

ICOs and Security Tokens: FCA Consults on Crypto Guidance

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The UK FCA launched on 23 January 2019 its highly anticipated consultation¹ (CP19/3) on Guidance for market participants as to where certain cryptoassets sit in relation to the regulatory perimeter - and whether relevant stakeholders need to be FCA authorised. Comments are due by 5 April.

Last year's UK regulators' Cryptoassets Taskforce Final Report² trailed the FCA's aim to clarify the regulation of security tokens for market participants, including Initial Coin Offering (ICO) issuers and secondary market platforms, who may not realise that they fall within the current regulatory perimeter.

In parallel, the FCA has been monitoring for potential breaches by entities or individuals carrying out regulated activities without the appropriate authorisation³ and will be increasing its anti-avoidance focus on ICO issuers who market securities as non-regulated utility tokens.

CP19/3 sets out the FCA's views on where the tokens it has seen in its regulatory sandbox or in the market are likely to be "specified investments" under the Regulated Activities Order (RAO) (and where they are not), "financial instruments" such as "transferable securities" under the Markets in Financial Instruments Directive II (MiFID II), "e-money" under the E-Money Regulations (EMRs) or captured under the Payment Services Regulations (PSRs).

The FCA uses the term "security token" to denote tokens constituting "specified investments" under the RAO and notes that HM Treasury will shortly be publishing a consultation on potentially broadening the FCA's regulatory remit to capture additional types of cryptoassets.

What does this mean for market participants?

The Guidance is aimed at helping firms more easily determine whether certain cryptoassets fall within the perimeter by mapping them across to RAO and MiFID II instruments and investments, with case studies, an indicative list of market participants undertaking cryptoasset activities and the types of permissions they may need, and model Q&A.

The FCA is expecting the number of authorisation submissions from firms undertaking cryptoasset activities to increase as a result of the enhanced regulatory clarity provided by the final Guidance scheduled to be published before summer 2019, with commensurately fewer referrals to its Unauthorised Business Division and Financial Promotions team.

¹ <https://www.fca.org.uk/publication/consultation/cp19-03.pdf>

² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/752070/cryptoassets_taskforce_final_report_final_web.pdf

³ <https://www.fca.org.uk/publication/foi/foi5673-response.pdf>

Consumer protection

The FCA has commissioned research on UK consumers' use of cryptoassets (to be published shortly) and will be conducting a follow up consumer survey in 12 months' time to assess if the Guidance also helps consumers to understand the cryptoasset market better. Confusion over consumers' lack of recourse to the Financial Services Compensation Scheme (FSCS) and the Financial Ombudsman Service (FOS) is compounded by firms offering both regulated and unregulated cryptoasset products in parallel.

CP19/3 cites examples of consumer harm caused by poor cyber security, fraud, market infrastructure failings, volatility, misleading advertising and limited transparency around price formation and prospectus-type disclosures in the white papers typically accompanying ICOs.

The FCA will consult during 2019 on a potential prohibition of the sale to retail consumers of derivatives referencing certain types of cryptoassets e.g. exchange tokens, including contracts for difference (CFDs), options, futures and transferable securities.

Equality and Diversity

The FCA is also considering whether the complex technological aspects of cryptoassets could potentially create equality and diversity considerations for certain consumers, and asks for input on this.

Market abuse

While CP19/3 does not cover the Market Abuse Regulation (MAR), the FCA notes that the novel nature of the cryptoasset market may create new abusive behaviours which are not captured by current regulation and market monitoring and surveillance arrangements.

Prospectus and transparency requirements

While issuers of tokens may themselves not need to be authorised, the FCA flags that prospectus and transparency requirements may apply.

If a token is a transferable security and will either be offered to the public in the UK or admitted to trading on a regulated market, the issuer will need to publish a prospectus unless an exemption applies (e.g. for offers made entirely in the UK for less than €8m in any 12-month period). The FCA points out that for equity-type securities, historical financial information is required as well as a confirmation that the issuer has sufficient working capital and a capitalisation and indebtedness statement. New listed issuers of tokens also need to complete an eligibility review with the FCA.

