

Clients & Friends Memo

UK Government Consults on Expanding the Cryptoasset Regulatory Perimeter

9 February 2023

The UK Government (Treasury) has published a consultation and call for evidence on a [‘Future financial services regulatory regime for cryptoassets’](#) which sets out what is being called ‘phase 2’ of the UK’s approach to regulating crypto. While the ethos behind the consultation is ‘same risk same regulatory outcome’, it acknowledges that crypto poses particular challenges and risks requiring solutions that address investor and market jeopardy while preserving the benefits and opportunities that (rapid) innovation affords.

A recap on what has already been done in ‘phase 1’

- Cryptoasset exchanges and custodian wallet providers have been required to register with the UK’s Financial Conduct Authority (FCA) for anti-money laundering and terrorist financing (AML and CTF) supervision since January 2020.
- Legislation is on foot to bring cryptoasset promotions under FCA regulation.
- [Legislation](#) is also currently on the table to require the regulation of fiat-backed stablecoins used for payments and that also addresses regulation of, the issuance of and custody activities relating to, those coins.
- These legislative proposals are in the Financial Services and Markets Bill (currently in the committee stage after its second reading in the House of Lords and expected to be laid before Parliament in the first half of this year). The FS Bill also gives an intentionally broad definition of ‘cryptoasset’ as meaning:

Any cryptographically secured digital representation of value or contractual rights that:

(a) can be transferred, stored or traded electronically; and

(b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology).’

This is wider than the current definition, found in the AML regulations and is designed to be flexible as to future developments and uses of crypto technology.

What is being proposed?

The UK government’s view is that cryptoassets and associated activities should comply with the standards required of other similar financial services activities (same risk same regulatory outcome). To that end, the proposed regulatory framework involves expanding the list of

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'specified investments' in Part III of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 to include cryptoassets (as newly defined). This in turn would mean that the conduct of certain activities in or into the UK by way of business would require authorisation under the Financial Services and Markets Act 2000 (the **Cryptoactivities**).

The consultation is looking at 'phase 2' of a rollout of Cryptoactivities, namely:

- a) *Cryptoasset issuance and disclosure:* The Cryptoactivity occurs when the asset is admitted to trading on a regulated cryptoasset trading venue. Because cryptoassets often do not represent a claim on an identifiable issuer, unlike other transferable securities, the consultation proposes updating the existing UK prospectus regime to include new rules on the admission and disclosure requirements for cryptoassets that would be the responsibility of the authorised cryptoasset trading venue. These rules would include minimum standards of investor disclosures, liability and compensation provisions for untrue or misleading statements, due diligence obligations pre-admission and controls to prevent harmful offers from being made. Should a public offer of cryptoassets meet the definition of a security offering, the proposal is that the offering should comply with the requirements of the UK's public offer regime and go through a public offer platform or regulated market/multilateral trading facility (MTF). Again, due diligence would be the responsibility of the platform concerned.
- b) *Operating a cryptoasset trading venue:* This Cryptoactivity will be based on the existing regime applicable to regulated trading venues, including MTFs. The result will be the application of prudential, governance, consumer protection and operational resilience requirements as well as resolution and insolvency provisioning.
- c) *Cryptoasset intermediation activities:* Recognising the importance of dealers and liquidity providers, the government's proposal is to require relevant intermediaries to become authorised to deal in or arrange deals in cryptoassets. Again, FCA authorisation would entail adherence to prudential requirements, as well as consumer protection, reporting, governance, operational resilience and resolution and insolvency requirements.
- d) *Cryptoasset custody:* While custody of fiat-backed stablecoins is by phase 1 legislation currently going through the parliamentary process, phase 2 would require the authorisation of providers of custody for cryptoassets that will subsequently enter the regulatory perimeter. The proposal is to base cryptoasset custody requirements on the FCA's existing Client Assets Sourcebook, which would entail provisions to protect investors' rights via safeguarding, organisational, and books and records obligations.
- e) *Market abuse requirements:* The UK Government considers that the cryptoasset market is as susceptible to market abuse as any other financial market, and points to 'significant evidence' of pump and dump/trash and cash/wash trading and spoofing instances. However, the concepts on which rules and strategies to combat market abuse in traditional markets are based face significant challenges in the context of cryptoassets. Inside information, for example, often hinges on information held and created by an issuer that is not a concept that transfers easily to a market where the issuer is not necessarily identifiable. The consultation therefore proposes a series of 'sensible outcomes' based on existing UK market abuse rules that would place the onus on trading venues and authorised intermediaries to establish systems and controls to prevent, detect and disrupt market abuse.
- f) *Cryptoasset lending platforms:* Unsurprisingly, the Government is making the development of a cryptoasset lending and borrowing regime a priority phase 2 item. In light of the role of credit risk in driving recent market issues and firm failures, financial

resources, liability provisioning, collateral management, and valuation and contingency and wind-down planning are priorities within that priority. The regulated activity of operating a cryptoasset-lending platform will also entail requirements to give adequate risk warnings to consumers and clear contractual terms on ownership (itself a challenge).

Other regulatory consequences of the new Cryptoactivities

Financial crime: Firms undertaking Cryptoactivities will be subject to the full FSMA financial crime regime, including money laundering, bribery and corruption, sanctions and fraud provisions. This is a wider regulatory remit than the AML and CTF regime registered exchanges and wallet providers are currently subject to and adds another layer of process to Cryptoactivities.

Geographical scope: Cryptoactivities covered by the new regime will be those performed in or into the UK. Given the international, and often peripatetic nature of cryptoasset businesses, this is a necessary intervention, but the consultation does open up possible exceptions such as an accommodation of reverse solicitation of cryptoasset activities performed from outside the UK. However, the consultation also notes that firms operating a cryptoasset trading venue are likely to require a UK subsidiary, which is a fairly significant outcome given current models.

Responses are due by 30 April.

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If you have any questions, please feel free to contact the following Cadwalader attorney.

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