tokens be regulated)?
- “safeguarding the token”: Does the government foresee having different safeguarding requirements should it decide to regulate unregulated tokens in the future (i.e. imposing more stringent measures)? This may have an operational impact on firms that deal with both stable tokens and unregulated tokens.
- “Safeguarding the token”: if a cooperation between cryptoassets businesses and credit institutions is necessary to fulfil such requirements, we would welcome proposals from the government that would encourage credit institutions to accept opening a bank account for cryptoassets businesses as currently cryptoassets businesses are facing issues in contracting with credit institution despite the entry into force of the 5AMLD in the UK.
- Please provide elements to differentiate between “safeguarding the token” and “providing custody and administration of a stable token for a third-party”.

Finally, whilst it is clear that businesses in the UK should follow the regulation, it is not so clear for overseas businesses that issue to UK citizens on a cross border basis. If this occurs perhaps there will be a requirement to establish in the UK or have a presence to be regulated. If it is a systemic stable token, then there may be a greater case for UK Bank of England regulation. This needs further clarification.

12 Do you have views on whether single-fiat tokens should be required to meet the requirements of e-money under the EMRs, with possible adaptation and additional requirements where needed?

We believe it is clear that single currency fiat tokens meet the criteria for electronic money and should already be regulated as such if they are being issued in the UK. The wider question of multi-currency fiat tokens needs to be addressed. In our view such tokens

would also fall within the definition of electronic money as defined in the regulations/directives, namely:

“‘electronic money’ means electronically, including magnetically, stored monetary value as represented by a claim on the issuer which is issued on receipt of funds for the purpose of making payment transactions as defined in point 5 of Article 4 of Directive 2007/64/EC, and which is accepted by a natural or legal person other than the electronic money issuer.”

There is no suggestion in the definition that the stored monetary value needs to be a single currency and hence, so long as all the currencies in the basket are real fiat currencies, then it fits the definition and should be regulated. Indeed, many e-money issuers already offer multi-currency accounts, so it is already anticipated.

13 Do you have views on whether exclusions to the authorisation regime are needed in relation to the stable tokens regime, in light of the government’s objectives? If so, which activities do you think should be excluded?

The concept of exemptions for things such as ‘limited network’ tokens makes a lot of sense, as stable tokens which act and behave like e-money should not only have the same requirements but also the same exemptions to ensure a ‘level playing field’. If a token can only be exchanged for goods or services within a limited number of merchants then of course it should be exempt. Equally the other key exemptions in Schedule 1 Part 2 of the UK’s Payment Services Regulations 2017 should apply to stable tokens.

14 What are your views on the appropriate classification and treatment of (unbacked) tokens that seek to maintain a stable value through the use of algorithms?

These tokens, if not backed by actual assets, cannot be anything other than utility or exchange tokens and treated accordingly. It is hard to see what value they could give, as their stability is governed by the algorithm which formed them and, compared to fiat currencies, there is every chance that it too could have volatility.

15 Do you agree Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens?

The EPA agrees that where any stable token gets, or is likely to get, to systemic proportions then the organisation behind it and the tokens themselves should be treated as a bank and the same systems and controls should apply. It must always be remembered, however, that new types of stable tokens may further exclude communities who rely on cash.

If, however, this is supposed to apply to all stable tokens then such a requirement would impose stringent restrictions on issuers of stable tokens and slow down innovation. As issuers of stable tokens are already subject to strong regulatory provisions set out in paragraph 3.23 of the consultation paper (safeguarding, preparation for insolvency, authorisation requirement, conduct of business requirements), we believe that the application of Part 5 would be disproportionate to the objectives set out in paragraph 2.1 of the consultation paper (protecting financial stability and market integrity, delivering robust consumer protections, promoting competition, innovation and supporting UK competitiveness).

16 Do you have views on potentially extending Bank of England regulation of wider service providers in the stable token chain, where systemic?

As stated in 15 above, where systemic, the stable token and all its entourage should be treated under BoE regulation.

17 Do you agree that Part 5 of FSBRA 2013 should apply to payment systems facilitating the transfer of new types of stable tokens?

As stated in 15 and 16 above, where systemic, Part 5 should apply.

18 Do you have views on location and legal entity requirements?

As stated at the end of our answer to 11 above: it is clear that businesses in the UK should follow the regulation but more detailed rules on how it applies to stable tokens coming in from other jurisdictions is needed to fully assess and respond here.

Chapter 4

Call for evidence on investment and wholesale uses

Security Tokens

19 Are there any areas of existing regulation where clarification or amendments are needed to support the use of security tokens?

The Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO) is a sensible start point for regulation in this area. There would be a need for some clarification added to explain how tokens can be securities as defined in the RAO but, as the definition of 'instrument' is very wide, a token can definitely fit.

DLT-based financial market infrastructures

20 What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

Areas of use could include trade management processes, through to clearing and settlement, and on to post-settlement activities such as custody and asset servicing. The key is to understand whether the benefits are incremental or transformational. In addition, how DLT will interact with existing rules around transfer of title, settlement finality, financial collateral, shareholder rights and corporate actions, and whether there is a need to optimise legislation across these areas to better accommodate DLT to different financial market infrastructures while safeguarding stability and security.

