30 April 2023

Future Regulatory Regime for Cryptoassets – Consultation
Payments and FinTech
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

SENT VIA EMAIL: cryptoasset.consultation@hmtreasury.gov.uk

To whom it may concern,

Re: HM Treasury Future Financial Services Regulatory Regime for Cryptoassets Consultation and Call for Evidence

GBBC Digital Finance ("GDF") supports efforts by global standard setters, national authorities and regulators to consult and work with the nascent global digital / virtual asset industry.

To that end, we are hereby providing input to the HM Treasury consultation paper on Managing the failure of systemic Digital Settlement Asset (including stablecoin) firms.

The input to this response has been curated through a series of discussion and roundtables and GDF is grateful for all of its members who have taken part.

As always, GDF remains at your disposal for any further questions or clarifications you may have and we would welcome a meeting with you to discuss these matters in more detail with our members.

Yours faithfully,

Lavan Thasarathakumar
Director of Government and Regulatory Affairs

About GDF

GDF is a not-for-profit industry body that promotes the adoption of best practices for crypto and digital assets, and digital finance technologies through the development of conduct standards, in a shared engagement forum with market participants, policymakers and regulators.

Established in 2018, GDF has convened a broad range of industry participants, with 300+ global community members - including some of the most influential digital asset and blockchain companies, financial institutions, and professional services firms supporting the industry.

The GDF Code of Conduct (the 'Code') is an industry-led initiative driving the creation of global best practices and sound governance policies. GDF is informed by close conversations with regulators and developed through open, inclusive working groups of industry participants, legal, regulatory and compliance experts, financial services incumbents and academia. The principles set out in the Code undergo multiple stages of community peer review and open public consultation prior to ratification.

Executive Summary of the GDF Response

Overall, GDF welcomes this consultation paper. It firmly outlines HMT's intention to position the UK as a global cryptoasset hub and delivers a clear plan on how it intends to create a framework that would enable this. GDF appreciates the engagement shown by both HMT and the FCA during this process to consult industry and appreciate the opportunity to attend discussions in addition to responding to the paper.

GDF is in complete alignment with the core values of this paper and urges HMT to stick to this when it delivers the final framework.

Same risk, same regulatory outcome: whilst often said, the risk element of this is statement is often not given much attention and there is an assumption of risk. GDF calls on HMT to continue to engage with industry to ascertain what the true risks are with the activities taking place and where additional measures need to be put in place due to novel risks and where risk is mitigated by the very nature of the technology used.

Proportionate and focussed: proportionality will be one of the most fundamental constituents as to whether this framework is a success and this is where one of the core concerns of members lies. Without seeing the detail of how this approach will be administered it is difficult to say, however high barriers to entry with disproportionate capital and regulatory requirements will squeeze out SMEs and new market entrants and will not deliver the ecosystem HMT desire to create.

Agile and flexible: noting the fast-moving nature of this industry, it is vital that an agile and flexible approach is taken so as to adapt to the nuances of the industry and the novel challenges that it brings. As such GDF welcomes mechanisms within the framework which allows for HMT to adapt its approach to fit the change in circumstances.

It is through the lens of these values as well as the stated policy objectives that GDF makes the following recommendations in our consultation response, which has been put together following a series of roundtable discussions as well as member-wide consultation:

- **A compressed and considered phased approach** – whilst accepted generally as a sensible approach to target the areas that are of most importance and urgency

ahead of focusing on the wider industry, it is important for HMT to recognise that businesses entering the UK will have parts of their business that are already conducting activities that will become regulated under later phases and will not have the clarity on how that will be treated. If the aim is to become a global hub for digital assets, this clarity is necessary to avoid such firms opting to locate themselves in jurisdictions where they can obtain such clarity immediately. As such, it will be important to set out clear timelines with an accelerated timeframe between phases as far as possible. HMT will also need to give consideration as to how they will be able to ensure consumers are able to make well-informed choices and understand risk in a phased approach where it may be unclear as to which products are and are not regulated.

- **A phased approach to market abuse** – at present, the consultation seeks to place an obligation on trading venues to tackle market abuse. This will be quite difficult to achieve given the global nature of the activity. HMT has shown itself to be open to technological solutions to this matter. While it will be important that trading venues to monitor their own venues, there is a case to be made for an increased role for the FCA in helping to create fair and orderly markets in the UK, and eventually globally. GDF proposes a phased approach to deal with this that sees venues reporting into the FCA who will develop a blacklist which can then be shared amongst regulators worldwide, in the hope that it pushes for a global approach to market abuse. Market integrity is vital and GDF considers that this approach presents a viable way in which this can be delivered without stifling innovation through overburdening venues.

- **Clarity on staking** – given the definition of a collective investment scheme, there are strong concerns from the industry that the threshold for staking to fall within this definition is quite low and unduly so. This does not take into consideration the nuance of the activity and kills off certain products such as staking for the purpose of governance which should not fall under a collective investment scheme. GDF call for HMT by way of Order under s235(5) of FSMA to outline that staking for the purpose of blockchain governance is not a collective investment scheme.

- **Authorisation metrics** – following the FCA's anti-money laundering registration process, it will be imperative for the FCA to implement a more streamlined process for authorisation. GDF calls for the FCA to be held accountable for this process via publishing the number of applications that have been approved, the length of time taken for an application to be processed and the justification in the event that a firm's application has been rejected. An enabling regulator is a key to being able to deliver HMT's intention to deliver growth, innovation and competition in the UK. The FCA will be 'the face' that businesses see when entering the UK and it needs to be one that is welcoming but continues to be known for its credibility so that the UK can be a safe jurisdiction for cryptoasset activity.

- **Proportionality and focus for admission to trading documents** - the documents required for admission to trading could be quite onerous for smaller firms. GDF notes that where an exchange wants to list a token where there is no issuer, the exchange is responsible for issuing the required white paper and current rules will make it challenging and arguably commercially unviable to list them. GDF considers that this is disproportionate in its current form and that measures should be put in place that balance consumer protection with encouraging innovation and the listing of new tokens.

- **Definition of a cryptoasset** – with the definition being so broad, there is scope for there is the potential for the definition of a cryptoasset to cover far more than perhaps what is intended. GDF calls for HMT to clearly define what is intended to be captured and clearly delineate between different categories.

- **Resist a lift and shift approach** – whilst maintaining a desire for technology neutrality, it is imperative that HMT does not fall into the trap of applying existing financial services rules which have been developed for traditional finance. Whilst the decision has been made to authorise cryptoasset activities through the FSM authorisation route, to apply this approach in its current form will be incredibly onerous and would stymie innovation and not encourage new market entrants. As such, GDF suggests that should the FSMA authorisation approach be taken, a specific cryptoasset handbook should be put together which will clearly outline the tailored rules for the industry.

- **Clarify territorial scope** – whilst GDF understands the growing policy challenges that surround regulating an asset that is cross border and global in nature, there is concern that the proposed approach may not have the desired effect and threatens to both be incompatible with existing rules as well as ringfence the UK. Whilst HMT may have approached this as means to address the policy objective of consumer protection, GDF want to highlight that HMT may instead be compromising another objective of growth and innovation. It also seems to run contrary to its core principles of ensuring tech neutrality. HM Treasury's recommendations seem to deviate from existing legislation on this matter and it is not clear as to how S418 of FSMA will be applying.

- **A proportionate and focussed approach to DeFi** – GDF is happy to see that considerable thought has gone into how HMT intends to address DeFi. GDF agrees that it is imperative to take a global response and that it would be remiss of the UK to try and front run a regime which will be out of tandem to other jurisdictions and any international organisations' recommendations. GDF want to remind HMT that this is a nascent technology which would benefit from a nuanced approach that looks at novel ways of regulation. GDF advocates for a principles based approach that adopts a co-reg model, which encourages innovation whilst ensuring market integrity.

