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Future financial services regulatory regime for cryptoassets–consultation response and call for evidence

The Crypto Council for Innovation ("CCI") submits this letter in response to HM Treasury's future regulatory regime for cryptoassets (the "Consultation"). CCI is a global alliance of crypto industry leaders with a mission to communicate the benefits of crypto/Web3 and demonstrate its transformational promise. Our members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto. The Consultation is welcomed by us and our members and marks a significant and important milestone for the global cryptoasset industry. It presents the opportunity for the United Kingdom to establish itself as the leading and most attractive destination for firms and exchanges that wish to grow their businesses and benefit from a credible, responsible regulatory regime with sound policy objectives that promotes innovation and protects consumers.

We and our members support HM Treasury in its important work in developing a world-class regulatory framework for crypto in the United Kingdom. It will be essential to align the policy goals of this Consultation with the actions of the regulators charged with delivering on the objectives. We are ready and willing to work with HM Treasury, regulators, and wider industry participants to accomplish the policy goals of the Consultation, and ensure that the most transformative innovations of this generation and the next can be incubated and developed in the United Kingdom.

The United Kingdom's innovative and outcomes-focused approach to regulating financial services has created a framework capable of evolution alongside financial products themselves, whilst at the same time being robust and proportionate. We believe that this approach lends itself to developing a suitably tailored world-leading regulatory regime for cryptoasset activity; one that can promote growth in the United Kingdom ahead of other jurisdictions. Capitalising on the demand for clear and effective cryptoasset regulation is advantageous for businesses, customers, and authorities alike. The future contemplated by HM Treasury's proposals is highly promising and attractive to our members, and we embrace the opportunity to contribute to this in our responses below.

About CCI

CCI is an alliance of crypto industry leaders with a mission to communicate the benefits of crypto and demonstrate its transformational promise. CCI members include some of the leading global companies and investors operating in the crypto industry. CCI members span the crypto ecosystem and share the goal of encouraging the responsible global regulation of crypto to

unlock economic potential, improve lives, foster financial inclusion, protect national security, and disrupt illicit activity. We and our members are particularly excited about the potential for the United Kingdom to become a global hub for cryptoasset business and are willing to work alongside the government to realise this vision.

Introductory Remarks

Blockchain technology enables the creation of decentralised internet infrastructure that has the potential to democratise the internet. This enables several significant potential benefits, including:

- Promotion of Competition - decentralisation enables blockchain networks to be credibly neutral and composable. This ensures that they function like public infrastructure and makes them attractive to build on top of. This then lowers the barrier to entry for anyone wanting to build an internet business, as it provides internet infrastructure upon which such businesses can build.
- Safeguards Freedoms - decentralisation necessitates the broad distribution of control of blockchain networks amongst their stakeholders and ensures that the network effects of such systems accrue to such stakeholders, not just the companies that created them. By limiting the power that can accrue to companies in this manner, decentralisation limits corporate power to gatekeep, censor or otherwise infringe individual liberties. As a result, decentralisation has the power to safeguard freedoms.
- Reward Stakeholders - the decentralisation of Web3 networks and protocols also enables the design of systems that prioritise stakeholder capitalism–systems that are designed to more equitably serve the interests of all stakeholders (including end-users), rather than reward only a certain subset of stakeholders.

Cryptoassets are a critical component of decentralisation. For blockchains, cryptoassets fund the computational resources (i.e., miners or validators) that enable the network to function. For smart contract protocols (software deployed to a blockchain that provides enhanced functionality), digital assets can be necessary for the functioning of the protocol (like with blockchains) or their use can be limited to governance. Developers of blockchains and smart contract protocols will typically issue cryptoassets to their employees as a reward for having developed its protocol and to its investors for having funded the development of its protocol in equity private placement transactions. Such issuances are typically structured in accordance with applicable exemptions under securities or other laws. The remaining digital assets of a given protocol are often distributed as incentive-based rewards (such as in exchange for mining, validation, staking, or liquidity mining) or for free to users of the network via “airdrops” as well as to a foundation that acts on behalf of the protocol’s ecosystem.

