21 March 2021

Cryptoassets and stablecoin consultation
Payments and Fintech
HM Treasury
1 Horse Guards Road
SW1A 2HQ

VIA EMAIL:

cryptoasset.consultation@hmtreasury.gov.uk

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

To whom it may concern,

Global 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 (**'HMT'**) consultation and call for evidence on the UK regulatory approach to cryptoassets and stablecoins (**'Consultation Paper'**).

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 token companies, academics and professional services firms supporting the industry. GDF is proud to include 100x Group, Coinbase, Diginex, DLA Piper, EY, Hogan Lovells, Huobi, the London Stock Exchange Group, R3, and SDX as patron members.

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.

The input to this response has been curated through a series of roundtables organised by GDF, convening a wide cross-section of the industry. This response covers questions in the consultation section of the paper. GDF will submit a separate response to the call for evidence following a further roundtable discussion that GDF has proposed to HMT. Should you have any questions with regards to this submission, GDF remains at the disposal of HMT to respond as required, and can be reached at: lavan@gdf.io.

Yours faithfully

The GDF Board

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

GDF welcomes this initiative and highlights the need for greater regulatory clarity for cryptoassets. GDF notes that the UK regulatory landscape for cryptoassets is complex and the FCA guidance provides a suitable method of navigating this. However, at present there are a number of tokens that do not fall neatly within one of the categories and will fall outside of the regulatory remit.

Stablecoins are a good example of this. On initial analysis, a stablecoin may appear to fall within the e-money classification and as such be regulated under the Electronic Money Regulations 2011 (**'EMRs'**). However, one of the elements that needs to be fulfilled to fall within the scope of e-money is that there needs to be a claim on the issuer. This is not always easy to define in a stablecoin project and leads to them being classified as an unregulated token. The proposed creation of supplementary categories may address this issue.

Whilst it can be argued that creating new categories may go some way towards solving this, such approach could in itself create confusion with the possibility that this piecemeal approach leads to regulatory overlap. Adding on new classifications will always be retrospective and regulation will constantly be playing catch-up to innovation and new tokens that are being issued.

GDF also cautions the effectiveness of such an approach. A key objective for GDF is the creation of regulatory certainty. The current approach is useful in a broad assessment of the nature of the token but leaves room for interpretation. This frustrates issuers who are unsure how their tokens will be treated. This results in having to conduct detailed regulatory analysis of the UK regulatory regime to determine the classification. This is complicated and expensive.

GDF considers that the UK could take a bolder approach in the creation of a bespoke regime for cryptoassets which provides certainty of treatment. Rather than attempting to shoehorn tokens into existing legislation that do not neatly fit the activity, principles and regulatory outcomes of existing legislation could be used in creating a new regime that addresses cryptoassets. This should follow the same objectives of protecting financial stability, market integrity, consumer protection, competition and innovation.

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

On the whole, GDF welcomes the proposed creation of a new regulated category of 'stable tokens'. As mentioned in the response to question 1 of this Consultation Paper, stablecoins often do not fall within the current regulatory perimeter and therefore the creation of this new category will be useful.

<u>Definitions</u>

However, GDF notes that the devil will be in the detail of this definition. GDF notes that the definition of stable tokens will need to be carefully constructed to ensure that it does not unwittingly cover more than what it intends to. GDF acknowledges that this is one of the concerns that it has highlighted in the EU's Market in Crypto Asset Regulation proposal (**'MiCA'**) and that it is equally important to ensure consistent terminology is used.

GDF highlights that there are a number of ways that this can be achieved, either through looking at the economic function of the token and defining a regulatory boundary around that or instead,

defining the regulatory perimeter by reference to the legal rights and obligation. Existing payments legislation does take both approaches. GDF does not have a preference as to which approach is used or whether a hybrid is used, however an important aspect of this is how the regime will be 'switched on'. The approach that can be taken is either a bright line rule i.e. Where there are clearly defined rules with little room for interpretation or a switch function based on a set of criteria. This will be key in the legislative design to establish the regulatory perimeter.