- **Custody is key** – Custody sits at the heart of cryptoasset adoption and understanding and delivering on this will go a long way in unlocking the industry's potential in delivering growth but also deliver on the consumer protection objective. In addition to the comments added in the paper, our Custody Working Group, a joint association industry group comprised of a mix of 20 tradition and new digital custodians intends to publish a report later this year.

Response to The HM Treasury Future Financial Services Regulatory Regime for Cryptoassets Consultation and Call for Evidence

On the definition of cryptoassets:

The consultation paper proposes an unprecedentedly wide definition of cryptoassets. GDF recognises Treasury's objective of creating a flexible definition that is technology-neutral and one that also captures future developments in the digital assets space.

We appreciate the consideration for a broad future-proof definition, nevertheless, GDF would like to highlight the potential, unintended consequences of such a broad definition - and importantly the lack of regulatory clarity for making the UK an attractive global crypto hub. It would bring a lot of inadvertent technology and services into the scope of the Treasury's authority – it would theoretically classify any running modern securities system into a crypto-technology, even though the technology would not be connected to DLT or blockchain in any way. Although, the consultation paper explains that the Treasury intends to create further, narrower definitions or exclusions for specific activities and services – limiting the actual scope and application of the regulation to a particular subset of cryptoassets – this would potentially still make those services or activities that were initially classified into cryptoassets rely on the Treasury's authority to explicitly state which obligations they would have to be subject to and from which they would be excluded.

Such an approach is misleading in principle as it would bring a lot of uncertainty to the industry, which will likely need to seek a legal opinion as to how they are classified. Furthermore, the definition suggested by the consultation paper is wider than in any existing or proposed cryptoassets regime in other jurisdictions, which creates issues from an alignment / competitiveness perspective.

GDF suggests that existing definitions have been effective to date and keeping them would allow for alignment and clarity. GDF notes that it is imperative to have consistent terminology when discussing the industry globally, and therefore, look to influence / remain consistent with global definitions.

Consultation questions:

1. Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please specify why.

Whilst members highlighted the missed opportunity to create a bespoke framework, GDF understands the intention of HMT to expand the list of "specified investments" to include cryptoassets, and as a result, require those performing regulated activities to obtain authorisation under FSMA. GDF note that the decision to do so however, does open up a large swathe of requirements for cryptoasset firms to comply with. Most significantly, the conduct of business rules, senior managers regime and change of control to name a few. When considering the conduct of business rules, the requirements are different depending on the activity you are conducting, so this could create added complication surrounding which rules firms have to follow. This can be very onerous and GDF advocates for flexibility and adaptability in the application of FSMA to cryptoassets, with a bespoke handbook for cryptoassets being the preferred option. This would in practice allow FCA to create robust rules for cryptoassets but tailored for the risk that an activity entails. GDF would like to note here that innovation is still a key part of this technology and therefore particular attention should be paid not to limit its development – at the same time not ignoring investor protections.

GDF supports regulation that employs an activities-based approach which is suited to the specific technology. However, it would like to highlight the need for such rules to be diligent and clear – allowing the industry to comprehend and comply with them.

2. Do you agree with HM Treasury's proposal to leave cryptoassets outside of the definition of a "financial instrument"? If not, then please specify why.

GDF agrees that it is sensible to leave cryptoassets outside of the definition of a financial instrument. This way cryptoassets can be subject to a more tailored framework rather than be subject to pre-existing traditional financial services regulation which carries with it years of weighty guidance that may not be suitable to this particular technology.

GDF wants to reiterate concerns about the lack of clarity arising from the wide definition of cryptoassets. It is unclear how the two regimes for cryptoassets and "financial instruments" would interact with one another and what the delineation would be. If the definition of cryptoassets only refers to the cryptoassets that are currently unregulated, then GDF would agree with the proposal.

Nevertheless, there is a risk that traditional financial institutions dealing with previously regulated securities would fall into the scope of the cryptoassets regime due to some securities fitting into the definition of crypto activities, which would result in regulatory overlap and uncertainty. This relates to a wider point around the need to provide greater clarity on what constitutes a native cryptographic asset security token, versus non-native cryptographic assets, such as bonds or stocks which are fully dematerialised in digital smart contracts on DLTs. The wider point must also consider that transmutational nature of native cryptographic assets that start their existence as "non-securities", and change during their lives to become securities. GDF urges HMT to put in place further guidance outlining the delineation between tokens.

GDF, therefore, urges HM Treasury to add more precision, clarity and guidelines as to the delineations between 'cryptoassets' and 'financial instruments.' A solution could be to state that when a 'financial instrument' is defined as one, it can no longer be also defined as a 'cryptoasset' – carving out a sensible and established regulatory exclusion from the wide cryptoassets definition. This falls within the point of the earlier question – it is necessary that the HM Treasury clearly defined where the regulatory perimeter is in order to provide the industry with certainty and more stability. It would also move away from the principles of the consultation paper and not be technology neutral if a traditional financial instrument was not to be classified as a cryptoasset merely because it is using a different technology.

GDF also notes that the decision was made to leave cryptoassets outside of the definition of a financial instrument. In doing so GDF urges HMT to apply this across the board and not to apply rules developed for financial instruments to cryptoassets. GDF notes references to MiFIDPRU being the standards applied for prudential rules or MiFID terminology such as best execution. In order to be a competitive jurisdiction, the UK needs to take a proportionate approach and applying MiFID rules would create too high a barrier to entry and thus make the UK an undesirable jurisdiction to operate.

3. Do you see any potential challenges or issues with HM Treasury's intention to use the DAR to legislate for certain cryptoasset activities?

GDF, in principle, agrees with the HM Treasury's intention to use the DAR to legislate for certain cryptoasset activities – giving it more flexibility to add tailored rules where necessary. Nevertheless, it would be useful to indicate where the HM Treasury is hoping to use the DAR. Using the DAR to legislate would significantly widen the Treasury's authority and it would be helpful to understand – in what regard, and the extent to which the Treasury is hoping to legislate – in order to prevent a scope-creep of the DAR. In considering the DAR authority, the principle of proportionality, as well as the need for FCA accountability, is crucial to prevent unwanted overreach. GDF would like to stress the

importance of creating clearly delineated rules by way of engaging with the industry – allowing for dialogue and accountability in the actions taken by the regulators and fostering cooperation – rather than implementing disproportionate enforcement action which was not preceded by clear authoritative guidance and regulation.

4. How can the administrative burdens of FSMA authorisation be mitigated for firms which are already MLR-registered and seeking to undertake regulated activities? Where is further clarity required, and what support should be available from UK authorities?

GDF welcomes HMT's intention to remove duplications in the authorisation process for firms who are already registered with the FCA for the money laundering regime (MLR). To do so, information firms have already submitted during the MLR process should be analysed what and, where appropriate used in the FSMA authorisation rather than asking firms to re-submit it again. To ensure a smooth process, guidance is needed from the FCA for authorisation – considering their previous positive and negative experiences and taking them into account in the new approach.

Furthermore, lessons should be learned from the MLR process. A number of firms have been dissuaded from locating in the UK due to their experience or general expectation of what was an unclear process. Many of these firms have instead located their business in other jurisdictions in Europe, such as France and Switzerland. This means that the UK not only loses the tax and employment benefits that this sector offers but also reduces the development of the ecosystem in the UK to make it a global hub.

We consider that the key elements to rectify this position are to ensure that there is adequate experienced FCA staff to authorise a firm in a timely manner. Historically there have been several months' delay before even a 'case officer' has been allocated to review the application and well beyond the allocated legislative timeline for the FCA to do so. For the UK to be competitive on the global market in terms of digital assets, the authorisation process should have a competitive timeline. An idea would be to implement temporary permissions that would help both the industry and the FCA by helping them temporarily manage the workload. Moreover, it is crucial that there is enough staff with a sufficient level of technical competence that can address and be aware of the level of nuance necessary for the authorisation process.

