

Guidance of Crypto Assets – CP 19/3 – January 2019

General Comments:

- We very much welcome CP 19/3 and believe it helps to position this complex area of innovation. Our comments below, aim to contribute to the creation of a safe and workable framework for crypto and DLT.
- We would suggest that the FCA should take a leadership position on use of English language when referring to the crypto marketplace and DLT. Words like:
 - asset in crypto-asset could misrepresent quality to lay persons. It implies intrinsic value;
 - standardised – the standards used in the crypto ecosystem are not yet recognised by any reputable standards setting bodies;
 - “cryptographically-secured record” – the use of the word secured implies safety and the level of theft from crypto markets and DLT stored assets is enormous, suggesting that even if the cryptography is strong, the storage, operational and recording methodologies are anything but secure. Statements at conferences talk of theft levels reaching over \$1.5 Bn in 2018 alone. This is around 1% of its market capitalisation. Encoded may be a better word.
 - classifying stablecoins as stablecoins when underpinned by cryptoassets and derivatives thereof. There is no intrinsic stability to such products as we doubt that any reputable bank or CCP would accept cryptoassets as collateral and therefore how can the coin be said to be stable.
- Section 2.20 onwards, Harm to Customers does not appear to deal with the interface to the crypto market, the access to and from the crypto markets, and whether the boundary should have higher policing levels. Customers are harmed in the way that the FCA outlines, but also because there is easy, unsupervised and unregulated access to the crypto ecosystem. By contrast, it is often difficult or impossible due to the policies of the operators, to leave the ecosystem. Many platforms or ICOs have disappeared or restrict the redemption back to Fiat. Also, once in the ecosystem, unlike the regulated markets, one is not interacting with a homogenous group of regulated counterparties with clean histories. This asymmetric entry/exit structure and contaminated ecosystem means that the conventional policies of the FCA or the UK Government as a whole need re-thinking as it is not business as usual. Fundamental questions need to be asked and answered – should an individual be able to use their credit/debit card without any checking or validation by the card operators to enter this ecosystem? When Fiat is returned from the crypto ecosystem to the nominated bank account after have interacted with unlaunders monies, sourced in some instances from the dark net etc, is this still clean? How clean does it need to be – 100%, 95%? These policy issues do not appear to be addressed in this consultation paper and they are fundamental.
- The crypto platforms and ICO issuers can link to the fiat or regulated world via a simple payment gateway e.g. visa/mastercard. There seems to be no additional licensing requirements for crypto platforms to be added to payment networks and no additional surveillance, control and validation obligations on payor banks when transferring money into the crypto environments. It would not be unreasonable for all transfers to be validated by fraud / surveillance call centres to ensure that the payor is really aware of what they are doing as well as introducing a new collateral compensation scheme funded wholly by the transferee crypto platforms for the privilege of accessing the fiat network. This compensation scheme can be used to finance losses. This is not unreasonable given the scale of theft relative to the size of the market especially when the crypto space uses unproven

technologies, and given, in the case of crypto exchanges, many of them are acting as principal rather than being neutral matchers of supply and demand.

- A more fundamental question would be - why should access to these products be available at all to unsophisticated investors and the poor? Should it be stopped at the regulated boundary – the card interface/bank interface, black listed? Or should there be a white list of ICOs / crypto platforms that meet the standards of the regulated space.
- A lot of these platforms publicly mock the conventional Fiat/regulated space and propose that they are offering the new panacea. If that was the case, why do they need to collect Fiat? Their product should have intrinsic value as a mutual exclusive alternative to Fiat or securities. If their lifeblood of Fiat was cut off, could they survive and what would the world lose?
- It is very surprising that regulators are allowing the use of risky CFDs on crypto assets – this is securing sentiment on sentiment and then leveraging it. How does this sit with the obligation on regulators to protect investors?
- There is no sanctions or enforcement schemes against ICO / crypto exchange platforms or their owners. There appears to be no finality of legal title even for security tokens.