Financial promotions

The FCA reminds firms to communicate financial promotions for cryptoasset products and services, regulated or unregulated, in a way which is clear, fair and not misleading, including setting out precisely which activities are regulated and those which are not, and ensuring that consumers can easily differentiate those activities which the firm is authorised by the FCA to conduct.

Money laundering

The FCA also reminds firms that the EU Fifth Anti-Money Laundering Directive will be transposed into UK law by the end of 2019, extending anti-money laundering and counter terrorism financing regulation to entities carrying out the following activities, pending formal consultation by HM Treasury:

- exchange between cryptoassets and fiat currencies
- exchange between one or more forms of cryptoassets
- transfer of cryptoassets
- safekeeping or administration of cryptoassets or instruments enabling control over cryptoassets
- participation in and provision of financial services related to an issuer's offer and/or sale of a cryptoasset

Security tokens: inside the regulatory perimeter

Factors listed by the FCA as indicative of an RAO “specified investment” include any contractual entitlement to profit share, revenues, payments or other benefits, quasi-voting rights and tradability on cryptoasset exchanges.

The FCA believes the most relevant RAO “specified investments” are shares, debt instruments, warrants, certificates representing certain securities, units in collective investment schemes, and rights and interests in investments. The FCA’s proposed Guidance on mapping these across to tokens is summarised as follows:

Shares

Tokens giving holders voting, dividend, capital distribution or similar rights to shares, or that represent ownership or control, are likely security tokens. But a token that provides the holder with the right to vote on future ICOs in which the firm will invest, and no other rights, would likely not be considered a share, since the voting rights give only direction and do not confer control-like decisions on the future of the firm.

For a token to be considered a MiFID II “transferable security” it must be capable of being traded on the capital markets, so tokens conferring ownership, control and similar rights which are so tradable are likely “transferable securities”.

Even if a token which looks like a share is not a MiFID II “transferable security” e.g. due to restrictions on transferability, it may still be capable of being an RAO “specified investment”.

Debt instruments

A token creating or acknowledging indebtedness by representing money owed to the holder is a debenture and constitutes a security token. If it is tradable on the capital markets, being transferable from one legal titleholder to another, it may be a MiFID II “transferable security” too.

Warrants

Tokens giving holders the right to subscribe for different tokens in the future, where the latter are RAO “specified investments”, will likely constitute warrants and thus securities.

Certificates representing certain securities

Tokens akin to depository receipts would fall in this security token category if they confer rights on the holder in relation to tokenised shares or tokenised debentures.

Units in collective investment schemes

A token acting as a vehicle through which profits or income are shared or pooled, or where the investment is managed as a whole by a market participant, is likely to be a collective investment scheme. References to pooled investments, pooled contributions or pooled profits in the ICO white paper could also render a token more like a security.

Rights and interests in investments

Tokens representing rights to or interests in certain investments, including those listed above, comprise RAO “specified investments”. So a token representing a right in a share is a security token, even though the token itself does not have the characteristics of a share.

Products referencing tokens

Products that reference tokens (e.g. derivatives) are very likely to fall within the regulatory perimeter as “specified investments” (either as options, futures or CFDs under the RAO) and may also be MiFID II “financial instruments”.

Jurisdictional differences

The FCA notes that different countries may define a security differently, so the nature of the token must be assessed for every jurisdiction in which the token is sold or in which the firm operates, to determine whether it triggers the application of any securities regulation.

Exchange tokens: outside the regulatory perimeter

The FCA asks stakeholders if they agree with its conclusion that exchange tokens are not RAO “specified investments” and currently fall outside the regulatory perimeter. While they can be held for the purpose of speculation rather than exchange, the FCA views this as insufficient for exchange tokens to constitute “specified investments”. So a cryptoasset exchange which only facilitates transfers of exchange tokens such as Bitcoin, Ether and Litecoin between participants is not carrying on a regulated activity.