The second key element is to ensure adequate communication, transparency and accountability. The largest complaint from the MLR was the opacity of the process. Applicants did not know where they were in the process, were not communicated to and often received a rejection without an explanation. This did not allow firms to be able to reflect on how they should improve. It is important that the authorities work with firms to aid them in completing their registration process rather than remove them if they had not met the requirements without providing additional comments or explanations. GDF welcomes the good application and bad application communication that the FCA put out – it was clear and detailed what was expected of firms.

The FCA approach must also offer transparency and accountability. This is necessary to create trust and attract market participants to the UK. To ensure this, for example, the FCA should publish monthly anonymised details of applications received, when a case officer is allocated, when information is requested and where, for example, a firm has been asked to withdraw its application. In addition, HM treasury should engage with the FCA on a regular basis on these data and should hold them to account if they are not performing at the desired (service) level. HMT could also offer a portal for crypto firms registering to report their interest to for example have quarterly roundtables with HMT so that officials and the relevant minister are kept updated on general progress but not entering into a discussion on the details of specific cases.

The process and time taken for authorisation is one of the key battlegrounds of 'winning' businesses and will be vital in making the UK a global cryptoasset hub.

In addition to this, HMT should put in place transitional arrangements to those firms already conducting activity in the UK and awaiting an authorisation to ensure business continuity and that firms who are authorised under phase I are still able to conduct activities in future phases.

5. Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

GDF finds that the delineation between the regime for fiat-backed stablecoins and the broader cryptoassets regime is unclear due to the wide definition of cryptoassets. It is uncertain from the definitions which stablecoins will fall into which regulatory framework. The difference between the regime for fiat-backed phase 1 and broader crypto phase 1 is not sufficiently clear – there are features that would fall within either of the categories.

Furthermore, it appears to not address how tokens which do not fall under existing legislation or under the classification of fiat-backed stablecoins would be treated if used for payments purpose. More guidance from the Treasury would be beneficial in this regard.

The importance of this topic cannot be underestimated as, currently, stablecoins are the fiat on/off ramp to blockchain and DLTs, and are critical to the (final) settlement of transactions, whether the asset or instrument is a native cryptographic asset (e.g. bitcoin), or a non-native cryptographic asset on a smart contract (e.g. stocks and bonds).

6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

GDF appreciates the challenges of delivering everything in a fast timeline and would not want to slow the legislative timeline. However, we wish to highlight a potential challenge that could arise for market participants from the division presented in the phasing approach. From the perspective of businesses, the division into the different regulatory stages creates uncertainty as some of the functions which are regulated at different phases and in a varied timeline overlap with one another – impeding the businesses' regular functioning. For instance, a trading or exchange venue offering stablecoin trading most often also implies that the company must meet custody requirements. Splitting the two regulatory requirements into two phases with different timelines without specifying the exact times between them makes it more difficult for the company to have legal certainty, ensure compliance stability or function uninterrupted. To illustrate, there could be, for instance, three varied entities involved in custody in different ways: (i) a stablecoin issue that creates fiat reserves, then (ii) a crypto custodian providing infrastructure, and (iii), a trading venue at the front-end that provides custodial wallets to clients based on the back-end infrastructure. The question that arises and is unclear from the consultation is whether all these three entities would have to seek authorisation separately, whether there would be a principal-agent or central mechanism to navigate through the authorisation process of all three connected entities, or would it be done in the same phase?

The phasing approach is also challenging from a customer's perspective to understand which parts and functions are protecting them in which regulatory stage and to what extent. For both the companies and the customers it would be useful to have a more comprehensive timeline and additional clarifying guidelines that illuminate the process involved in the different phases of the regime.

Handling the phased approach, we want to mitigate a situation in which as we move through the phases, the authorisation process is streamlined so there is no significant delay in the onboarding of activities already authorized in phase 1. There also needs to be a transition period for the implementation for firms which are already operating in the market under AML registration or under the existing FSMA permissions but would now require to modify their application given the introduction of the new regime.

GDF would like to highlight that staking, where it is the case for the governance of a blockchain, in particular, requires regulatory attention and clarity, also because it could provide an important economic opportunity for the UK. It would be beneficial for the Treasury to ensure that the regime comprehensively facilitates staking for digital asset businesses as it would attract a lot of market participants to the UK. GDF finds that to fulfil this goal, it would be more beneficial if the staking registration were not pushed to the third phase – ensuring that firms are aware of the requirements and timelines of providing the service early on. Otherwise, those potential firms might not seek authorisation in the UK but decide to provide staking as part of their business in a different jurisdiction. Importantly, GDF would look for HMT to make clear by way of an Order that staking for the purpose of the governance of the blockchain is not a collective investment scheme, under s235 (5) FSMA. GDF notes that where HMT consider this should still be an activity that should be regulated that a new specific regulated activity should be created rther than grouping this with collective investment schemes.

If, however, HMT does not intend to set out this regulatory clarity, GDF would welcome some clarity from the FCA on why they appear to consider a staking arrangement to be a CIS. Having undertaken analyses on staking models, it is not always apparent why this should necessarily be the case. However, without understanding the FCA's thinking around this, it is difficult to counter the conclusion. Therefore, it will be imperative and a matter of urgency, that there is greater regulatory clarity as to what may constitute a CIS and how to structure it to meet the FCA's interpretation.

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

GDF members request more detail from HM Treasury on what the precise territorial scope of the regime would be. The consultation proposes to capture '*cryptoasset activities provided in or to the UK*'. '*To the UK'* widens the authoritative scope, as it could impose UK regulation on crypto services of UK persons living permanently outside of the UK. GDF notes that this could both prove confusing and, as seen in similar approaches, difficult to administer – how exactly would HMT propose to enforce against an entity that is located wholly overseas?

GDF proposes that a preferred approach would be to have a granular approach that looks at specific regulations, e.g., financial promotion restrictions, and to assess the scope based on the provided service or activity and its relevant framework. Adopting granularity would allow the UK to cater to a large market of firms based outside of the UK but offering their services to UK persons. Currently, FSMA looks at the activities such as arranging, dealing and investment advice in determining if something is carried out in the UK. A similar approach could be adopted with regard to cryptoassets.

It is also important to highlight that such an adaptation of rules should not look to be inconsistent with the existing reach of current legislation so as to maintain the core principles the paper discusses around a level playing field. At present S418 of FSMA outlines the criteria for carrying on regulated activities in the UK, this proposal seems to depart form that.

In addition, GDF members raised questions as to how enforcement of overseas entities with no-UK presence works in other financial regulations and as such how effective this will be in practice. What is meant by excluding reverse solicitation? It will be important to understand what the parameters are and how they will be applied in practice. GDF also seeks clarifications on how and whether the overseas persons exclusions apply to cryptoassets. Failing to adequately address this matter will see firms choose not to locate in the UK or even touch UK consumers, which would run contrary to the objectives of this consultation.

Concerning the territorial scope, GDF would like to welcome equivalence as a way of cooperating between markets and jurisdictions. Cryptoassets are global and operate cross-border by nature. Therefore, it is crucial to recognise and facilitate those strong ties through sensible regulation rather than to stifle innovation by overburdening the industry with regulation and inhibiting cross-border collaboration.

Nevertheless, considering equivalence regimes, MiCA does not have such a measure and as such raises the question of how firms would interact with both regimes. Would substantially diverging from MiCA make the UK very attractive if firms would have to have in place a completely different set of measures for two separate jurisdictions? GDF members urge the UK to consider this and ensure that the rules in place are at least at par with other regimes to ensure that the objective of the UK being a global cryptoasset hub can be realised.

