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Client Alert

November 2023

United Kingdom: The future of UK crypto regulation – Treasury provides clarity on the wider regime

In brief

Following its February 2023 consultation and call for evidence on a future financial services regulatory regime for cryptoassets, HM Treasury issued its policy statement on the wider cryptoasset regulatory regime on 30 October 2023. The policy update was published alongside a flurry of publications on the regulation of cryptoasset services, including interlinked policy documents covering regulation of fiat-backed stablecoins and the failure of systemic digital settlement asset (DSA) firms. This briefing covers the so-called "Phase 2" regulation of wider cryptoasset activities.

For more information on the stablecoin regime and the failure of systemic DSA firms, see our dedicated alert issued alongside this one.

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Key takeaways

- The Treasury's policy statement largely confirms that it intends to implement the proposals consulted on in February 2023 – moving to a FSMA-style authorisation regime of crypto activities and bringing a significant proportion of crypto related activities fully in-scope of FCA authorisation requirements. For background and detail on the Treasury's initial proposals in its consultation, see our client alert from earlier this year.
- It is helpful that there is further clarity on the intended outcomes for non-fungible tokens (NFTs), utility tokens, security tokens and other data objects or 'things' that were previously thought could be unintentionally captured by the new regime. However, there remains some uncertainty as to how NFTs and utility tokens will be treated, as their regulatory treatment will ultimately depend on how they are used, and ultimately firms will still need to analyse their characteristics given that they have not been entirely excluded from the future regulatory regime.
- No grandfathering is expected to be available for FCA authorised firms or firms registered for money laundering requirements under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs). In particular, FSMA authorised firms will need to submit a Variation of Permission (VoP) application to include the relevant cryptoasset services in their scope of permissions, while MLR-registered firms will need to go through the full authorisation process.
- It is important to note that the Treasury has confirmed that it does not intend to extend the overseas persons exclusion (OPE) to cryptoasset activities – therefore imposing stricter territoriality requirements on cryptoasset firms. The current policy position as articulated by the government is that firms providing cryptoasset services directly to retail customers in the UK should be subject to regulation, wherever they are located. The position is currently unclear as to whether any exemptions may be applicable in relation to non-retail customers. Overseas firms that rely on the cross-border provision of services to remain out of scope of the regulatory perimeter should take note of developments in this regard and consider whether to reassess their business models.

- There will, however, be an equivalence regime for market access in the future and some time-limited ability to access overseas liquidity pools before this regime is in place – what this access looks like and whether it will require e.g. authorised branches in the UK remains unclear
- Disclosure requirements will apply to offers of cryptoassets to the public and when cryptoassets are admitted to trading venues. The content of these disclosures is to be determined by the trading venues themselves, although some centralisation and agreement is encouraged.
- It is clear that the final regime and applicable rules will require significant work from the FCA to map across existing concepts to cryptoasset rules. The government seems to envisage relying heavily on FCA rulemaking and guidance as part of the regime – in line with the post-Brexit regulatory trajectory toward requirements being set out in more agile regulatory rules as part of the Smarter Regulatory Framework.
- Finally, market abuse rules will apply to cryptoassets. Whilst the FCA acknowledges that an implementation / transition period will be needed to lay out and effect these requirements, it intends to take forward the proposals to apply rules based on the Market Abuse Regulations (MAR) to cryptoassets, which will apply to cryptoasset trading venues and other regulated market participants.

We consider these issues further below.

Phasing and timetable

Establishment of the wider crypto regulatory regime is viewed as a 'Phase 2' in the government's crypto regulation plans, to follow the initial regulation of fiat-backed stablecoins in Phase 1. The Treasury is aiming for secondary legislation on wider cryptoasset regulation to be laid in 2024, subject to available parliamentary time. Whilst timelines remain unclear, it possible that we will have draft legislation, as well as FCA discussion papers and consultation papers, by the end of 2024 and implementation could follow in 2025.

Definition of cryptoassets and approach to regulation

The government confirmed that it intends to proceed with its proposal to expand the list of 'specified investments' in Part III of the Regulated Activities Order (RAO) and require firms undertaking relevant activities involving cryptoassets by way of business to be authorised by the FCA under Part 4A of the Financial Services and Markets Act 2000 (FSMA).

