

## Advisory

# UK Government Confirms Final Proposals for Cryptoasset Regulation

1 November 2023

On 30 October 2023, the U.K. Government published a series of reports outlining its responses to earlier consultations on the regulation of cryptoassets:

- i. Response to the consultation and call for evidence to the future financial service regime for cryptoassets.<sup>1</sup>
- ii. Update on plans for the regulation of fiat-backed stablecoins.<sup>2</sup>
- iii. Response to the consultation on managing the failure of systemic digital settlement asset (including stablecoin) firms.<sup>3</sup>

The reports are part of the government's panoply of measures and initiatives to regulate cryptoassets and include its final proposals in this area. Key outcomes from the reports are summarised below.

- i. Response to the consultation and call for evidence to the future financial service regime for cryptoassets

### *Definition of cryptoassets and scope of regulated activities*

In its initial proposals, the government set out a phased approach to the regulation of cryptoassets split into Phase 1 and Phase 2, with Phase 1 addressing fiat-backed stablecoins, which are used for payment and Phase 2 addressing cryptoasset legislation more generally, including issuance; exchange activities; investment and risk management; lending, borrowing and leverage; and safeguarding, administration and custody activities ("**Phase 2**"). In Phase 1, the government will prioritise the creation of FCA-regulated activities for the issuance and custody of fiat-backed stablecoins issued in the U.K. and the regulation of payment services relating to certain fiat-backed stablecoins where these are used in a U.K. payment chain. The aim is for Phase 2-related secondary legislation to be laid in 2024.

The government has now confirmed that it plans to expand the list of "specified investments" in Part III of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (**RAO**) to include the Phase 1 and Phase 2 activities described above. Firms undertaking those regulated activities by way of business and where services are being provided in or to the U.K. will need to be authorised by the Financial Conduct Authority (**FCA**) under Part 4A of the Financial Services and Markets Act (**FSMA**).

Responding to concerns that the definition of cryptoassets used by the government in its consultation<sup>4</sup> is too broad, the government has confirmed that the precise legal mechanism for distinguishing between tokens which are in and out of scope will be set out in secondary legislation and FCA rules. The government does not intend to capture cryptoassets which are specified investments that are already regulated, which includes security tokens representing debt or equities. Algorithmic-backed or crypto-backed stablecoins will not fall within the scope of the forthcoming regulatory regime for fiat-backed stablecoins but will be regulated under the wider framework for unbacked cryptoassets. Further, NFTs will not be in scope for regulation as a financial service, as they are more akin to digital collectibles or artwork. However, whether an NFT falls within the regulatory regime will need to be assessed on a case-by-case basis depending on whether it is used for one of the regulated activities (for example, where it is used as an exchange token) regardless of how it is described.

Utility tokens will be subject to a similar treatment, with the focus on how they are used rather than a hypothetical application on the technology.

The government intends to enable Phase 2 activities to be conducted across both private and public blockchains subject to certain measures to address risks in a flexible manner through, for example, disclosure/admission requirements.

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#### *FSMA authorisation process for regulated cryptoasset activities*

The new FSMA authorisation process will be broader than the current registration process under The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (**MLR**), requiring further assessment of aspects of regulatory compliance not previously assessed. Firms registered under the MLR will not be granted automatic authorisation, but the FCA will provide more detail on what the assessment will involve in due course and will also consider the regulatory histories of all applicant firms in those assessments. The expectation is that firms which have an existing authorisation will apply for a Variation of Permission, and this approach would also apply to firms registered for Phase 1 activities.

#### *Market access and prioritisation of activities*

The government's response confirms that it wishes to avoid a highly restrictive location and market access policy. A way of achieving this could be to permit U.K. firms that are operating a regulated cryptoasset trading venue in an overseas jurisdiction to be able to apply for authorisation for a U.K. branch extension of their overseas entity. The branch could be authorised to specifically handle trade matching and execution activity.

The government also confirmed that it plans to bring forward its work on staking but portfolio management and provision of investment advice on cryptoassets will not be brought within the regulatory perimeter at this stage.

#### *Disclosure and admission requirements*

The government's view is that disclosure documents should be in place for all cryptoassets made available for trading on a U.K. cryptoasset trading venue. This would include all well-established tokens (i.e., those characterised by relatively high levels of liquidity and at least several years of trading history) as well as those which do not have a clearly identifiable issuer such as Bitcoin. Disclosure/admission requirements will apply only to tokens that are made available to the U.K. public.

While publicly available information may be used for the preparation of such documents, those who opt for such information would need to be clear as to its origins and the level of due diligence conducted in respect of it.

Disclosure requirements are expected to be less prescriptive for venues which only admit institutional investors.

Tokens made available through ICOs or similar issuances will be subject to requirements and exceptions similar to those proposed in the U.K. government's new "Public Offers and Admissions to Trading Regulations 2023."<sup>5</sup> Tokens offered only to professional or sophisticated investors; free airdropped tokens; or tokens earned via reward mechanisms likely to be exempt as a public offer. However, this will be kept under review to ensure that any such determination is not utilised to avoid appropriate disclosure obligations.

