

Crypto regulation: UK FCA clarifies regulatory perimeter – but leaves open questions over its tech neutrality

August 2019

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On 31 July 2019 the UK Financial Conduct Authority (FCA) published final Guidance¹ on the cryptoasset activities within its regulatory perimeter, in response to feedback on its January 2019 consultation paper² and as trailed in last year's UK Cryptoassets Taskforce final report³.

Changes made to January's draft guidance in the FCA's final policy statement PS19/22, which also gives the FCA's feedback to the 92 responses to its consultation, are primarily intended to provide greater clarity on what is and isn't regulated. The final Guidance sets out where tokens are likely to be specified investments under the Regulated Activities Order (RAO), e-money under the E-Money Regulations (EMRs), or within scope of the Payment Services Regulations (PSRs).

The FCA has also updated its Cryptoassets webpage⁴ which lists regulated security and e-money tokens, unregulated utility and exchange tokens, and its current open consultation⁵ on potentially prohibiting the retail sale of derivatives and exchange traded notes referencing certain types of unregulated cryptoassets.

Is the FCA revisiting its tech-neutrality?

Though this is not flagged by the FCA in its feedback, a comparison of the draft and final Guidance shows that all references in January's draft to the FCA's policy of technology neutrality when considering whether a firm is carrying on a regulated activity, and to the FCA's agnostic stance regarding the type of technology used by firms, have been deleted from the final Guidance.

The FCA's approach to regulation has up to now explicitly been technology neutral, such that it does not mandate regulated firms to use a particular type of technology to facilitate their services, while acknowledging that the choice of technology may influence the way regulation applies to take account of any unique risks associated with carrying on a certain activity.

¹ <https://www.fca.org.uk/publication/policy/ps19-22.pdf>

² <https://www.whitecase.com/publications/alert/icos-and-security-tokens-fca-consults-crypto-guidance>

³ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

⁴ <https://www.fca.org.uk/firms/cryptoassets>

⁵ <https://www.fca.org.uk/publications/consultation-papers/cp19-22-restricting-sale-retail-clients-investment-products-reference-cryptoassets>

The FCA's Director of Innovation was seen openly questioning⁶ in June 2019 whether the FCA is able to remain 'technology-neutral' in a world where technology is so embedded in the delivery of financial services and so fundamental a driver of consumer outcomes.

It is not yet clear to observers whether these are indicators of a change in the FCA's thinking towards preferring, or even mandating, certain technologies over others.

Consumer protection issues and AML

The FCA warns consumers who are considering buying unregulated cryptoassets (e.g. Bitcoin, Ether and XRP) that they have no intrinsic value and are not covered by the Financial Services Compensation Scheme (FSCS) or the Financial Ombudsman Service (FOS). Where the FCA is made aware of potentially fraudulent or harmful unregulated cryptoasset activities in the cryptoasset market, it will work with the Advertising Standards Agency, local police forces and other agencies.

The FCA remains concerned that the complex tech used for cryptoassets could potentially create equality and diversity considerations for certain consumers and will continue to look at this aspect following implementation of the final Guidance. It is also considering the complex nature of cryptoassets, and misinformation targeted at certain groups of consumers as part of its wider consumer research work.

The FCA notes that firms may be impacted by the UK's transposition by 10 January 2020 of the EU Fifth Anti-Money Laundering Directive (MLD5)⁷ and should ensure they know how existing anti-money laundering (AML) requirements apply to their business. The FCA will be the UK supervisor under MLD5 and intends to consult later this year on its approach.

Unregulated cryptoassets; authorised firms

- *FCA authorised firms carrying on unregulated cryptoasset activities*: The FCA notes that authorised firms may still need to apply the FCA's Principles for Business (PRIN) and the individual conduct rules under the Senior Managers and Certification Regime (SMCR) to any unregulated activity. The FCA can take action for breaches of both. Unregulated activities may also be relevant in assessing whether the firm continues to comply with the FCA's Threshold Conditions for authorisation.
- *Exchange tokens*: Exchange tokens fall outside the regulatory perimeter, but are within scope of the MLD5 AML regime.
- *Exchange tokens used to facilitate regulated payment services e.g. international money remittance*: These exchange tokens are unregulated, but the PSRs would apply to each side of the remittance – and, from 1 August 2019, PRIN and the FCA's Banking Conduct of Business sourcebook (BCOBS).
- *Utility tokens*: Utility tokens are outside the regulatory perimeter unless they fall within the definition of e-money, in which case they would be regulated under the EMRs.

Regulated cryptoassets

- *E-money tokens*: The FCA has created a new regulated category specifically for e-money tokens regulated as electronic money in the EMRs, i.e.:
 - electronically stored monetary value that represents a claim on the issuer
 - issued on receipt of funds for the purpose of making payment transactions
 - accepted by a person other than the issuer
 - not excluded by regulation 3 of the EMRs.