The employees, investors, protocol miners, validators, users, and any other recipients or acquirers of the protocol’s cryptoassets typically make up the constituents of any decentralised governance mechanism of such protocol, and therefore, the process of issuing such cryptoassets is a key step in handing control of such system from a centralised entity to a decentralised organisation. Any new restrictions to these types of primary and secondary transactions of decentralised cryptoassets would thereby add friction to the process of decentralisation, dissuading developers from pursuing decentralisation and harming innovation. Furthermore, where the value of such cryptoassets is not dependent on the original developer company and is instead dependent on market forces and the functioning of the decentralised protocol, such restrictions would be unnecessary.

We believe consideration should be given to a framework that enables decentralised cryptoassets to be issued in certain limited types of primary transactions and secondary transactions without the need for financial services authorisation, or disclosure requirements, which would undermine the ability of any issuer of such assets to ultimately decentralise the protocols to which such cryptoassets relate.

Responses to the Consultation

We welcome the wide and informed set of questions HM Treasury has set out in the Consultation. In our response, we have focused on addressing the questions which we believe are most pertinent to establishing the United Kingdom as the leading global hub for cryptoassets and are most important to our members.

We have noted a number of issues below where further research is required, due to the unique nature of the crypto industry. As we develop our thinking on these issues, we and our members would be pleased to discuss such issues with you further, including through periodic or quarterly meetings.

1. Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please specify why.

The proposed expansion of the current definition of "specified investments" to capture cryptoasset activity in financial services is a welcome step in providing certainty to the industry. We agree that clarity as to the precise scope of the FCA's remit would enable cryptoasset businesses to conduct activity with efficacy and continue to grow. We also agree with the Consultation's view that the definition of cryptoasset is very broad and covers a wide range of tokens and digital assets.

We broadly agree with the UK's "same risk, same regulatory outcome" approach to regulation, and are encouraged by the many examples of regulatory provisions derived from traditional financial services regulation being tailored for cryptoassets in the Consultation. Crucially, care needs to be taken to understand whether equivalent crypto models truly present the "same risk." Such tailoring of traditional rules will ensure that regulation stays proportionate while maintaining the "same outcomes" as for traditional finance. Simply copying out traditional finance regulations poses a danger of over-regulation, which would inhibit development and even militate against achieving the "same outcome." Regulatory regimes should be "technology neutral"; that is, they should not favour perceived winners amongst nascent technologies and allow market participants to choose for themselves the most effective technology based on individual need. It is important for there to be a level playing field that at the same time recognises that activities carried by digital operators carry different benefits as well as risks.

For this reason, we believe it is important for any regulatory change to include cryptoassets as a type of "specified investments" focuses on the cryptoassets which are similar to investments currently included within the definition of "specified investments." For example, we understand why security tokens and certain stablecoins would fall within the definition. The value of such assets is driven by the actions of a centralised management team, which is also the case with traditional securities. It is, therefore, sensible for such tokens to be regulated using a framework similar to traditional financial services instruments.

In contrast, bringing tokens such as NFTs, utility tokens, governance tokens, or fan tokens within the definition of “specified investments” in our view, would extend the regulatory perimeter too far. This would result in tokens falling within “specified investments” where analogous non-digital equivalents would clearly fall outside the scope of the definition. We do not believe that is the intention behind the proposed changes and would welcome clarity that the cryptoassets included within the definition will be narrower than all cryptoasset classes.

The new regulatory regime should include exemptions for decentralised finance (DeFi), even if the treatment of DeFi is deferred to future phases. DeFi is fundamentally different from traditional financial services, or even to centralised finance (CeFi) cryptoasset exchanges. It does not give rise to the same risks, and therefore the same regulation will not deliver the same regulatory outcomes. We provide further analysis on this point in our response to question 36.