#### *Liability*

In principle, all firms required to publish cryptoasset disclosure documents should be liable for their accuracy. However, cryptoasset exchanges – which choose to take responsibility for the disclosure documents – should not be held liable for all types of consumer losses arising from events relating to that token, provided that they have taken reasonable care to identify and describe the risks. This would be the case where a loss is caused by a failure outside of the venue's control or operation (e.g. loss caused by a protocol failure outside of the exchange's control) provided that the venue had performed reasonable due diligence on the token and the underlying network; communicated its findings to consumers very clearly; and had not made misleading statements guaranteeing the network's performance and resilience.

Forward-looking statements (e.g. in connection with future use cases of the token) should be held to a different liability standard than historical, factual statements (e.g. in connection with code audits). The former will generally be subject to recklessness/dishonesty standards, while the latter will be subject to negligence standards.

#### *Intermediation activities*

The government plans to define a new set of regulated activities akin to those in the existing regulatory perimeter

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(e.g. dealing in investments as an agent). Requirements will differ depending on whether the intermediaries deal with retail as opposed to wholesale counterparties.

#### *Custody*

The government will legislate to define a new regulated activity for custody covering the (i) safeguarding; (ii) safeguarding and administration; or (iii) the arranging of safeguarding or safeguarding and administration of a cryptoasset. Existing tradfi frameworks for custodians will be used as the basis for the regime, but the government will be ready to make suitable modifications where needed.

Generally, the provision of self-hosted wallet technology to a consumer will not in itself be a safeguarding activity but this will be kept under review. On the other hand, third-party custody arrangements will fall within the new regulated custody activity and the FCA will be considering detailed rules.

Custodians will not be expected to be subject to full, uncapped liability in case of a malfunction or hack outside of their control. Custody of security tokens will no longer be regulated in the same way as other specified investments and will instead be specified by a new regulated activity to address fundamental differences in the way that cryptoasset custody operates versus traditional custody arrangements.

#### *Market Abuse*

A cryptoassets market abuse regime will be introduced, which will be based on the existing Market Abuse Regime and include the insider dealing, market manipulation, and unlawful disclosure of inside information prohibitions. Obligations will apply to cryptoasset trading venues and other regulated market participants. Regulated firms will be expected to have policies and procedures in place to identify price sensitive information and put controls around this. The government will discuss with the FCA how to address risks posed by overseas firms in this regard.

#### *Cryptoasset Lending*

The government will establish a newly defined regulated activity of “operating a cryptoasset lending platform.” It will differentiate between lending to retail customers and lending between wholesale counterparties. In principle, wholesale bilateral cryptoasset lending arrangements would not be subject to the same types of regulatory requirements as those applicable to retail business models. Cryptoasset staking (where legal title in the cryptoasset is not transferred) will be treated differently to cryptoasset lending; see below.

#### *DeFi*

The government accepts that a spectrum of decentralisation needs to be recognised within the DeFi ecosystem rather than a binary approach between centralised or decentralised. The government further concludes that it would be premature and ineffective to regulate DeFi activities currently but confirmed it does not intend to ban DeFi.

#### *Other cryptoasset activities: Staking and mining*

The government is accelerating exploratory work to develop a clear definition of cryptoasset staking on a Proof of Stake (PoS) blockchain, to establish a taxonomy of different PoS staking business models in the market, and to identify how to mitigate associated risks and take advantage of the potential benefits of a carefully defined, permitted form of staking in the U.K. It is the government’s view that any activities, services or products marketed as “staking” but which do not directly facilitate a validation process on a PoS blockchain should not be currently considered staking.

The government also confirmed it does not intend to regulate mining at this stage, recognising that mining in and of itself does not constitute a financial services activity.

#### ii. Update on plans for the regulation of fiat-backed stablecoins

The government intends to facilitate and regulate the use of fiat-backed stablecoins in U.K. payment chains. In order to deliver this, the government intends to bring the regulation of certain activities relating to fiat-backed stablecoins within the U.K.’s financial services regulatory perimeter. This will include bringing the use of fiat-backed stablecoins in

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payment chains into the Payment Services Regulations 2017 (**PSRs**). To achieve this, the government plans to bring forward secondary legislation as soon as possible and by early 2024, subject to available parliamentary time.

Furthermore, the government intends to regulate the activities of issuance and custody of fiat-backed stablecoins when issued in or from the U.K. irrespective of their uses. It will define the category of fiat-backed stablecoins in legislation, and the definition will capture those stablecoins which seek to maintain a stable value by reference to a fiat currency and hold (in part or wholly) that currency as “backing.” Importantly, algorithmic or crypto-backed stablecoins will be excluded from the definition, as will commodity-linked tokens. The activities of issuance and custody of U.K.-issued fiat-backed stablecoin will be included in the RAO. In respect of overseas stablecoins, the government’s plan is that it will, along with the FCA, engage industry ahead of legislation on options for doing this safely.