8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

We support the list of economic activities and encourage HMT to continue to evaluate these activities and consult with the industry as to the activities that are already within the scope. Any changes should be conducted in consultation with the industry. Again, it is important to ensure proportionality in the regulatory perimeter as well as clarity.

9. Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?

GDF supports the phased approach and the currently proposed prioritisation. Nevertheless, GDF would like to note the importance of compressing the time scales for reasons mentioned earlier. Many of these firms will already be conducting activities in future phases and if the UK is going to be able to attract these industries to the UK market, it will be imperative to assure those companies that their whole business will be given clarity and not just part of it. Failing to do so, such companies might choose another jurisdiction that provides more clarity and stability.

Moreover, GDF proposes that HMT address the immediate issue of ensuring that staking for the purpose of governance of a blockchain is not considered a collective investment scheme. At present, it appears as though the FCA are treating all staking as such and this lack of nuance will not ensure proportionality nor adopt an approach that presents the UK as a choice jurisdiction for cryptoassets. To this end, GDF proposes that HMT create an exception under S235(5) of FSMA. Many firms are already taking part in staking, and therefore, the lack of clarity on how that part of their business will be treated may prove an obstacle to entering into the UK market.

GDF notes that taking a phased approach will require clear guidance. Members commented that whilst the phased approach made sense, it can create confusion for cryptoasset businesses that deal with activities and tokens that are in different phases but

also for consumers who do not understand, for example, what assurances come with different tokens e.g. a stablecoin vs an exchange token.

10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?

GDF understands the concerns that HMT presents in the consultation paper and agree that in the digital asset industry vertically-integrated business models may present a risk due to the different types of market risks are brought together in one entity. This can pose problems due to the ability for each of those risks to flow into each other, potentially creating even greater market risks. An example of this is if a market participant was issuing tokens, operating an exchange and providing custody. A regulator may find it difficult to enforce against one activity in fear of how it may affect the rest of the entity. For example, there may be concern as to whether taking action against the exchange would impact the custodial wallets provided or the value of the tokens being issued. As such it is important that there are safeguards in place to ensure that the different business lines are separate and the assets are segregated and protected.

There is also cause for concern as to whether vertically integrated businesses are privy to information which puts them at an advantage over those only operating across one business line. As such, it will be important to put in place strong conflict of interest policies, barriers between regulated business lines and policies to prevent insider trading.

11. Are there any commodity-linked tokens which you consider would not be in the scope of existing regulatory frameworks?

No comment.

12. Do you agree that so-called algorithmic stablecoins and cryptobacked tokens should be regulated in the same way as unbacked cryptoassets?

GDF understands the Treasury's approach on this matter – balancing the need to bring the tokens into the regulated sphere but in a proportionate manner that is in line with other regimes. As such, algorithmic stablecoins may pose unique challenges to regulatory oversight and investor protection. However, the economic model of a stablecoin typically follows the price of a currency. GDF, therefore, considers that algorithmic stablecoins by their nature are more stablecoin-like than commodity-like. For this reason, GDF believes that they should fall under the broad category of stablecoins and not commodity, but we agree, that they pose distinct risks and therefore may require differing regulatory obligations – similar to that of asset reference stablecoins. It may make sense to create a new category and look to regulate it accordingly, noting the potential for its development.

13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

GDF agrees with the proposed treatment of NFTs and utility tokens. As mentioned in MiCA, the regulation has adopted a substance-over-form approach which ensures that, as long as the token is not conducting a specified investment, then it will not fall into the regime's scope.

That being said, HMT should avoid the confusion that has been created in MiCA and put in place clearer guidelines as to where they draw the perimeter. This would allow to

distinguish more clearly whether NFTs and utility tokens can fall in scope. GDF suggests, HMT consider the approach taken by the DFSA, in which they have adopted clear criteria for what constitutes an NFT. Members also called for the explicit exclusion of NFTs and utility tokens so as to create clarity.

14. Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

GDF agrees with the regulatory trigger points that the HMT proposes. However, our members have concerns about the close annexation to MiFID and are conscious of the dangers of this approach. We agree that there is a general point about the 'lift and drop' approach that HMT are taking on some of the obligations.

We believe that admission to trading documentation is an area that is sensible, however, where there is a too-close read across to traditional finance, we find it to be not appropriate. To that end, GDF considers that the liabilities and obligations do not appear to be fairly balanced and as such not conducive to creating the UK into a global crypto hub.

Nevertheless, we agree that there clearly needs to be investor protection and some liability placed on the venue not to list certain coins, and for there to be some general disclosures to inform investors. Yet, the admission to trading a cryptoasset is not the same as for a security. In the latter, there is always an issuer involved and the liability is clear. Here, we are switching the liability onto the trading venue as there is no issuer. Investors need the information to base a decision on, but the approach taken by HMT to assess a level of liability whether strict or negligent still requires the venue to set out its position on a cryptoasset where a white paper may be lacking - particularly as the obligations will be to provide 'necessary information'. This is not to say that the venue should provide disclosures to the investor - just that it should be sourced from more public information, relevant to cryptoassets and the level of liability linked to that disclosure. In addition, this does not give a free license to venues to list certain coins. There should be systems in place to ensure that due diligence is done on a coin before it is listed. This is similar to the product development that FCA expects of firms under the broad: treating customers fairly.

15. Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

In principle, GDF agrees with this approach, however, members urge for there to be some form of standardisation of requirements to ensure that we are not in a situation where we have different requirements between trading venues but also so that there are no inconsistencies with requirements in other jurisdictions.

It makes sense for trading venues to be in charge of due diligence. That being said, the lift and shift of traditional rules to trading venues might cause issues as it does not take into consideration the strain this puts on some exchanges that will have to conduct due diligence with an issuer that is completely decentralised. Many crypto exchanges are already conducting their own due diligence before admitting a cryptoasset to trading and GDF considers that these principles are clearly ones that can set best practices and can be codified as principles - allowing some flexibility within the principles for different approaches.

Nevertheless, again, there should not be too much of a burden on trading venues to look at market manipulation - they should be required to have tools in place to analyse market

manipulation, but the obligation cannot be fully placed on trading venues to look at this in its entirety. Such large responsibility is impossible for individual trading venues to comply with, and are better in the hands of a cross industry entity or agency that look at the market as a whole.

GDF would suggest that in phase I trading venues have some requirements put in place, such as market surveillance tools, and then in phase II the FCA can play a larger role in bringing this together. Looking at the reliability of the assets or the risks to market manipulation should be an industry-wide effort and one led by the FCA in consultation with industry – it should not just be placed on a trading venue alone. The FCA should develop clearer guidelines on this that address their responsibility in assessing those risks.

In other words, GDF agrees that it should be for the venue to set the detailed contents, but this should be done based on principles set by the FCA. Our concern is that the FCA is adopting a securities listing regime and may not, therefore, adequately tailor this to meet the crypto industry. It is necessary for the FCA, in conjunction with the industry, to set out what such principles might look like or whether there is an alternative – for example, where there is a white paper they provide and link to coin market cap for liquidity.

16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?

GDF agrees that the liability should lie with the issuer when there is one. However, when there is no issuer, it could still be with the trading venues to consider the liability of admission disclosure documents but they should have a set of criteria provided by the authorities under which the trading venues can assess and admit documents – providing a minimum standard for cryptoassets without an issuer. Yet, the extent of liability is importantly – as we have noted above – related to the types of information that are provided in the admission to trading document. In our view, the 'necessary information' test places an unfair liability on trading venues. There may be solid investor protection grounds as otherwise, the investor has little recourse but equally, you will be requiring trading venues to take this liability on – unlike in traditional finance – and the question will be: where is the right balance of investor protection to industry costs, and what will promote UK competitiveness – albeit, we are not arguing for low investor protection standards but for reachable obligations for trading platforms.