The FCA gives a case study from its regulatory sandbox where exchange tokens are used to facilitate regulated payment services and the PSRs cover the fiat currency remittance at each end of the transfer, but not the use of cryptoassets in-between which acts as the vehicle for fast remittance. It seeks feedback on whether further Guidance on this use case could be beneficial.

Utility tokens

While the FCA regards utility tokens as not constituting MiFID II “specified investments” (even if traded on the secondary market and used for speculative investment purposes), they could be e-money in certain circumstances, so related activities could fall inside the perimeter.

Cryptoassets as e-money

Exchange tokens e.g. Bitcoin and Ether are unlikely to represent e-money because they are not usually centrally issued on the receipt of funds, nor do they represent a claim against an issuer.

But any cryptoasset could be e-money under the EMRs if it is electronically stored monetary value as represented by a claim on the electronic money issuer, which is issued on receipt of funds for the purpose of making payment transactions, accepted by a person other than the electronic money issuer and not excluded under the EMRs. “Electronic storage of monetary value” includes the possibility of using Distributed Ledger Technology (DLT) and cryptographically secured tokens to represent fiat funds e.g. GBP or EUR.

Stablecoins as e-money

Cryptoassets which establish a new sort of unit of account rather than representing fiat funds are unlikely to amount to e-money unless the value of the unit is pegged to a fiat currency, depending on the facts. The FCA considers that “stablecoins” which are “fiat-backed”, “fiat-collateralised” or “deposit-backed” by being pegged to e.g. USD (usually with a 1:1 backing) and used to pay for goods or services on a network, could potentially meet the definition of e-money if they also meet the criteria in the paragraph above.

Indicative list of market participants, potential activities and permissions

Table 1 in CP19/3 shows the main cryptoasset market participants likely to be carrying out regulated activities, some of the more common services they are likely to provide, and the permissions required to carry these out. Exchanges trading security tokens may be carrying out the RAO regulated activities of arranging deals in investments and making arrangements with a view to investments.

If the tokens are also MiFID II “financial instruments”, the firm may also need permission to operate a multi-lateral trading facility (MTF)⁴ or an organised trading facility (OTF).

Firms providing custody services as wallet providers in relation to such securities may need to apply to the FCA for the relevant permission for conducting the RAO regulated activity of safeguarding and administering investments.

The FCA seeks input on whether any other key market participants are involved in the cryptoasset market value chain or whether any activities are performed in the cryptoasset market which do not map neatly across to traditional securities.

⁴ The FCA noted in its July 2018 response to a freedom of information request at <https://www.fca.org.uk/publication/foi/foi5824-response.pdf> that a cryptocurrency exchange had applied for an MTF licence.

Model Q&A

The Guidance Q&A includes model answers to the following questions:

- If I accept only cryptoassets as a form of payment for my token, can it still be a security token? The FCA model answer distinguishes e-money regulations where a token must be issued on receipt of fiat funds vs security tokens which disregard whether they are exchanged for fiat funds, exchange tokens, or other forms of cryptoassets, or in some cases anything at all.
- Utility tokens: My network is/aims to be fully decentralised and I will not have any control over the network anymore. Does this have an impact on whether the tokens could be regulated or not? The FCA model answer notes that the more decentralised the network, the less likely it is that the token will confer enforceable rights against any particular entity, so it may not confer similar rights to those of RAO “specified investments”.
- What other consumer protections may apply under UK law to utility tokens or cryptocurrencies that are not specified investments (e.g. not subject to financial service regulation)? The FCA model answer lists Financial Promotion rules, Conduct of Business rules, Principles for Business rules, the Senior Managers and Certification Regime (SMCR) and the accountability regime, the Advertising Codes regulated by the Advertising Standards Authority, Trading Standards, general common law, criminal law, and the General Data Protection Regulation.

Benefits of cryptoassets

The FCA views the only benefits of the current generation of cryptoassets as increased speed and a reduction in cost of cross-border money remittance when cryptoassets are used as a vehicle for exchange, but notes that this is a rapidly developing market.

Firms providing innovative propositions with genuine consumer benefits are encouraged to contact the FCA's Innovate team if they are unsure about which regulated activities apply to their business models.

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