The government will ensure that the FCA has the power to require that the backing assets of fiat-backed stablecoins are held in a statutory trust and that the terms of the trust are set out in the FCA’s rules.

With regard to insolvency, it is expected that the standard corporate insolvency procedures as enshrined in the Insolvency Act 1986 will apply.

A new regulated activity under the RAO will be created for custody of fiat-backed stablecoins, which will comprise the (i) safeguarding, (ii) safeguarding and administering, or (iii) the arranging of safeguarding or safeguarding and administering of U.K.-issued fiat-backed stablecoins.

Amendments to the PSRs will bring into regulation payment chains for mixed stablecoin payments and pure stablecoin payments. In line with fiat peer-to-peer transfer, this will not include peer-to-peer stablecoin transfers where the payment service underpinning or facilitating the transfer is not offered on a commercial basis. The intention is that the regulatory regime would cover the use of fiat-backed stablecoin issued in or from the U.K.

Where an FCA authorised fiat-backed stablecoin is recognised as systemic, it is expected that the Bank of England (**BoE**) will be the lead prudential regulatory but that the firm will continue to be regulated by the FCA as conduct. Details of the government’s plans for the BoE’s role are included in a separate document addressed below.

iii. The response to the consultation on managing the failure of systemic digital settlement asset (including stablecoin) firms

The government’s intention is that the Financial Market Infrastructure Special Administration Regime (**FMI SAR**) will apply, with amendments, to systemic payment systems, and service providers of systemic importance to those systems, which use digital settlement assets (including stablecoin) (**DSAs**). Under the FMI SAR, an administrator will seek to ensure that the services of a failed payment system are continued ahead of the interests of its creditors.

DSAs will be brought under the remit of the BoE and the Payment Systems Regulator (PSR) to achieve this. To that end, the government intends to:

- a) appoint the FMI SAR as the primary regime for systemic DSA firms which are not banks;
- b) establish an additional objective for the FMI SAR, as it applies to systemic DSA firms only, focused on the return or transfer of customer funds and custody assets, similar to that found in the Payments & Electronic Money Special Administration Regime;
- c) provide the BoE with the power to direct administrators, and to introduce further rules to ensure the additional objective can be effectively implemented when applied to systemic DSA firms; and
- d) require the BoE to consult with the FCA prior to seeking an administration order or directing administrators in respect of systemic DSA firms subject to regulatory requirements imposed by both the Bank and FCA.

The government acknowledged that the FMI SAR regime may not fully address the potential consequences of a systemic DSA firm becoming insolvent, due to the potentially different structure that such a firm may have to traditional payment systems. It therefore notes that, in due course, it may conduct further work to consider whether

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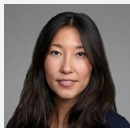
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a bespoke legal framework is appropriate.

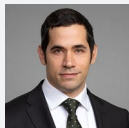
It is anticipated that the BoE will publish its own paper on the regulatory regime for systemic stablecoin arrangements in due course. In terms of the government's next steps, it plans to:

- a) lay regulations to appoint the FMI SAR as the primary regime for systemic DSA firms, establish an additional objective, and provide the BoE with the requisite powers as described above; and
- b) make the requisite insolvency rules to consider issues such as the transfer or return of customer funds and custody assets under the FMI SAR.

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- a) [https://assets.publishing.service.gov.uk/media/653bd1a180884d0013f71cca/Future\\_financial\\_services\\_regulatory\\_regime\\_for\\_cryptoassets\\_RESPONSE.pdf](https://assets.publishing.service.gov.uk/media/653bd1a180884d0013f71cca/Future_financial_services_regulatory_regime_for_cryptoassets_RESPONSE.pdf)
- i. [https://assets.publishing.service.gov.uk/media/653a82b7e6c968000daa9bdd/Update\\_on\\_Plans\\_for\\_Regulation\\_of\\_Fiat-backed\\_Stablecoins\\_13.10.23\\_FINAL.pdf](https://assets.publishing.service.gov.uk/media/653a82b7e6c968000daa9bdd/Update_on_Plans_for_Regulation_of_Fiat-backed_Stablecoins_13.10.23_FINAL.pdf)
- ii. [https://assets.publishing.service.gov.uk/media/653a6d5fd10f3500139a69f7/CR\\_Managing\\_the\\_failure\\_of\\_systemic\\_dsa\\_including\\_stablecoin\\_firms.pdf](https://assets.publishing.service.gov.uk/media/653a6d5fd10f3500139a69f7/CR_Managing_the_failure_of_systemic_dsa_including_stablecoin_firms.pdf)
- iii. "cryptoasset" means any cryptographically secured digital representation of value or contractual rights that— (a) can be transferred, stored or traded electronically, and (b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)."
- iv. [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/1122741/Draft\\_SI\\_Admissions\\_to\\_Trading\\_and\\_Public\\_Offer\\_Regime.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1122741/Draft_SI_Admissions_to_Trading_and_Public_Offer_Regime.pdf)