From a prudential perspective, there should be an assessment of how much should be held based on a number of defined criteria – and this should be proportionate to the risks. Members also suggested the use of professional indemnity insurance in lieu of or in addition to holding certain levels of own funds so as to allow smaller players to be able to enter the market and meet these high standards. It is noted that there may be a lack of protection available and HMT may need to consult the insurance industry on how they can treat cryptoassets in order for them to be able to create these products.

If the right balance between investor protection and costs is not achieved, either the UK will simply not attract venues and/or they will simply not list many coins, thereby, not promoting the UK market. This does not mean that we would like to allow listing all coins even those that are 'bad'. Nonetheless, there are other regulatory mitigants to ensure that this does not happen – as e.g. due diligence committee before admission to trading – rather than the proposition that the HM Treasury is putting forward.

17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?

GDF is conscious that the level of obligation is still unclear and seems to be closer to a simplified prospectus / key information document. As described above, where there is no issuer, the liability is being imposed on the venue. This will deter trading venues from listing these products. As such, GDF urges HMT to take a proportionate approach, which is not unduly onerous on trading venues. GDF also notes that the proposed approach could lead to variation as to what information is outlined across different trading venues. GDF suggests that should a similar approach be taken the FCA should set out requirements and guidelines that trading venues can link to, in order to avoid duplication and varying information. It is also imperative that these requirements are aligned with other jurisdictions.

GDF also wants to reiterate the point raised earlier that where existing legislation was drafted with traditional finance in mind, requirements are tailored for those products and may not be suitable or proportionate for the tokens being listed on trading venues.

18. Do you consider that the intended reform of the prospectus regime in the Public Offers and Admission to Trading Regime would be sufficient and capable of accommodating public offers of cryptoassets?

GDF finds that if something is a Public Offer then it must meet the set obligations. However, the concern is the admission to trading documents. In practice, what may happen, is that someone airdrops or ICOs in another jurisdiction and simply seeks admission to trading on a venue. For this reason, admission to trading documents needs to find that right balance.

19. Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

GDF to an extent supports the idea of implementing the existing RAO activities to cover the activities of cryptoassets trading venues as it is a known regulation that businesses understand – making it easier to comply with. However, some issues may arise from the lack of clarity regarding a missing distinction between servicing professional clients versus retail clients, particularly in the topic of tax liability and the proposed disclosure documents from issuance and trading venues. It would be useful to have a clearer delineation between these requirements.

The RAO has been designed to deal with professional services but not as much with retail clients and so drafting the cryptoassets regime poses an opportunity to address this regulatory gap in the UK. The cryptoassets regime should be more tailored in this regard to also include retail businesses and clients.

Moreover, what needs more elaboration in the introduction of new rules is the distinction between primary and secondary issuances and equity trading – it is referred to in the consultation but not further elaborated on in detail.

20. Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?

GDF is broadly supportive of the proposition but would like to stress the necessity to have a global approach to this and one that facilitates the particularities of crypto. Adopting blockchain analytics and using tech is vital in the cryptoasset trading regime approach and GDF welcomes HMT encouraging this approach. There are technical differences between

traditional finance and cryptoassets which make the implementation of traditional reporting obligations difficult when applied to crypto – they would be overly burdensome.

Location requirements make sense from an operational resilience perspective, but we should be cognisant that there are global firms who will want to have parts of their business abroad and outsource to different locations – the UK regime should enable that whilst ensuring that rules are kept consistent throughout.

21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

GDF has a number of concerns with the proposed approach. The issue with applying existing regulated activities as the basis of a regime for cryptoasset intermediation activities is that MiFID carries with it a long history of guidance which is tailored to the traditional finance industry. As such, it does not track well across to crypto and we need to ensure we do not fall into the trap of simply accepting and translating the rules one-to-one. Best execution, for example, would be something which is understood and works in traditional markets, however, would be best re-thought for the application for crypto. What would it mean in crypto? Would those requirements be suitable for crypto? As mentioned earlier, there was a conscious decision to leave crypto outside of the definition of a financial instrument, this should be carried out throughout.

22. Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?

GDF is broadly supportive of this approach but highlights that proportionality is key here. We need to make sure that we are able to balance the risks and understand how this can be guarded against.

23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

GDF finds that adapting the existing framework for traditional finance is not entirely appropriate for cryptoasset custody activities. There are some of the principles of custody that apply to traditional assets that may be relevant to cryptoasset custody. For example, principles of safekeeping, segregation, and asset identification are sensible in the crypto context and may be adapted to it. However, as a whole, it is more sensible to create tailored frameworks that can address the unique challenges and risks associated with cryptoasset custody. This is also a significant consideration to the custody of non-native cryptographic assets dematerialised in smart contracts on DLTs, such as native securities, where the nature of the decentralised technologies offer both challenges and opportunities to a tradition central securities depositary (CSD) framework.

24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

GDF agrees with the need for custodians to be subject to prudential, conduct and operational resilience requirements. Members consider that the regulatory framework should address the unique challenges and risks associated with crypto custody - holding and safeguarding assets. The regulation must focus on creating clear and consistent

definitions of key terms, ensure segregation and safekeeping of assets, and the need for robust operational controls and cybersecurity measures. GDF notes the dangers of lifting existing CASS rules and applying it to cryptoasset as this would neither be proportionate, nor would it be effective. As such a bespoke regime should be put in place.

One of the differences between traditional custody and cryptoasset custody activities, which the regime should account for, is the requirement of demonstrating proof for custody providers. Proving to hold a cryptoasset would be different to proving to hold a traditional/physical asset or paper security. Depending on how this would be addressed in the regime, the rules should more clearly describe how to prove to hold either one of these assets and how to demonstrate the proper management of that asset.

Members understand that HMT has not included FSCS within the consultation but note it is within the PRA and FCA to include this. Questions were raised as to how this would be administered, in particular, which entities this would be applied to, what the levies would be.

GDF also want to highlight the following (early draft) recommendations being considered by a GDF / joint association industry custody working group:

1. **Ensure bankruptcy remoteness of assets through regulatory reform, where needed, and clearer information to investors about the implications:** uncertainty around the effectiveness of asset segregation in case of a custodian's default is a major concern that could undermine the very basis of this industry. Ongoing legal reform is required but equally important, so is a better understanding among investors of how the conditions of a custodian could impact their rights. Generally speaking, investor asset protection improves if the insolvent intermediary is a bank or broker-dealer since the applicable insolvency regimes are most suited to ensuring this result.

2. **Resolving regulatory uncertainty related to sanction risks in the context of DLT transaction fees (mining / validator fees):** in a decentralized system, traditional notions of direct links between transaction originators and miners do not apply. As a result, originators cannot predict which miner will be selected to confirm their transaction. This means there is potential uncertainty if the participant in a permissionless network facilitates financial transactions with sanction parties in conflict with the law. The DLT transaction fees do not create a direct payment from the initiator of a transaction to a miner. Whether this represents sufficient control is somewhat uncertain, but resolving this issue is critical to allow regulated financial firms to participate in this market.

3. **Allow for de minimis principle Crypto asset holdings in support of digital asset custody activity:** There is a challenge for digital custodians e.g., banks in certain jurisdictions prohibiting them from owning cryptoassets to effectively perform all certain custody-related functions in case of blockchains with incentive-based control requirements e.g. in the context of staking. Such requirements include the need to possess cryptoassets to run validator nodes, or any node or even open wallets. This creates a dilemma for digital custodians who need to commit assets to the network to manage network fees on behalf of their clients or exercise influence in the consensus mechanism. This poses the question of whether the effective provision of digital custody services should make holding a de minimis amount of principal crypto investments permissible.

4. **Technology neutral regulation for key management**: technical requirements for wallet protection should be principle-based (i.e., proportionate to the security risks) rather than focused on specific cold and hot wallet technologies.