21 What are the potential drawbacks of DLT for wholesale markets and FMIs?

It is likely to be a good growth area over time but there are significant issues around blockchain identity, geographic fragmentation (lack of harmonised securities laws) that suggest it would be wise to let each specific sector come forward with proposals for improving efficiencies using the blockchain and deal with them on a case by case basis. As this is such a wide and complex topic, it should be separated from this consultation on stablecoins and split up into different consultations dealing with, for example:

- Settlement rules for tokenised securities
- Custody rules related to tokenised securities and other cryptoassets
- Legality and management of corporate member registers and actions on the blockchain

22 Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation be optimised for DLT?

Whilst this is largely outside the scope of the EPA and its members, we would recommend that the UK postpone the proposed regulation or legislation at issue until greater clarity is received from the EU and their plans to regulate the same industry.

By significantly diverging from EU regulation in this industry, especially where such divergence would increase rather than decrease the regulatory burden on the industry in relation to future EU regulation, the UK would put itself at a significant disadvantage when attempting to attract this industry to the UK.

23 What are the wider industry incentives or obstacles to the adoption of DLT in wholesale markets and FMIs in the UK?

OUTSIDE SCOPE OF EPA

24 If market coordination is required to deliver the benefits of DLT, what form could it take?

OUTSIDE SCOPE OF EPA

25 Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

OUTSIDE SCOPE OF EPA

26 What should the UK government and regulators be doing to help facilitate the adoption of DLT/new technology across financial markets/FMIs?

OUTSIDE SCOPE OF EPA

Other unregulated tokens and new developments in the market

27 Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

OUTSIDE SCOPE OF EPA

28 Do you have any views on how the government should bring these tokens into the regulatory perimeter in the future?

OUTSIDE SCOPE OF EPA

29 What are the risks and opportunities you see in relation to DeFi?

While decentralised finance (DeFi) activities prevent a lot of third-party risk existing in transactions (decentralised exchanges have a lower risk of theft resulting from hacking of exchanges, less possibility of price manipulation, etc), it does have its drawbacks where its decentralised nature does not provide any possible recourse for consumers (mainly due to its anonymity).

30 Do you have any evidence of risks to consumers when using tokens as a form of speculative investment or through DeFi that may be of interest to the government and UK authorities?

OUTSIDE SCOPE OF EPA

Conclusion

The EPA is laser-focussed on promoting and leading the UK's payments industry, including working with start-ups and established players across the value chain, from banking to non-bank payments services providers, technology companies, lawyers and merchants.

The EPA sees the regulation of the crypto sector as key to the UK's continued leadership in payments, and as a result, of the fintech industry of which payments is the largest part. Many countries around the world have started to create regulation in the crypto sector and it is important for the UK to look at what has been done and where appropriate ensure that the UK regulation proposed is in line with it.

The European initiative, MiCA, is of particular relevance as we continue to develop EU-friendly regulation post-Brexit. As such we should pay particular attention to ensuring we produce complementary regulation whilst showing the UK's leadership. Our regulation on electronic money and payment services has enabled the UK to create more fintech businesses in this sector than any other country in Europe, and hence the adaption of these regulations into the stable token environment is key. What we want to avoid, at all cost, is the inadvertent creation of regulatory arbitrage.

As always, it is the EPA's view that the facilitation of cross-party stakeholder groups is the best way to avoid any unintended consequences. UK regulators like the FCA have led the way in such discussions prior to the implementation of payment services and electronic money regulation so it is a path well-trodden. The EPA offers to support this process by running or contributing to such stakeholder groups as required.

So in conclusion, the EPA supports the direction of travel outlined in this consultation. To help accelerate the UK's adoption of these changes, a separate working group of members has been established with a view to creating a GBP stable token. We would welcome HMT, FCA and BoE's input into this group as we believe that the commercial creation of such a token, approved by the BoE, could serve the UK well in keeping its leadership of fintech globally.

Finally, but not least, the EPA is planning a research project on **The UK's Leadership in Crypto and Stable Tokens** with a view to publishing a white paper and delivering a webinar in the summer of 2021 to explain it. We will be waiting for the next iteration of BoE's 'Central Bank Digital Currency: opportunities, challenges and design' paper due to be published imminently before commissioning the research and would welcome the involvement of those responsible for these areas at HMT, BoE and the FCA in this initiative.

About the Emerging Payments Association

The Emerging Payments Association (EPA), established in 2008, sets out to make payments work for everyone. To achieve this, it runs a comprehensive programme of activities for members with guidance from an independent Advisory Board of 16 payments CEOs.

These activities include a programme of digital and (when possible) face-to-face events including an online annual conference and broadcast awards dinner, numerous briefings and webinars, CEO Round Tables, and networking and training activities. The EPA also runs six stakeholder working groups. More than 100 volunteers collaborate on the important challenges facing our industry today, such as financial inclusion, recovering from COVID-19, financial crime, regulation, access to banking and promoting the UK globally. The EPA also produces research papers and reports to shed light on the big issues of the day and works closely with industry stakeholders such as the Bank of England, the FCA, HM Treasury, the Payment Systems Regulator, Pay.UK, UK Finance and Innovate Finance.

The EPA has over 130 members that employ over 300,000 staff and process more than £7tn annually. Its members come from across the payments value chain including payments schemes, banks and issuers, merchant acquirers, PSPs, retailers, TPPs and more. These companies have come together to join our community, collaborate, and speak with a unified voice.

The EPA collaborates with its licensees at EPA EU and EPA Asia to create an interconnected global network of people passionate about making payments work for all.

See www.emergingpayments.org for more information. Contact malik.smith@emergingpayments.org for assistance.