GDF considers that a switch function will be burdensome on the regulator given the number of applications that will be handled. Instead, it is suggested that this approach can be used for systemic stable tokens or particularly complex use cases. As such, a form of bright line test may be considered for common use cases that are not as wide reaching. HMT will however, have to ensure that whilst this test provides clarity and certainty, it could also be quite restrictive and as such careful consideration needs to be given to the substance of it.

Tech neutrality

GDF notes that the proposed new category intends to remain technologically agnostic. This is welcomed as it is agreed that something should not be regulated differently for the mere use of Distributed Ledger Technology (**'DLT'**). However, GDF notes the importance of tech specificity as well.

Whilst legislation does not reference technology, it is built around the technology that is used at the time. As mentioned in question 1 of this response, the need for there to be a claim on the issuer for e-money was a framework that was built around the technology and the models that were used at the time. If technology has moved to a new plane where there is not an issuer and instead a token is 'issued' programmatically, this should be reflected in legislation.

GDF considers that legislation should be more conducive to enabling innovation and this at times requires having technology at the forefront of policy making and considering how the benefits of this can be harnessed whilst safeguarding against risk. Taking a technology neutral approach leads to shoehorning new concepts into old frameworks because of similar characteristics rather than taking a closer substantive view.

Level Playing Field

GDF highlights the importance of a level playing field when creating a new category. However, this concept should be centred around risk. There are circumstances where the use of technology carries a different risk, or where the proposed activity is different to what the regulation is looking to cover. GDF notes that the Consultation Paper refers to same risk, same regulatory outcome, however strong consideration needs to be given to what the risk is and whether the rules being applied are proportionate to this.

An example of this is the creation of the e-money regulation. At the time, concerns were raised about unequal treatment, however the key factor behind the creation of the new regime was differing risk. The risk profile of e-money is very different to providing credit and as such it should be treated differently. The same consideration should be given when considering some of the models that are being used for stablecoins. For example, a stablecoin that does not have a central reserve and the user remains in control of their funds, thereby eliminating counterparty risk, carries a different risk profile to that of what the e-money regulation was established to cover. This should not have to carry to the same regulatory treatment. This is a shortcoming of the current regulatory approach and GDF considers that a proportionate and tiered approach could prove effective. For example, a banking licence covers deposit taking, maturity transformation and credit but there is not a differing regulatory

regime if a company only covered one of those activities. As such, a company that only takes deposits would be considered to have the same as one that did all three. Whilst this is a point that stretches further than stablecoins, breaking these sections out would allow for greater flexibility and encourage innovation.

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

GDF welcomes the objectives and principles put forward in the Consultation Paper. Whilst the three objectives are important, GDF would like to see innovation and competition prioritised. Whilst a strong base is in place to mitigate against financial stability, market integrity and consumer protection, GDF urges the UK to do more to support innovation and competitiveness. At present rhetoric surrounding the cryptoasset industry in the UK has been cautious and in places negative. This does not encourage firms to locate or remain in the UK or conduct business here. Furthermore, those that do stay suffer from a crypto-unfriendly ecosystem. An example is the ability to obtain banking services. Despite following AML/CTF rules and enhanced due diligence requirements, crypto businesses find it difficult to open a bank account. A number of banks are not comfortable offering these services and are not blockchain friendly. The lack of 'access to a variety of high-quality services and products' is inhibiting the UK cryptoasset industry.

GDF wants to reiterate that the promotion of competition and innovation should not compromise the other two objectives. It is important to consider that innovation allows for companies to deliver new products that are of the benefit of consumers which could in fact improve market integrity and consumer protection.

Please see response to question 2 for views on the principle of same risk, same regulatory outcomes and a technology agnostic approach.

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

GDF welcomes this approach, however, would like to highlight the importance of effective implementation. The assignment of the AML registration programme to the FCA is an example of where this did not happen. It transpired that the FCA were not well equipped to deal with this role. The complexity of the task, the lack of comfort to register and insufficient resources were the reasons given for the backlog of applications. Innovative regimes are only as effective as the ability to implement them. There has been reputation damage as a result of this and more needs to be done to upskill and equip regulators with the resources to run this regime.