5. **Preserve a clear delineation between the responsibilities of a digital custodian as compared to investors:** the issuance of crypto assets is often unregulated, and the risk profile of each asset differs materially. Any risk assessment performed by a custodian should not become a control obligation to determine whether a certain digital asset investment is suitable for a professional investor. Digital custodians are not in the business of undertaking smart contract code reviews.

6. **Work towards industry-wide wallet matching solutions:** the pseudo-anonymity of blockchain transactions creates not only AML challenges but also a transaction processing risk. There are no specific entry controls allowing for the pseudo-anonymity of participants, which is one of the main concerns with respect to Anti-Money-Laundering requirements. This structure, however, also means that counterparty relationships cannot be formed within DLT networks, since it requires off-chain activity to exchange counterparty details. The industry needs a vendor agnostic method to exchange wallet addresses and confirm real-world identities.

7. **Recognize shifts in risk when implementing digital asset solutions:** new technologies bring about changes in traditional operations and sometimes lead to a shift in risk management. For example, certain operational activities may become IT risks, etc. It is important to recognize the impact that new technologies have on risk management and to develop appropriate strategies to manage these risks.

8. **Develop skill and expertise operating in peer-to-peer networks:** maintaining any DLT node requires regular upkeep and monitoring to ensure the secure and efficient operation of the node. This includes keeping the node software up to date, making sure it is overloaded, and ensuring sufficient storage space. Running a node can require significant computing resources, including processing power, memory, and storage. In addition, it is important to monitor network connectivity to ensure that the node is able to connect to the network and communicate with other nodes, and also to take steps to protect the node from cybersecurity threats.

9. **Rethink traditional problems to capture opportunity from DLTs:** using DLT, custodians can provide cryptographic hashes as proof of data accuracy and completeness to clients, which increases transparency and builds trust. Custodians can use the DLT capabilities to provide cryptographic hashes that act as proof of the accuracy and completeness of the data they provide to their clients, such as account statements. This allows clients to independently verify the data and ensure that it has not been tampered with or manipulated. This will require change on the part of all involved parties, but the industry must not lose sight of these opportunities.

25. Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?

GDF finds that more clarity would be useful in understanding how the FCA would supervise and control cryptoassets trading venues differently to traditional markets, given that the FCA has expressed its concern with the difficulty of investigating offences conducted in cryptoassets markets due to its cross-border and cross-jurisdictional nature. The consultation suggests that the obligation of determining the ‘disruption’ would be placed on cryptoassets trading venues under the supervision of the FCA. Tools, which the trading venues should implement, are suggested to be Know Your Customer (KYC) requirements, public blacklists, order book surveillance, STORs, and other means for ongoing cross-trading venues' cooperation and disclosures of information to the market. This is a departure from the traditional approach in the market abuse regime and it might produce significant challenges for firms to comply with and abide by. Cryptoassets companies might

find it difficult to assess what is 'insider information' according to the regime, and when it should be reported to be 'disruptive'. More guidance from the FCA as to the responsibility placed on trading venues would be useful.

The decentralised nature of cryptoassets markets does make it difficult to hold one entity or authority to account and have them ensure that market abuse is presented. Therefore, there is sympathy to HMT's approach to require a global approach, however members were keen to see the FCA take a more prominent role as well.

26. Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?

GDF agrees with this.

27. Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?

GDF agrees that the prohibitions for market abuse should broadly be similar between traditional finance and crypto.

However, depending on the extent that the FCA will actually police manipulative practices we highlight that there are some elements of potential manipulative behaviour that may take place in
MEMpools. We are not stating whether this is the case or not but merely that the small potential is there. MEMpools are spaces where pending blockchain transitions are being stored prior to being picked up by a miner and added to the ledger. It is important that any regulatory approach to MEMpools is taken carefully as this is an essential part of the blockchain technology - and must be allowed to carry on efficiently and effectively.

It is therefore important that these processes are allowed to carry on - but it may be that the FCA - if it intends to police market manipulation more closely - may set out practices within a MEMpool that may constitute market manipulation. If the FCA does not intend to approach this topic, we argue for clarity for the activity within these pools.

The specificity of the MEMpool technology under the traditional financial regime would likely classify MEMpools as an illegal form of insider trading. However, GDF would find it helpful for the Treasury to specify if classifying MEMpools within the definition of insider trading is the Treasury's intention or if that effect is not intended, for the Treasury to specify that certain manipulative practices if conducted with prior knowledge is market manipulation and outline what those certain practices are.

28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?

GDF agrees that trading venues have a significant role to play here in bearing the responsibility, but the FCA must be running this as a coordinated effort of surveillance and enforcement. GDF considers that trading venues cannot be expected to police the entire market, they should just be monitoring what is happening on their venues.

Instead, members suggested that HMT take a three-phased approach to market abuse. Phase I would include ensuring firms have in place measures, as detailed above, as well as the use of novel technologies to monitor their own platforms. Phase II would be to

monitor the market with a UK nexus, sharing information with the FCA who will put together a blacklist. Phase III would then be the global approach which would be coordinated at an international level (perhaps IOSCO) but run by the FCA in the UK.

The importance of this is clear. What HMT are suggesting would be incredibly impractical. Cryptoassets firms have a global orderbook which they cannot be required to report on. As much as that would be impractical and incredibly expensive it could also be illegal. The passing on of information of a natural person may create data protection issues in some jurisdictions which would prevent them from doing so. As such, the phased approach would allow at first to ensure that venues are monitoring their own activities before then reporting to the FCA any activity with a UK nexus. The FCA would then be able to produce a blacklist which can be made available to all firms. The global part can then be achieved via coordination at a global level for example IOSCO. Regulators are able to share information between each other and can create a global list which can be viewed by all market participants. This method, would be practical, cost effective and ensure the fair, transparent and orderly functioning of the market. Whilst it puts more of a responsibility of the FCA, it is a practical solution that the UK can lead both domestically and globally.

29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?

Engagement with the UK Financial Conduct Authority (FCA) and HM Treasury (HMT) can play an important role in fostering the development of RegTech solutions. This could involve providing clear guidance and support to RegTech firms to help them navigate regulatory requirements, as well as encouraging collaboration between RegTech firms and regulators to develop effective solutions. The FCA's regulatory sandbox and HMT's innovation pathways can be valuable resources for RegTech firms to test and refine their solutions in a controlled environment.

Moreover, government implementation of RegTech solutions can help to drive adoption and spur further innovation in this space. For example, the UK government could mandate the use of certain RegTech solutions to prevent and detect market abuse, such as the use of artificial intelligence (AI) and machine learning (ML) tools to monitor trading activities and identify suspicious behaviour.

Encouraging or mandating the use of embedded RegTech solutions in trading venues can be an effective way to prevent and disrupt market abuse. For example, trading venues could be required to use RegTech tools that automatically flag suspicious trading activity or patterns or to incorporate enhanced data analytics capabilities to detect unusual patterns of behaviour.

Finally, working with member associations like GDF to establish a “Shared Market Surveillance” capability to promote global industry standards for monitoring and reporting, through agreed “suptech” dashboards for regulators would go some way to accelerating industry and “regtech” collaboration, and harmonising global reporting standards.

30. Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?

No comment.

31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?

The main risk is capital risk and disclosure, which is uniform across the board. However, there is a difference between staking, providing liquidity and running a crypto lending platform – and as such these should be treated differently.

32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?

No comment.

33. Do you agree with the idea of drawing on requirements from different traditional lending regimes for regulating cryptoasset lending? If so, then which regimes do you think would be most appropriate and, if not, then which alternative approach would you prefer to see?

GDF broadly supports this but would like to see more clarification as to whether this section applies only to retail clients and if not how would this apply to wholesale. Moreover, a differentiation between the types of activities should be applied. The proposed requirements would not apply well to staking platforms – a bespoke set of rules should be used for this.