The definition of cryptoassets is drawn broadly (using the definition given in the Financial Services and Markets Act 2023), with the intention of capturing all current and possibly future cryptoasset types. However, the precise legal mechanism for distinguishing between tokens that are in and out of scope of the regime will be set out in the relevant secondary legislation and FCA rules. The broad approach seems to be that the focus will be on capturing cryptoassets which are being used for regulated activities or as financial services instruments (in a broad sense) and not cryptoassets that are not used for these purposes.

As we discuss below, there remains some uncertainty as to how the treatment of utility tokens and NFTs will be made clear and whether this will depend on FCA guidance, rather than specific legislative definitions and exclusions.

The government has also confirmed that activities across both permissioned (private) and permissionless (public) blockchains will be permitted and that the risks in these models will be addressed in a flexible manner through, for example, disclosure / admission requirements and obligations on cryptoasset service providers.

The government also considers that the Designated Activities Regime (DAR) will likely form part of the delivery of the new regime. The establishment of the DAR is part of the post-Brexit shift of retained EU law into the FSMA model of regulation, and will allow activities related to financial markets to be regulated within a framework which is compatible with the FSMA model. Taking inspiration from the regulated activities regime, the DAR will regulate the carrying on of certain designated activities without requiring authorisation – with these activities likely to include, among others, offering securities or cryptoassets to the public.

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NFTs and utility tokens

Although the government accepts that activities relating to truly unique or non-fungible NFTs that are more akin to digital collectibles or artwork than a financial services instrument (in the general sense) or product should not be subject to financial services regulation, it has not gone as far as entirely removing NFTs from the scope of the future regime. Per the policy paper, in determining whether an NFT is a specified investment, the question will be whether the token is used for one of the regulated activities within financial services markets or as a financial services instrument (in the general sense) or product, rather than how it describes itself.

The example given in the policy update is where a large class of NFTs, which are technically unique but largely indistinguishable from each another, is minted. If buyers purchased these tokens as a financial services instrument (in the general sense) or product without having a preference of one NFT over another (for example, if there was little or no price differentiation between the different tokens), this could be considered an exchange token for those purposes – which means that exchanges trading in the token will be subject to the applicable financial services regulatory regime.

The government expects utility tokens to be subject to a similar assessment as NFTs.

Whilst there is some logic to this approach, it remains to be seen how this distinction will be articulated in legislation / guidance. The government is clearly concerned about the potential for loopholes if NFTs and utility tokens are excluded wholesale, but the approach of looking at whether it is used for "financial services" seems open to subjective assessment. Clear guidance from the FCA, which is updated regularly to take into account changing trends, would seem necessary to give clarity where this is left open in the legislation itself.

FSMA authorisation process

Notwithstanding feedback from the industry on grandfathering and the need to take into account the significant efforts already undertaken by crypto firms who are registered with the FCA for money laundering purposes, the government has confirmed that there will be no automatic grandfathering for such registered firms. Further, firms with existing Part 4A permissions for FSMA activities (e.g. operating an MTF) will need to apply for a VoP, rather than having automatic permissions or exemptions to enable them to undertake newly regulated cryptoasset activities.

The government does note that the FCA will provide more detail on what the assessment will involve in due course and will also consider the regulatory histories of all applicant firms. Given the burdensome nature of applications already undertaken by crypto firms and the recent memory of the challenges the FCA experienced in managing the influx of cryptoasset money laundering registrations, industry participants will be disappointed to see that no grandfathering is expected.

Scope of cryptoasset activities

As noted above, the government intends to bring cryptoassets within the definition of a specified investment under the RAO. In Phase 2 (following the introduction of stablecoin regulation in Phase 1), the following activities in relation to cryptoassets will be regulated / subject to FCA rules:

1. Admitting a cryptoasset to a cryptoasset trading venue
2. Making a public offer of a cryptoasset
3. Operating a cryptoasset trading venue which supports:
    a. The exchange of cryptoassets for other cryptoassets
    b. The exchange of cryptoassets for fiat currency
    c. The exchange of cryptoassets for other assets (e.g. commodities)
4. Dealing in cryptoassets as principal or agent
5. Arranging (bringing about) deals in cryptoassets and making arrangements with a view to transactions in cryptoassets
6. Operating a cryptoasset lending platform

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7. Safeguarding or safeguarding and administering (or arranging the same) a cryptoasset other than a fiat-backed stablecoin and/or means of access to the cryptoasset (e.g. a wallet or cryptographic private key) (custody)

Interestingly, unlike the regime under the EU Markets in Cryptoassets Regulation (MiCAR), the government has decided not to bring advising on cryptoassets and portfolio management of cryptoassets within the regulatory perimeter as part of Phase 2. You can read more about MiCAR in our November 2022 and May 2023 briefings.