In light of the above, we believe that a separate classification or further clarification is necessary with respect to tokens of decentralised protocols, which include but are not limited to, “layer-1” and “layer-2” blockchains (such as Ethereum, Polygon, and Avalanche), as well as smart contract protocols deployed to such blockchains like Uniswap and Compound Protocol. Where protocols are decentralised, their digital assets are less analogous to the items currently captured by the “specific investments” definition, due to asset values not being affected or controlled by a central management team. These are more analogous to non-digital equivalents, such as currencies or commodities, the direct exchange of which is currently unregulated. The decentralised nature of the underlying protocol obviates many of the risks that regulations relating to primary transactions (such as issuance, validation, and airdropping) and secondary transactions (including exchanging) involving “specified investments” are intended to address. Further, the regulation of secondary transactions in decentralised tokens is problematic because it potentially restricts the ability of such tokens to be fully decentralised.

However, we would support the regulation of other activities involving decentralised tokens which have analogous risks when provided by a centralised entity, such as lending, custody, borrowing, and derivatives.

2. Do you agree with HM Treasury’s proposal to leave cryptoassets outside of the definition of a “financial instrument”? If not, then please specify why.

We agree with the proposal to leave cryptoassets outside the definition of “financial instrument.”

3. Do you see any potential challenges or issues with HM Treasury’s intention to use the DAR to legislate for certain cryptoasset activities?

Any regulatory framework, be it under the FSMA or the DAR, should be tailored to reflect the variety of cryptoassets and sensitive to technological developments in the industry. On the face of it, the DAR has a wide reach. We would request any future regime be consulted in advance of any detailed rules being introduced with market participants in order to achieve the same degree of certainty and regulatory understanding afforded by the FSMA framework. In particular, the precise definition and scope of activities “relating to financial markets” should be clarified. Further, it would be conducive to market certainty for participants to know the position of firms that may be restrained by DAR but are awaiting authorisation.

5. Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

We query the interaction between the regime for fiat-based stablecoins and the broader cryptoassets regime. We understand that custody of fiat-based stablecoins used as a "means of payment" will be a regulated activity under the stablecoin regime and that this regime will be adapted from the payment services regime. The effect of this is that most cryptoasset exchanges operating in the UK will be required to seek authorisation under the stablecoin regime or to stop providing stablecoins in their exchange offering, as most exchanges provide both custody and exchange as one service. In the case where exchanges apply for authorisation, this will result in an inappropriate mismatch where the core service of exchanges will not be regulated and only a narrow subset of their activities are subject to regulatory requirements. We would propose that custody of stablecoins is addressed as part of the broader phase 2 regime, which will regulate both the exchange and custody of most cryptoassets and welcome clarity from HM Treasury on this issue.

6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

We support a phased approach to the introduction of the new regulatory regime to reflect the differing classes of cryptoassets and to allow for time to consult on detailed rules in each area. We also believe that, while certain categories of cryptoassets are already relatively well understood, others may not be so easily categorised, including those that relate to decentralised protocols as well as smart contract protocols deployed to such blockchains DeFi, being fundamentally different from CeFi, will also require more time to develop and mature before an appropriate regulatory regime can be designed. The phased approach will allow the government, regulators, and market participants to work together to design an appropriate regulatory regime for certain types of cryptoassets and DeFi without stifling innovation and growth. In addition to these general principles, we would note the following specific points in relation to the proposed phasing of the new regulatory regime.

Firstly, while the concept of stablecoins is better understood by market participants than certain other cryptoassets, we note that the regulatory perimeter for stablecoins remains somewhat unclear. Stablecoins issued by a decentralised protocol face the same general issues as the regulation of DeFi (please see our response to question 36). Stablecoins that are not issued by a centralised entity should remain outside of the regulatory perimeter.