The Treasury does not go into detail on separating different cryptoassets services offered by one company and the potential conflicts of interest that might arise as a consequence. The consultation only briefly describes that firms should be conscious of managing their conflicts of interest. Nevertheless, GDF encourages the Treasury to take a more granular approach – that would mean adding advice for vertically integrated models and creating sensible divisions and distinctions for them.

34. Do you agree with the option we are considering for providing more transparency on risk present in collateralised lending transactions?

No comment.

35. Should regulatory treatment differentiate between lending (where the title of the asset is transferred) vs staking or supplying liquidity (where the title of the asset is not transferred)?

GDF considers that there is some confusion in the consultation paper here. Lending, staking, and supplying liquidity are all different activities and the HMT should make sure that the regulatory proposal is reflective of that. Title transfer is an important factor – all of this will come down to what the levels of risk are – what disclosures and prudential requirements will be needed. There are also examples of staking and supplying liquidity where title is transferred which should be considered. As such, we need to make sure that the HMT adopts a bespoke approach that is clear and takes into consideration these nuances.

CALL FOR EVIDENCE (DeFi)

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

GDF agrees that the main challenges for regulating DeFi lie in the lack of traditional intermediaries that are substituted by smart contracts relying on the blockchain. The reliance on technology instead of identifiable intermediaries or central authorities makes it difficult to define entities responsible for the network and activities performed on it. This results in difficulties of enforcement, accountability, and transparency in governance – regulators may struggle to identify and penalize bad actors in the space without stifling or blocking innovation of the technology.

Moreover, the globalized and borderless nature of DeFi presents challenges to policymakers as the traditional model of regulation for traditional finance based in one jurisdiction cannot be easily translated to DeFi. The DeFi ecosystem is also made up of different protocols, blockchains, and varied applications which makes it difficult to establish interoperability and standardization of created regulations. Furthermore, the privacy offered by some DeFi platforms, although attractive to users seeking privacy, can pose an additional risk in identifying bad actors in the market and the enforcement of regulations. These difficulties result in insufficient investor protection, exposing users to significant risks, including fraud, cyber-attacks, scams as well as a lack of backstops in a period of market stress.

GDF considers that an innovative approach could be adopted to regulate DeFi. The UK has an opportunity to lead internationally by leading a dialogue across the industry and different jurisdictions on creating an inventive regime for the regulation of DeFi by exploring the potential of smart contracts technology. Smart contracts through automation can provide greater transparency and security of financial transactions if appropriate safeguards and frameworks are put in place to facilitate their safe use. However, the HM Treasury proposal for regulating DeFi appears to have a 'wait and see' approach rather than proactively leading the way to new regulatory solutions. Identification of challenges to the DeFi systems is the crucial first step in allowing policymakers to create a tailored and innovative regime that aims at striking a balance between promoting innovation and protecting users while ensuring that the DeFi ecosystem remains open, transparent, and accessible.

A potential way of approaching DeFi regulation is embedding supervisory functions into the technical design infrastructure of DeFi protocols and applications, rather than relying on external regulators to oversee DeFi activities. An example of such would be supervisory nodes – they would be designed to ensure that DeFi applications and protocols are operating in a manner consistent with the relevant regulatory frameworks, such as those related to anti-money laundering (AML) and know your customer (KYC) requirements. By integrating compliance requirements into the technical infrastructure of DeFi protocols, it may be possible to reduce the risks of illicit activities, such as money laundering and terrorist financing, while also enhancing the transparency and accountability of DeFi activities. This, in turn, could help to build greater trust in DeFi among regulators, investors, and other stakeholders, and facilitate the continued growth and development of DeFi as an alternative financial ecosystem. The UK has the potential to lead on this regulatory innovative development through its established regulatory infrastructure, innovative FinTech ecosystem, and by implementing supportive policies.

In approaching the regulation of DeFi, it is essential that regulation does not establish a protocol as a regulated activity – that would regulate developers of the new technologies – leading to a stifling of innovation, and in the long run, bring to an end to the newly-developed industry.

37. How can the size of the "UK market" for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?

The size of the UK market can be analysed by assessing the amount of activity occurring on DeFi platforms that are accessible to UK citizens, such as transaction volume, number of users, and amount of assets under management. Data from decentralized exchanges (DEXs) serving UK customers may be used to evaluate the number of users – however, the numbers provided will not be exact as there is no centralized authority accurately tracking all such activities.

However, below are several metrics which can be used to evaluate DeFi and its market in the UK:

1. **Total Value Locked (TVL):** TVL is the total value of assets locked in a DeFi protocol. It is an important metric for evaluating the overall health and growth of the protocol.
2. **Active Users**: The number of active users in a DeFi protocol can indicate the level of adoption and engagement with the platform.
3. **Volume**: Volume refers to the total amount of trading or transaction activity on a DeFi protocol. High volume can indicate a high level of liquidity and user activity.
4. **Liquidity**: Liquidity is the availability of assets for trading on a DeFi protocol. Higher liquidity can make it easier for users to buy and sell assets.
5. **Yield Farming Returns**: Yield farming returns refer to the rewards or incentives offered to users for participating in a DeFi protocol. Higher returns can incentivize users to participate and contribute to the growth of the protocol.
6. **Fees**: Fees refer to the transaction fees charged by a DeFi protocol. Lower fees can make it more attractive for users to transact on the platform.
7. **Market Share**: Market share is the percentage of overall market activity captured by a DeFi protocol. A higher market share can indicate a higher level of adoption and popularity among users.
8. **Token Price**: The price of a DeFi protocol's native token can indicate market sentiment and the overall health of the protocol.
9. **Smart Contract Audit**: The security of a DeFi protocol is critical for ensuring the safety of user funds. Smart contract audits can assure that the protocol has been thoroughly reviewed and is secure.
10. **Governance Participation**: Governance participation refers to the level of engagement and participation by users in the decision-making process of a DeFi protocol.

38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?

GDF agrees with the general idea that the same regulatory outcomes should be achieved for comparable "DeFi' and "CeFi" activities. However, by looking at regulating DeFi, the UK should cooperate with other countries and take a global approach. It is crucial that the UK does not jump the gun and act out of step but that it is focused on leading global discussions to bring a synchronized action for a technology that is intrinsically cross-border.

On the approach itself, the HM treasury by seeking the same regulatory outcomes across analogous activities, would be promoting a level playing field and ensuring that consumers and investors are protected regardless of whether they are using DeFi or CeFi platforms. However, it is indeed important to note that different regulatory tools are needed to achieve these outcomes in CeFi and DeFi, given the different operational and technical structures.

Depending on the levels of decentralization of platforms and services offered, the regulatory tools should reflect and seek to facilitate these differences through creative, embedded, practical and technology-based solutions.

39. What indicators should be used to measure and verify “decentralisation” (e.g. the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?

Measuring and verifying the degree of decentralization of a DeFi protocol poses many challenges since the technology and nature of specific platforms and services on it significantly differ. Decentralization should be seen as a spectrum – networks are rarely fully centralized or decentralized. The question of decentralization boils down to control – it depends on the particular governance structure of a network – who has the control or ability to gain control in the given model – will indicate the level and perils of decentralization/centralization. Regulatory approaches should reflect the nature of underlying activities and the structure through which actors can participate in the governance structure.