Specific Questions

- *Q1: Do you agree that exchange tokens do not constitute specified investments and do not fall within the FCA's regulatory perimeter? If not, please explain why.*
 - Yes, but the Fiat/securities/commodities interface to exchange tokens needs a higher level of regulation and supervision, and in fact a question should be asked why there should be a Fiat or securities/commodities interface to exchange tokens. If there was no such interface, as stated above, then the intrinsic value of such tokens would need a new paradigm of value and extraction of real assets (fiat, securities and commodities) into an under-world of fraud would be more difficult. We are not saying that the whole crypto space is disreputable.
- *Q2: Do you agree with our assessment of how security tokens can be categorised as a specified investment or financial instrument? If not, please explain why*
 - Yes, however we note that the case studies and descriptions exclude any specified:
 - form of tokenisation as we believe the FCA is relying on its assumption that it is possible for the FCA to be technology neutral. We believe that this may not be the case as the smart contract or other components of technology may not safely translate all the rights of a security into the security token;
 - regulatory licensed persons environment for the forming/defining and custody of security tokens;
 - safety and recoverability of security tokens under all circumstances e.g. even if there is a loss of private keys. In the regulated environment, there are very high standards of technology imposed on trading venues, post-trade FMIs and investment firms. The same is not the case for security tokens creating a whole range of risks; and
 - the requirements for covered security tokens, e.g. security tokens which are “depository receipts” of their underlying.

If these matters are not specified, it can create regulatory arbitrage between security tokens and securities.

- *Q3: Do you agree with our assessment of utility tokens? If not, please explain why.*
 - Yes
- *Q4: Do you agree with our assessment that exchange tokens could be used to facilitate regulated payments?*
 - Yes, but the example shown may not cover all the use cases on how the parties build up inventories of currencies and the cryptoassets. If the cryptoasset is purely a common internal multi-currency conversion tool and all debtors and creditors of Fiat are compliance checked then the token could be used to facilitate regulated payments with no additional regulatory overload. However, if the token is tradeable in its own right on multiple crypto exchanges or can be issued via ICOs, and if the Fiat can be accumulated from unregulated sources and not compliance checked then the exchange tokens can be used to facilitate regulated payments, but it would seem that regulatory guidance is required to cover how compliance checks and history should be undertaken.
- *Q5: Are there other use cases of cryptoassets being used to facilitate payments where further Guidance could be beneficial? If so, please state what they are.*
 - The issues raised in Q4 need to be answered.
 - Whether and when there is any requirement to identify the ownership history of the cryptoasset and ensure it complies with regulatory requirements such as AML.
- *Q6: Do you agree with our assessment of stablecoins in respect of the perimeter?*
 - We believe the perimeter needs to distinguish between stablecoins, where:
 - the initial deposit and the stabilisation mechanism is based on Fiat e.g. deposit £1 and receive £1 equivalent stablecoin unit of value; versus
 - the initial deposit and the stabilisation mechanism is based on cryptoasset and there is some sort of swap / conversion mechanism e.g. deposit 1 bitcoin and receive say £3,000 equivalent stablecoin unit of value
 - We believe that in the former case, the fiat based stablecoins need a definitive set of rules to determine their issuance, custody, redemption etc. otherwise there is a risk that the coins will have a very slow and expensive route to realisation.
 - We believe that there may be a need to provide guidance on stablecoins being issued by regulated investment firms versus unregulated entities, and also third country stablecoins usable in the UK
 - Stablecoins may not be issued by a central authority but could be an almost identical substitute for say Fiat. Where the features are sufficiently similar, or are considered by users to be sufficiently similar, should the regulator require the issuer to have an e-Money license? If so, what would be the criteria of similarity of the stablecoin?
- *Q7: Do all the sections above cover the main types of business models and tokens that are being developed in the market?*
 - Probably not, there is endless innovation and trialling of ideas.
- *Q8: Are there other significant tokens or models that we haven't considered?*
 - Stablecoins issued by regulated investment firms that may be systemically important.

- *Q9: Are there other key market participants that are a part of the cryptoasset market value chain?*
 - In the case of security tokens, we believe Central Securities Depositories/Registrars would be part of the cryptoasset market value chain, particularly if the venue was endeavouring to offer finality of settlement and legal title to the security token.
 - We also believe the miners are not always outside the perimeter as they can affect the “legal title” as they affect settlement.
- *Q10: Are there activities that market participants carry on in the cryptoasset market that do not map neatly into traditional securities?*
 - The business models of cryptoasset providers do not map to the structure of regulated equivalents and the activities of many segregated licensed persons get co-mingled, raising the question of conflicts of interest and objectivity. Alternatively, does it raise the question that the regulated environment is too fragmented by a large number of intermediary types.