Secondly, stablecoins are critical for the cryptoasset ecosystem in ways that go further than their use as a "means of payment" as set out in the Consultation. To restrict their definition to fiat-backed tokens only would inadvertently lead to the re-categorision of certain existing stablecoins which are not necessarily fiat-backed but are issued by a centralised issuer, as a different kind of cryptoasset. Stablecoins (howsoever described or 'backed') that are used for payment purposes may also fall within the remit of the Payment Services Regulations (the "PSRs"), and it remains to be seen how this regime fits together with FSMA in this context. The construction of "used for payment" is notably broad, and we believe careful further consideration is needed as to what activity will be caught by this proposed definition. For example, we would welcome clarity as to whether the government intends firms to register under the PSRs as well as obtain authorisation under FSMA. It is also unclear how fiat-backed stablecoins, once regulated pursuant to Phase 1, will interact with regulation to be devised in Phase 2.

Thirdly, further guidance as to proposed timelines of each phase, and any future phases, is desirable and welcomed by our members as we develop business strategies and future presence in the UK; in particular, to gain a better sense of precisely what activities will be in scope and when. It would also be helpful to understand the role, if any, of the regulators in the phased approach; in particular, whether, and to what extent, HM Treasury and the FCA will work together, in parallel, or sequentially, in devising and implementing the new regulatory regime. The Consultation raises the prospect of attracting leading businesses to be established and redomiciled to the UK to operate existing services and products and design new ones. Providing certainty on timing in relation to the proposed phases (and noting that other jurisdictions, such as the EU, are also developing cryptoasset regulation) would allow our members and other industry participants to plan effectively, including for any business migration. This predictability would enhance the UK's attractiveness as a place to be located for crypto businesses.

7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

We agree that a cross-border approach is fundamentally important. The proposed territorial perimeter is for firms conducting businesses "in or to the UK," which casts a wider net than the current FSMA reach of activity "in the UK." We understand the rationale for widening this to include "to the UK." We would welcome further clarity on how UK regulators would monitor and enforce the widened territorial scope to ensure a level playing field for market participants. It is important that this scope aligns with that of the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, as this is useful for market participants who want to off-shore outside of the UK.

The Consultation is silent on the availability of the overseas person exclusion, which is relied upon, amongst others, by non-UK persons conducting cross-border wholesale business with mainly non-retail UK customers. We would welcome the expansion of this exemption to include cryptoasset activities where relevant. This would avoid a scenario in which a firm benefiting from the exemption for the purposes of dealing or offering cryptoasset derivatives would not be able to offer custody, exchange, or other intermediation services.

We note the importance of the "reverse solicitation" exemption (familiar to traditional financial markets participants across the EU), for firms operating outside of the UK to have certainty that they are not within the UK financial services regulatory perimeter. We strongly agree with making available a statutory "reverse solicitation" exemption.

8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

As discussed at question 1, we support the view that a nuanced "same risk, same regulatory outcomes" approach is appropriate to bring cryptoasset activities within the financial services landscape in the UK. This is subject to adequate carve-outs for cryptoassets that are not similar and do not present the same risks as traditional financial instruments or services. In the same vein as the above, we also believe that activities will need to be subject to a carve-out in order to ensure equivalent treatment with non-crypto assets of similar characteristics and to allow room for new models such as DeFi to develop and mature.

We note the intention to bring "public offers of cryptoassets" into the regulatory perimeter. As discussed above, decentralised tokens do not have a centralised management team and are

more akin to currencies or commodities. This means that many risks present in the traditional financial services context are alleviated–and we note that for currencies and commodities, there is no requirement to prepare a prospectus prior to dealing in primary transactions. Therefore, to the extent that this was not previously being considered, we would request a carve-out for the primary activities relating to decentralised tokens–specifically where they are being issued as a reward for staking, mining, and airdropping.