Some of the potential indicators that could be used to evaluate the level of decentralization of the underlying technology or governance of a DeFi protocol could include:

1. **Hash rate distribution**: in proof of work blockchains the decentralisation of the network depends on what the hash rate is and among how many entities the hash rate is distributed. The hash rate is the cumulative processing power miners provide the network – the higher the hash rate the safer the network is and the more decentralised it is. Essentially, a more decentralized system (with a higher hash rate) would have a wider distribution of mining power among a larger number of participants.
2. **Count of stake pools**: in proof of stake blockchains the level of decentralisation can be measured by the count of stake pools or validators as well as the percentage of token supply that is staked. A more decentralized system would have a wider distribution of tokens among a larger number of participants, rather than being concentrated in the hands of a few. The higher the percentage of the token supply staked (higher level of decentralisation) the safer the network and more resistant to disruption.
3. **Governance structure**: The governance structure of a DeFi protocol can also be an indicator of decentralization. For instance, the spread of the stake across validators in proof of stake blockchains can give an insight into the percentage of the network being controlled by a particular group – if the consensus model is based on a minority, majority or supermajority – it will indicate its level of decentralisation. If the governance structure allows for a larger number of stakeholders to participate in decision-making, it may likely be considered more decentralized.
4. **Openness**: due to the nature of DeFi and its initial creation – many DeFi platforms stress the importance of openness and transparency of their protocols to incentivise stronger involvement in decision-making. For this reason, a more open and transparent network, allowing for greater participation and scrutiny by all stakeholders would usually be more decentralised.

40. Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?

No comment.

41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

In its DeFi report in 2022, GDF stated that it will seek to engage members and the wider global community of DeFi firms in a medium to long-term engagement platform with regulatory agencies to set out and agree a structured agenda of risk identification. As outlined in the GDF Co-Regulation Model (adopted from Malcolm Sparrow's Fundamentals of Regulatory Design, 2020) the discovery process of risk identification across DeFi could be conducted in a shared across industry and regulators. A mutual discovery process of risk identification and assessment should go some way to removing the "cat and mouse" guessing game that is often employed through regulatory consultation with industry. It seeks to deliver a more fair, orderly and transparent process for the identification and assessment of risk.

As well as identifying the risks, regulators and industry have a unique opportunity to take advantage of and consider algorithmic consensus models, and explore the design and operation of regulator nodes, and ultimately compliance nodes and tokens in a DAO. This cluster of frameworks and activities is known in GDF as RegDAO, and would include legal frameworks, policies, standards, regulations, licensing, and enforcement.

RegDAO would look at how these might exist as part of a DAO consensus mechanism. GDF would seek to engage IOSCO in the first instance, as the association working across global jurisdictional securities regulators. IOSCO has done significant work to date on reporting on the identification of risk across DeFi and works closely with jurisdictional regulators on such programs. The inclusion of other organizations who have contributed significantly to the topic, such as the OECD and BIS, to engage in further input and or observation of the Track 2 engagement must be considered. Given the nature of DeFi and the DeFi ecosystem, it would be incumbent on industry to lead with the provision of technical resources, software engineers, DAO governance specialists, and algorithmic finance specialists to ensure premium resources are available for the appropriate level of knowledge transfer to agencies. Where possible, industry must also commit resources to the development of a prototype RegDAO in the Track 2 engagement.

Track 2 would seek to cover DeFi knowledge domains such as:

- The nature of human and financial capital deployment at the inception of a DeFi project as it relates to non-native asset class definition and current jurisdictional regulations
- The convergence of open-source software licenses and financial services
- Understanding the reasonable consumer, the investor, or the wholesale counterparty using DeFi products and services
- The design and role of regulatory nodes and compliance notes for supervision, enforcement and reporting
- The role of AML/KYC/CFT regulation and the development of appropriate solutions for the prevention of illicit activity
- The role of smart contracts, code-based rule execution, code-based principles execution, and the governance of algorithmic finance in the context of governance oversight, quality assurance, and liability
- The role of AMMs, order pooling, liquidity pooling, credit, leverage, and settlement
- The role of stablecoins and other tokens and determining which stablecoins and tokens can be used in the ecosystem
- The role of oracles and the nature and quality of external data provision used in pricing, settlement and other market mechanisms.

42. What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

No comment.

43. Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.

Regulating cryptoasset investment advice and portfolio management would be beneficial to the goal of creating consistency and coherence in the regulatory approach, protecting investors and users of digital assets – all to build a safe crypto market. Lack of regulation is a risk for investors seeking advice - potential perils include inadequate disclosure requirements, conflict of interests, lack of weighted responsibility and potential fraud. Further, cryptoasset investment advice and portfolio management are regulated activities under MiCA – regulating them in the UK would ensure consistency across different regulatory approaches.

However, there are a number of concerns that should be taken into account when designing such regulation. One consideration is whether the market is too small and undeveloped to take on obligations put on the advisors and for them to meet the necessary thresholds to deliver advice. Given the small size of the market, it may be challenging for companies offering advisory services to meet regulatory requirements, stifling the development of the investment advice market in cryptoassets – leading to fewer sensible advisers for users interested in cryptoassets investments.

Secondly, the definition of cryptoassets is so broad that it potentially includes a variety of instruments and areas that are not feasible to provide sensible due diligence for: e.g. NFTs. Each particular asset should have its own requirements on how to assess risk and conduct due diligence based on its technical and practical consideration – only these tailored-made and targeted rules would be reachable for cryptoasset investment advisers and cryptoasset portfolio managers.

44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

GDF considers that mining and validation activities should not be regulated per se. They do not constitute financial instruments or services and therefore should not be included in the financial regulation. This is aligned with the HM Treasury's approach that similar outcomes of DeFi activities to CeFi activities should be regulated but through different means. Regulating mining and validation activities would be putting limits and rules on the technology itself rather than its application and use – thus stifling innovation.

Furthermore, regulation in the UK of such technology could lead to unintended consequences. The cross-border nature of blockchain networks could mean that regulating such activities in the UK could drive mining and validation activities to countries with more lenient regulations and less environmental protection – producing sustainability-wise worse effects.

45. Should staking (excluding "layer 1 staking") be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

Staking is fundamentally different from lending and as a result, involves different levels of risk. The potential dangers of staking involve the possibility of network attacks or technical

issues that could result in the loss of staked assets. Nevertheless, these risks are different to those involved in staking where a transfer of funds takes place between parties and therefore includes a higher counterparty risk.

GDF finds that given these differences, staking and lending should be regulated separately and per their technical particularities.

46. What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?

No comment.

47. When making investment decisions in cryptoassets, what information regarding environmental impact and/or energy intensity would investors find most useful for their decisions?

Things that investors could take into account would be to distinguish if a cryptoasset is based on a proof-of-work or proof-of-stake mechanism – both have significantly different effects on the environment. Looking at the model on which the blockchain is built should be a foundational consideration in terms of sustainability.

48. What reliable indicators are useful and / or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and / or associated emission metrics, or other disclosures)?

GDF notes that measurements of environmental impact should be preferred over energy intensity. For example, the Crypto Climate Impact Accounting Framework, co-authored by the Crypto Carbon Ratings Institute (CCRI) and the South Pole, enables a better understanding of how companies involved in the cryptoasset ecosystem can begin to account for their emissions, which is a first step in determining how to reduce those emissions.

This Framework promotes the hybrid allocation model that takes into account both the holding and transacting use cases of cryptocurrencies. Since crypto network validators are incentivised by block rewards and transaction fees, greenhouse gas (GHG) emissions are allocated to crypto value chain participants (stakeholders) based on both the value of that stakeholder's holdings (which drives block reward revenue for validators) and the transaction fees paid by the stakeholder (which drives transaction fee revenue for validators).

49. What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?

GDF notes that in the ECB Stress test report on banks' emission data, it was found that banks depend on estimates using proxies. The recommendation was that future regulatory requirements should include EU disclosure rules which are currently under discussion which could increase the access to actual client data and remove the need for proxies. GDF notes that even though there are too few robust methodologies there should be a recognition that the process to improve proxies, estimates and measurement metrics will take time.

50. How interoperable would such indicators be with other recognised sustainability disclosure standards?

GDF notes that the Crypto Climate Impact Accounting Framework was developed through a multistakeholder consultation process. It is informed by and designed to be consistent with the Greenhouse Gas Protocol corporate standard and value chain standard. It is also aligned with the Science-Based Targets guidelines.

51. At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?

No comment.

52. Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?

No comment.