⁶ <https://www.fca.org.uk/news/speeches/innovation-hub-innovation-culture>

⁷ <https://www.whitecase.com/publications/alert/cryptoassets-and-open-source-software-uk-proposes-gold-plating-transposition-eu>

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- *Security tokens*: These tokens continue to be described in the final Guidance as providing rights and obligations akin to specified investments as set out in the RAO, excluding e-money.
 - *Stablecoins*: The FCA has amended the draft Guidance to provide further clarity on stablecoins. It notes that not every stablecoin will meet the definition of e-money or security token – instead, it may be a derivative, a unit in a collective investment scheme, a debt security or another type of specified investment. Stabilisation methods listed include fiat-backed, crypto-collateralised, asset-backed, and algorithmically stabilised.

Market observations

- *Airdrops*: Respondents to the FCA's January consultation referenced the distribution of tokens, usually for free, to consumers. These “airdrops” are primarily employed by new networks to attract more users but have also been employed by existing networks to gain additional users or generate further attention. The FCA notes that a specified investment is not contingent on its being purchased for value, and a token can be a security token even if nothing is received for it.
- *Other token types*: Respondents also mentioned additional types of tokens. If they do not meet the definition of e-money tokens or security tokens, these will be unregulated. New types include:
 - **“bank settlement tokens”** used by banks to increase back-office efficiency and for settlement,
 - **“dual tokens”** which can move between categories during their lifecycle, and sometimes work in tandem with other tokens during the launch of a new network – in either case, the regulatory treatment depends on the token's intrinsic structure, the rights attached to the tokens and how it is used in practice. If the token at some point reaches the definition of an e-money token or a security token, then it will become regulated, and
 - **“equity and debt tokens”** which are likely security tokens.

Brexit impact and international harmonisation

The FCA assumes a Brexit transition period up to end December 2020 and requires firms to continue with implementation plans for EU legislation yet to come into effect before then, including MLD5.

It will be monitoring EU and international regulators' work on the scope and detail of cryptoasset regulation. It points to inherent structural differences in different jurisdictions' securities markets and legal and regulatory frameworks and will work through the Global Financial Innovation Network (GFIN), the International Organization of Securities Commissions (IOSCO), the European Commission and the European Supervisory Authorities to encourage other regulators to approach cryptoassets in a consistent way.

What does this mean for UK market participants?

Improved consumer understanding of the regulatory perimeter may be measured via FCA survey in a year's time, and also by analysing consumer calls through the FCA Consumer Hub or Contact Centre. HM Treasury (HMT) is also scheduled to consult on whether further regulation is required in the cryptoasset market, particularly in relation to unregulated cryptoassets, and HMT and the FCA are working on MLD5 transposition.

The FCA expects an increase in the number and accuracy of authorisation submissions from firms undertaking regulated cryptoasset activities, fewer referrals to its Unauthorised Business Division and Financial Promotions team and also less need for support through FCA Innovate.

If firms' actions align with the FCA Guidance, the FCA will treat them as complying with the relevant rule or requirement. It notes that this can be a persuasive factor in a court's determination and encourages firms to seek expert advice if they are unsure whether their products, services or activities fall within the regulatory perimeter or are otherwise regulated.

Security tokens: US update

To date, the US has chosen a different path in providing regulatory clarity around digital asset securities. In addition to the April 3, 2019 Framework for “Investment Contract” Analysis of Digital Assets (the “Framework”), in July 2019 the Securities and Exchange Commission qualified the first two Regulation A token offerings by Blockstack PBC and YouNow, Inc. Through the qualification of these two Regulation A offerings the SEC essentially provided a viable route for structuring the sale and distribution of digital asset securities. Furthermore, the SEC’s Division of Corporation Finance granted two no action positions in connection with the *TurnKey Jet, Inc.* letter and the *Pocketful of Quarters, Inc.* letter, which demonstrated a real life application of the Framework when the digital asset does not constitute a security for purposes of federal securities laws, but rather a store of value that is not used for purposes of raising capital to build a profitable enterprise (*TurnKey Jet, Inc.* (Apr. 3, 2019); *Pocketful of Quarters, Inc.* (July 25, 2019)). The custody of digital asset securities continues to be an area where the US regulator is continuing to ask for input by market participants as also demonstrated by the joint statement the SEC and the US Financial Industry Regulatory Authority (FINRA) issued on July 8, 2019. That same month, US Treasury Secretary Mnuchin was quoted as expressly anticipating the upcoming publication of rules from US agencies to create a unified approach across all cryptoasset types in the US.

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