Upskilling staff and getting the regulators comfortable enough with the industry to process applications will be a challenge. However, building on the success of the FCA regulatory sandbox, GDF encourages the creation of a cryptoasset sandbox/scalebox. This will provide an opportunity for the regulator to better understand the industry and the complex developments, whilst simultaneously providing a positive experience for businesses who are able to gain certainty and scale their business in the UK.

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

Cryptoassets are global in nature and regulation needs to reflect this. The work of the Bank for International Settlements, the Financial Action Task Force and the Financial Stability Board (**FSB'**) have been instrumental for the industry and has to-date set the course for how jurisdictions are approaching cryptoassets. GDF urges the UK to continue to follow this work and ensure that they stay aligned.

GDF also notes that MiCA, is likely to become an international standard for crypto asset regulation. This is largely because it is the first jurisdiction to put in place an all-encompassing cryptoasset regime and it will apply uniformly across the entirety of the European Economic Area. As first mover, other jurisdictions are likely to use this as a starting point for their own regimes.

As such, GDF considers that the UK has two options at this stage, either to influence the development of MiCA and apply it in its entirety ensuring it is aligned, or develop its own regime and gain international support.

Should the UK opt for the latter option, one advantage is that it can move to implement a regime faster than the EU as there does not need to be compromise and consensus across 27 member states. However, the crucial element of this approach is that there needs to be buy-in from other jurisdictions or else the UK could run a regime that is vastly different and companies will need to weigh up the benefit of conforming to both sets of rules. This will also guard against regulatory arbitrage and a race to the bottom. If this option is taken, GDF encourages HMT to extend the proposal to bellwether crypto jurisdictions for comment and buy-in before implementation.

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

GDF acknowledges that existing payments regulation is a good place to start when looking to regulate stablecoins. However, as mentioned in question1 and question 2 of this response, it is clear that existing legislation does not neatly apply to stablecoins. Whilst applying a new category is a method of addressing this, GDF reiterates the benefits of a new bespoke cryptoasset regime.

GDF highlights that one of the shortcomings of MiCA is that it is a subsidiary piece of legislation that applies when all existing EU financial services legislation does not apply. The difficulty of this is that issuers and crypto asset service provider will have to go through all of the analysis required for existing legislation before they apply MiCA, which is time consuming and very costly. If a bespoke regime which sought the same regulatory outcomes was applied and was ringfenced from the analysis, there would be greater clarity and a draw to the UK as a jurisdiction to operate from.

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

GDF reiterates the point that was made in question 1 of this response that the EMRs were not developed with this technology in mind and therefore does not neatly fit, even if the stablecoin was only referencing a single-fiat currency. That being said, there is a possibility that a stablecoin can meet the definition of e-money and the proposed new category of stable token. In this scenario GDF encourages HMT to put in place exclusions to ensure that there is not an overlap.

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

GDF considers that the exclusion of algorithmic stablecoins from the remit of this Consultation Paper as a missed opportunity. Whilst at present, this is a token that is deemed to not fulfil the characteristics of a stablecoin, GDF notes that this may change in the future. The key tipping point will be comfort around what the token is backed by. In the same way that there was a period of adjustment to understand how stablecoins are referencing fiat currency or commodities to maintain a stable value, it may just be a matter of time until there is comfort with the asset that is being referenced here – the algorithm or smart contract programmability.

Whilst this may take some time, it is important to ensure that these tokens are not prematurely put into the unregulated or banned category. This is an innovation that has potential to deliver a number of benefits and leaving it outside the remit of this proposal could kill it off. Instead, GDF proposes that HMT keep an open mind for this but note that there needs to be certain criteria met before it can be considered.

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

GDF agrees that Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens to the extent that they meet the existing conditions for recognition, or a similar set of prescribed conditions in relation to stablecoins which ensure proportionality.