In addition, we discuss above that certain tokens, such as NFTs, utility tokens, governance tokens, and fan tokens, do not possess the characteristics or give rise to the risks of traditional financial services instruments. We think the most appropriate solution would be to exclude them from the definition of cryptoassets as a whole. In this respect, we are of the view that these tokens are not suitable to be in-scope of the scope of the "public offers" regime, for the same reasons mentioned above.

While it is sensible for centralised finance exchanges to be required to disclose public information relating to any given protocol, such as developer tools and white papers, this is a fundamentally different context as the centralised finance exchange is disclosing public information about a protocol—a situation that has little similarity to a corporate finance department preparing a prospectus.

Lastly, we note that the government has requested feedback on whether staking should be regulated. We think this economic activity should remain outside of the regulatory perimeter and provide our views on this in response to question 35 below.

10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?

We note that in the traditional financial services context, vertically integrated business models are commonplace, with their risks managed by regulation and responsible business practice. In the cryptoasset context, although vertically integrated business models could present challenges in relation to conflicts of interest and related issues unless appropriate mitigations are in place, these can be mitigated through systems and controls (such as segregation) and conflict of interest procedures. We note that such rules should be tailored to the nuances of cryptoasset operations, which operate differently from the traditional financial services context. For example, cryptoassets do not typically involve typical financial market infrastructure such as clearing houses or a central securities depository.

We are studying this specific issue further and would welcome further engagement from HM Treasury on this issue.

12. Do you agree that so-called algorithmic stablecoins and crypto-backed tokens should be regulated in the same way as unbacked cryptoassets?

We strongly support HM Treasury's recognition that an outright ban on algorithmic stablecoins is unnecessary and would be inappropriate. Restricting these cryptoassets in this way would have unintended and far-reaching negative consequences by virtue of the simple fact that algorithmic stablecoins are not all structured identically or indeed used for the same purposes. We note that the volatility and potential systemic risk of these cryptoassets are not related to any essential link to algorithms; rather, their volatility is related to issues relating to collateralisation. Algorithmic stablecoins play a crucial role in the crypto ecosystem. As with other categories of

cryptoassets, algorithmic stablecoins are not monolithic, and regulation should be tailored to their unique characteristics.

As indicated above, the conflation of all asset-referenced, including crypto-backed, stablecoins with unbacked cryptoassets diverges from the taxonomy in MiCA, which instead creates a separate category of asset-referenced tokens (“ARTs”) as well as fiat-backed stablecoins (e-money tokens, or “EMTs”). Given the widespread use of crypto-backed stablecoins, the prohibition of the use of the label ‘stablecoins’ for these purposes would be contrary to their status functionally as such. Where crypto- or other asset-backed stablecoins are issued in both the UK and the EU, the fact that the same products would need to be marketed in different ways could create confusion for customers, which is an undesirable outcome. However, direct regulation of an algorithmic stablecoin that is issued by a protocol would be a misdirected use of resources and difficult to implement (given the cross-border characteristics of algorithms) and monitor. We also believe that there should not be any legal uncertainty as to whether such protocols are outside of scope of regulation. This is also an issue posed by any attempted regulation of DeFi and protocols generally–please see our response to question 36.

More specifically, we suggest that HM Treasury further studies algorithmic stablecoins to assess the relative risks. Algorithmic stablecoins can be endogenous or exogenous. The former are collateralised by assets native to the issuing protocol and whose value is dependent on the success/failure of the stablecoin protocol, and the latter collateralised by assets external to the issuing system and whose value is not dependent on the success or failure of the stablecoin protocol (e.g., where a stablecoin is pegged to ETH for its issuance). Exogenous algorithmic stablecoins have a different risk profile from endogenous ones, because a decline in the use of the protocol has no direct impact on the value of the collateral. Well-designed regulation would recognise this distinction. Further, algorithmic stablecoins can be:

- Under-collateralised, where protocols require less than £1 of collateral to mint £1 of stablecoins;
- Fully-collateralised, where protocols require £1 of collateral to mint £1 of stablecoins; or
- Over-collateralised, where protocols require more than £1 to mint £1 of stablecoins.