In relation to the custody activity, it is interesting to note that the cryptoasset custody activity is broader than the activity for other financial instruments and captures safeguarding when carried on without administration. The government notes, however, that providing self-hosted wallet technology would not be caught as a regulated activity, although where regulated firms arrange for customers to use such technology this could be caught by outsourcing rules and guidance on operational resilience.

The policy update also focuses on staking and industry feedback on issues with the current treatment of staking as a collective investment scheme (CIS) product – which results in a de facto ban on the offering of staking services by crypto firms in the UK. The Treasury has signaled in the policy paper that it accepts that there are potential issues in the current approach. Its proposals include either carving out certain manifestations of the staking activity from the definition of a CIS, provided that participants are otherwise appropriately captured by regulation under the above in-scope activities, or alternatively introducing a regulated activity of "operating a staking platform" outside of the CIS framework. The Treasury says it intends to bring forward its work on staking but timelines for this are unclear.

Territoriality

The government intends to implement the territorial scope of the future regulatory regime as proposed in its consultation. This means – subject to the token category exceptions – a person (whether legal or natural) will generally be required to be authorised by the FCA under Part 4A of FSMA if:

- They are undertaking one of the regulated activities;
- By way of business; and
- They are providing a service in or to the UK.

The government has rejected feedback on expanding the current OPE to cover cryptoasset activities – the policy statement notes that it considers that the context of cryptoasset markets is not the same as those for traditional financial products to which the OPE already applies, and that firms dealing with directly with UK retail customers should be required to be authorised no matter where they are. However, the position remains unclear for institutional customers and whether there will be any type of exemption for non-retail business.

In place of the OPE, the government instead intends to work toward deference/equivalence arrangements to allow market access for overseas firms. Until these are in place, there is an acceptance that access to global liquidity pools is needed and the intention is to introduce a time-limited ability to access these types of arrangements. One suggested way of achieving this seems to be to permit firms who are operating a regulated cryptoasset trading venue in an overseas jurisdiction to be able to apply for authorisation for a UK branch extension of their overseas entity. The branch could be authorised to specifically handle trade matching and execution activity. The specifics of these requirements though remain unclear, and the Treasury expects the FCA to determine particular rules on physical location.

Whilst some aspects of market access continue to lack clarity (e.g. how equivalence arrangements will operate and what time-limited measures for access will look like), what is clear is that the approach to territoriality on cryptoassets will be stricter than that for other specified investments. Overseas firms will need to prepare for access to UK investors to be significantly curtailed for cryptoassets and related services.

Cryptoasset Issuance and disclosures

In general, the government intends to take forward the proposed approach to issuance activities, including the basis for the regime and trigger points. The government intends to proceed with the two regulatory trigger points that were proposed: (1) admitting (or seeking the admission of) a cryptoasset to a cryptoasset trading venue, and (2) making a public offer of cryptoassets (including initial coin offerings (ICOs)). The proposals around issuance and content of documents form a large part of the consultation and are worthy of consideration on their own; key points include:

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- The government's view is that there should be disclosure documents in place for all cryptoassets which are made available for trading on a UK cryptoasset trading venue. This would include all well-established tokens (i.e. those characterised by relatively high levels of liquidity and at least several years of trading history) as well as those which do not have a clearly identifiable issuer (e.g. Bitcoin).
- The issuance and disclosure regime for cryptoassets will be based on the Public Offers and Admissions to Trading Regime (POATR). Venues will be able to define detailed content requirements for admission disclosure documents – but the government is supportive in principle of the idea of a centralised coordinating body (like an industry association) to coordinate requirements – with FCA oversight. In principle, the government agrees that disclosure requirements may be less prescriptive for venues which only admit institutional investors.
- To reduce the risks and impacts of 'cliff edges' and avoidable removals from trading relating to the back book of tokens already in circulation, the government accepts that there will need to be sufficient transitional arrangements for bringing activities into the regulatory regime – i.e. sufficient time periods between laying the legislation and the regulatory regime becoming effective. However, the government also notes that some degree of token withdrawals from platforms may be beneficial through identifying and removing cryptoassets which no party is willing to stand behind or where reliable information cannot be obtained.
- Finally, the government has maintained the position that firms required to publish disclosure documents should be liable for their accuracy, but has agreed that cryptoasset exchanges – which choose to take responsibility for the disclosure documents - should not be held liable for all types of consumer losses arising from events relating to that token, provided that they have taken reasonable care to identify and describe the risks. For example, where a loss is caused by a failure of the underlying protocol or network that is not controlled or operated by the trading venue, this would be unlikely to constitute a liability event providing, for example, that the trading venue had (i) performed a reasonable degree of due diligence on the token and the underlying network, (ii) made very clear to consumers their findings and (iii) avoided misleading statements guaranteeing the performance and resilience of the network. This is similar to the envisaged approach to liability under the POATR, for statements believed to be true based on reasonable enquiries. Certain types of protected forward looking statements will be subject to recklessness/dishonesty standards, while historical, factual statements will be subject to negligence standards.
- From a sustainability perspective, for the time being, the government intends to tackle sustainability issues primarily through disclosures – with the intention to advance the development of interoperable metrics through international forums, while also recognising the challenges in addressing sustainability issues in the crypto context.