GDF is concerned at the methods that will be put in place to determine the appropriate point at which a stablecoin arrangement becomes systemic and should become subject to these provisions. GDF is concerned that smaller market participants will be regulated out of business by legislation designed to target systemic global stablecoin arrangements but which inadvertently goes too far.

GDF notes that it is likely that amendments will be required to the Banking Act. For example, the existing definition of payment system means 'arrangements designed to facilitate or control the transfer of money' which arguably may not cover money-like assets such as stablecoins and other cryptoassets. As such, HMT would need to consider how best to adjust this definition and other provisions in line with remaining technology-neutral whilst still capturing the essential characteristics of systemic stablecoins.

HMT may also consider adjusting or extending the recognition criteria on this basis. While many of the existing recognition criteria are likely to be relevant to stablecoin systems, some may need

amending and there are likely to be additional relevant factors that necessitate supplementary criteria. For example this may be the relationship of a stablecoin to the underlying assets backing it, which may include fiat currency and what overall implications there may be for financial stability if significant redemptions were to occur in a short timeframe. GDF suggests that the stablecoin-specific criteria for recognition includes a limitation based on the purpose of a stablecoin i.e. That only stablecoins which are used for making payments for goods and services should potentially be subject to the Banking Act provisions. This purpose can be distinguished from the narrow trading activity focused on crypto exchanges, which is what most stablecoins are used for at the moment.

GDF considers that any amendments / additions should be in line with the existing approach under the Banking Act to ensure consistency and that Bank of England oversight is only introduced where proportionate and required. However, recognising their global nature, the approach to regulation exercised by the Bank of England should be proportionate to the potential impact that the system could have on UK financial stability. As such, it should also be balanced against principles of fostering innovation and payment efficiency for customers.

It is also important to highlight whether and, if so to what extent, settlement finality protections should be awarded to token systems that are systemically important, noting that those that operate using DLT benefit from certain principles of transparency and immutability.

At present, only a small number of payment systems have been designated as recognised systems under the Banking Act. This illustrates that the threshold for the 'systemic' nature of payment systems is very high. This should remain the case and as such GDF considers that this regime will not be relevant for the vast majority of stablecoins.

Finally, GDF notes that including systemic stablecoins within Part 5 of the Banking Act is consistent with the recommendations from the FSB in relation to regulation, supervision and oversight of global stablecoin arrangements. The FSB recommendations also make clear the importance of authorities cooperating and coordinating internationally, as well as domestically, in recognition of the inherently international nature of cryptoassets including stablecoins. International consultation and cooperation is not something that is currently included within Part 5 of the Banking Act, but consideration should be given as to whether this is something that should be specifically permitted and mandated in line with other existing consultation powers within the Act.

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

GDF does not consider that technology providers should be regulated merely because they are providing technology to a systemic payment system, stable token or otherwise. Instead, GDF is of the opinion that the approach should be consistent with the way that FMIs and existing payment systems are regulated.

At present, the payment system itself is regulated but not the chain of related service providers. As a result, the regulatory burden primarily falls on the regulated entity and not on its service providers. GDF considers that this is the right balance to maintain. The mere use of DLT or other structural differences should not make the analysis different for stable tokens than any other payment system. In addition to this, the chain of service providers of stable tokens or other cryptoassets may be much smaller than in comparison to fiat money.

If HMT considers that it is necessary to have an extension of the regulations, this should be proportionate and mindful of existing regulations that impact these service providers. HMT should ensure that there is no overlap and that service providers are not subject to multiple sets of potentially conflicting regulation and oversight by multiple regulators whose jurisdiction is not clearly delineated.

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

GDF notes that the Payment Systems Regulator (**'PSR'**) is a competition markets regulator and as a result, one of its main objectives is to ensure that there is a level playing field and that large players do not have unrestricted control over access to payments infrastructure. Whilst historically the concern was in relation to large banks, the same principle applies to concerns about global stablecoin arrangements operated by large, global tech firms and the impact that this might have on competition and barriers to entry.