High-profile failures of algorithmic stablecoins such as TerraUSD were a result of under-collateralisation: given that there was insufficient collateral to back the stablecoin, the combination of a ‘bank run’ and an endogenous model (precipitated by a fall in the connected LUNA token). Nuanced regulation should permit fully- or over-collateralised algorithmic stablecoins, particularly for those that are exogenous and therefore are not exposed to conflict of interest concerns.

13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

The definition of “cryptoasset” is drafted widely enough to capture NFTs, utility tokens, governance tokens and fan tokens. The Consultation’s approach to regulate activities rather than underlying assets is appropriate in its implicit recognition that not all cryptoassets using the same label superficially will be, in practice, used for the same purpose.

We believe the new regulatory regime should distinguish cryptoassets such as NFTs, utility tokens, governance tokens, and fan tokens from other cryptoasset classes so that they can be clearly treated separately and, for the most part, if not completely, as outside of the financial

regulatory perimeter. This could be achieved by a suitable definition for these non-financial tokens, which are explicitly excluded from the regulatory perimeter unless those tokens are used in such a way that brings them back within regulated activity. These tokens are caught by the definition of cryptoasset because they provide a “contractual right,” even if they do not pose risks (to users or to the financial services system) analogous to traditional financial securities. Either these are carved out entirely in the definition of “cryptoasset” itself, or a carve-out would need to be included in each reference to cryptoasset throughout regulations, tailored to where it is appropriate for the relevant activity.

Further, while there may be a secondary market of these tokens in the gaming or digital art context, it does not follow that these are trading venues that should be regulated in the same method as cryptoasset exchanges. To illustrate this by a real-world comparison, financial services regulation does not regulate the trading of collectibles (such as football cards) or in-game tokens used in many video games. NFTs, utility tokens, and fan tokens have radically different practical uses than financial instruments and should be treated as such following the “same risk, same outcomes” principle.

16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?

There is no doubt that issuers’ disclosure of relevant risks is central to maintaining public confidence in the issuance of financial instruments. Users must be able to make informed decisions in relation to investments relative to their individual preferences and based on accurate information.

In the situation where there is a token issuer, this responsibility can clearly lie with the issuer. However, we do not agree that liability for the contents of these disclosures should fall on trading venues where there is no identifiable issuer. Casting the burden of verification upon trading venues diverges from both the traditional securities offering context and the approach taken by MiCA. If the liability standard is greater in the UK than in the EU this would reduce the UK’s competitiveness, as UK-based trading venues will be reluctant to admit unissued tokens for trading on their platform, undermining one of the key policy objectives of the new regime. Even if tokens are admitted, there would be an incentive for exchanges not to provide information for fear of assuming liability, which would achieve the opposite of the intended result.

And as discussed above, decentralised tokens are fundamentally different from traditional securities – it is disproportionate, and would undermine decentralisation, to force liability on disclosures to a centralised finance exchange.

More broadly, disclosure obligations on trading venues in relation to tokens without issuers could be set out in risk warnings connected to the cryptoasset itself, and in the form of terms and conditions. In addition, certain public information could be made available with appropriate disclaimers on the source of such information but without attracting direct liability to the exchange providing such information.

20. Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?

Operational resilience of centralised cryptoasset exchanges is key to customer confidence and stability of the cryptoasset industry more generally. This may be achieved by establishing effective frameworks for risk management, which includes robust cybersecurity policies, appropriate oversight of third-party and vendor relationships, employee training, secure identity management and access systems, and failover capabilities. The recognition requirement for Recognised Investment Exchanges as set out in the REC Sourcebook could be used as a source to develop suitably tailored requirements for cryptoasset exchanges.

Maintaining accessible, written policies on how these exchanges handle customer complaints would promote trust and strong business conduct. There should be segregation between client and non-client assets at all times.