The detailed contents of disclosure / admission documents will be defined by cryptoasset trading venues, subject to FCA principles. This could include, for example, information about a token's underlying code and network infrastructure, known vulnerabilities, risks (including cybersecurity and governance risks) and dependencies (e.g. reliance on third party or decentralised blockchains or other infrastructure). Further, the consideration of operational risks by FCA-authorised crypto firms will likely cover risks arising from dependencies on specific blockchains and networks.

Firms should also bear in mind that the cryptoasset financial promotions regime and the Consumer Duty are likely to play a role in determining some of the content to be disclosed in order for promotions to be fair, clear and not misleading, at least where retail customers are concerned. For more on the cryptoasset financial promotions regime, see our recent briefing. Firms should also review the FCA's recently finalised non-handbook guidance on cryptoasset financial promotions to understand more about these requirements and the interplay between the financial promotions regime and the Consumer Duty.

FCA rules for firms within the cryptoasset perimeter

Whilst the government intends to follow the approach of bringing cryptoasset activities within existing RAO definitions – for example by regulating operators of trading venues in the same way as e.g. operators of multilateral trading venues or cryptoasset intermediaries in the same way as traditional brokers – there is an acceptance that some concepts derived from the MiFID regime may not easily read across for crypto firms.

The Treasury notes, for example, that the FCA will need to consider concepts in traditional markets that may not map across well, such as the appropriate methods for defining and evaluating whether an intermediary has acted in accordance with the 'best interests' of a client.

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Further, the government makes clear that it does not intend to legislate to endorse or prohibit certain business models (for example trading venues who list their own tokens or also trade on a proprietary basis); instead, it expects that these issues can be dealt with via conflicts of interest rules from the FCA.

Market abuse

Finally, the government intends to take forward most aspects of the proposed approach set out previously, including the suggested scope of the regime, the regulatory trigger points, and the use of MAR as the basis for the regime. This includes the prohibitions covering insider dealing, market manipulation and unlawful disclosure of inside information. Obligations will apply to cryptoasset trading venues and other regulated market participants.

The government acknowledges the market abuse challenges presented around technical complexity, data privacy, and the protection of confidential IP – and therefore the need for a staggered implementation for cross-venue data sharing obligations. This will be factored into the approach as the government legislates. Lighter-touch arrangements on information sharing will be available only on a time-limited basis. The government also confirms that, as with content requirements for admission disclosure documents, it is supportive in principle of the idea of a centralised coordinating body (e.g. an industry association) to coordinate and harmonise information-sharing – with FCA oversight.

Next steps

Although the move to a comprehensive crypto authorisation regime under a FSMA model now looks certain, many aspects of that regime remain subject to secondary legislation and FCA rulemaking and guidance, and there is some way to go before the full implications of the regime become clear for industry participants. Again, whilst timelines remain unclear, it possible that we will have draft legislation and FCA papers by the end of 2024; if that is the case, implementation could potentially follow in 2025.

Whilst we await the finer details, industry participants should look out for further consultations and discussion papers on the Phase 2 requirements and prepare to respond to the specific proposals when available. In particular, overseas firms relying on the cross-border provision of cryptoasset services should consider whether they will need to reassess their business models in light of the future regime. The Treasury's support for the role of industry bodies in centralising and coordinating disclosure requirements and information-sharing presents a further opportunity for industry engagement in forming the shape of future regulation.

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