GDF acknowledges that whilst the provisions of Part 5 of FSBRA are designed to be broad and capture new types of payments systems, as mentioned in question 15 of this response, HMT will need to carefully consider what changes may be required to successfully accommodate stablecoin arrangements. For example, 'payment system' is defined broadly as 'a system which is operated by one or more persons in the course of business for the purpose of enabling persons to make transfers of funds, and includes a system which is designed to facilitate the transfer of funds using another payment system', it is not clear that funds would cover stablecoins. Similarly, the criteria for designation may need to be expanded to ensure that it adequately covers stablecoin arrangements.

As mentioned in question 15 of this response, GDF suggests that the criteria for designation should include a limitation based on the purpose of a stablecoin i.e. That only stablecoins which are used for making payments for goods and services should potentially be subject to the FSBRA provisions. This purpose can be distinguished from the narrow trading activity focused on crypto exchanges, which is what most stablecoins are used for at the moment.

GDF notes that one difference between stablecoin arrangements and more traditional payment systems is the type of entities involved and the appropriate terminology, for example the issuer, stablecoin exchanges, the operator or developer. As a result, HMT need to consider if sections around participants in payment systems are still fit for purpose.

Similar to the position under the Banking Act, at present, only a small number of payment systems have currently been designated as regulated systems under the FSBRA. This illustrates that the threshold for the 'systemic' nature of payment systems is very high. This should remain the case and as such GDF considers that this regime will not be relevant for the vast majority of stablecoins.

GDF reiterates that international cooperation and coordination between the PSR and other regulators, taking into account guidance issued at an international level, will be key for appropriate oversight of global stablecoin arrangements – it will not be sufficient for the PSR to act alone.

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

GDF considers location and legal entity requirements under following headings:

Technical Complexities to Location and Legal Entity

GDF notes the difficulty in establishing location when it comes to stablecoins due to their decentralised nature. Similarly it is difficult to ascertain the reach of a product as it is accessible by anyone who is connected to the internet. The US approach to this matter has been to determine that if a company was conducting business with US citizens, regardless of jurisdiction, registration would be needed in the US. However, this is not the case in the UK. The Overseas Persons Exemption means that a company does not need to register unless it is physically present in the UK. As a result, if a company is based outside of the UK it does not need to register but it can still carry out business with UK customers.

GDF highlights that much of the UK's existing work on territorial scope was based around centralised and not decentralised structures. As such, it worked on the premise of whether the company did business in the UK or not and this was tested on whether the company has a permanent place of business here. Those who do not have a permanent place of business are exempt from the regime. GDF suggests that consideration should be given as to whether the UK Overseas Persons Exemption is still fit for purpose.

That being said one of the tests that is in place is financial formations. This does not take into consideration where you are conducting business but more if the activity is capable of having an effect and if so, the company needs to comply with the financial promotions regime. GDF notes that HMT conducted a consultation on this last year and we await the outcome. This is something that will need to be looked at in more detail, especially in the context of COVID-19, where no one is working where they once would have been.

GDF also highlights that location can be impossible to determine in the context of DeFi, where it can be impossible to ascertain where something is located or even establish the existence of a legal entity. GDF considers that MiCA does not deal with this well and urges the UK to give this due consideration and introduce a regime which does not kill of this industry.

Location as an ecosystem

As referred to in question 3 of this response, it will be important to ensure that the UK presents itself as a crypto friendly location and delivers an ecosystem to complement the measures being implemented. This includes encouraging banks and professional services firms to provide services to these companies. GDF notes that whilst the ease of setting up and conducting a business in the UK is a large pull factor for people to locate their business here, the same cannot be said for crypto businesses. Delays, complexities and procedural hurdles make other jurisdictions such as France, Gibraltar, Malta, Singapore and the UAE more desirable. As such GDF urges HMT to do more to support businesses to locate and innovate in the UK which will ultimately result in the end user benefitting from better, cheaper and more innovative products.