Prudential requirements should be based on fixed overhead metrics similar to the requirements applicable to traditional financial services firms presenting similar risks. If an exchange carries on other activities, such as custody, then additional requirements may be appropriate.

21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

It is important for customers and market participants to have confidence that intermediaries will act transparently and in accordance with reasonable expectations of fair dealing and conflict management. We do not necessarily believe that MiFID rules will be the most appropriate, and would request rules tailored to the risks and characteristics unique to cryptoassets.

23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

Custodians play a critical role in the traditional financial services context. Given recent and high-profile examples of the use and application of customer assets by cryptoasset firms, such as FTX, it is important for customers to have confidence in the protection of their cryptoassets. Market participants must provide adequate safeguards for customer assets and would benefit from being able to disclose the existence of regulation-compliant protections to customers.

The key requirements of the existing framework for traditional finance custodians are well suited to, but should be tailored for, cryptoasset custody activities. Such requirements include segregation, accounts and records reconciliation, and annual third-party audits. Omnibus accounts should be permitted under such a framework, as is the case with traditional financial custodians. Cold storage facilities should be subject to tailored treatment.

24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?

It is sensible to require cryptoasset custodians to meet prudential capital requirements, and they should be no worse than under the IFPR regime. Customers should have confidence not only that their assets are segregated but that the custodians themselves are stable and solvent. Operational resilience will be of high importance, in particular because of the unique cyber risks

associated with cryptoassets and blockchain technology. Rules should be formulated in such a way that encourage, rather than limits, innovation in cybersecurity.

31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?

We concur with the government's assessment, and we support the introduction of a regime bespoke to cryptoasset lending platforms. As noted, there are a number of models available to cryptoasset lending platforms, and, given the range, we think it is appropriate to look at the risks that arise in common.

We reiterate that where cryptoasset lending and borrowing is provided by a DeFi protocol, it should not be subject to the same regulatory ruleset as that applicable to a centralised entity.

35. Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?

We acknowledge that it is reasonable, as a matter of policy, for the government to consider staking in the context of its expressed objective to ensure market stability. However, regulation derived from the treatment of consumer credit is inappropriate in the context of staking.

If the intent is to regulate staking as a standalone activity, it is not clear to us that staking (either directly or via an intermediary or validator) presents risks to the financial system which are best addressed by domestic financial services regulation. Staking is a fundamental feature of the current generation of blockchain protocols. Regulating staking in such a way that introduces complexity or difficulty in the offering is at odds with the government's stated intention to make the UK a global hub for cryptoassets innovation.

As the government has noted, staking does not involve the transfer of title. Staking is a central feature of Proof-of-Stake consensus mechanisms, which are increasingly critical to the crypto ecosystem. Ethereum's transition from Proof-of-Work to Proof-of-Stake in September 2022 (the "Merge") was a significant milestone: the most crucial component of its architecture switched while it was running, maintaining perfect uptime for millions of users and thousands of decentralised apps. As a result, Ethereum's energy consumption (in TWh) reduced by 99.95% in the time between the Merge and the end of March 2023. Ethereum now consumes 0.001% of the energy YouTube consumes annually.

Staking does not present the same risks to customers that lending does – risks relating to hypothecation, counterparty credit risk, information asymmetries, or failure to disclose. There is no trust needing placement in a credit institution. This is a direct benefit of its decentralised nature: the chance to earn a reward from validating the most recent transaction on the blockchain has to do with the amount of crypto invested, rather than the ability – or speed – to solve the puzzle (as in Proof-of-Work).

We also note that under the current regulatory ruleset, staking may amount to a collective investment scheme, and result in firms within the UK territorial perimeter generally not providing staking to UK customers. Given the importance of staking to the crypto ecosystem, and the government's stated intention to make the UK a global hub for crypto, we would suggest this issue is addressed by an amendment by HM Treasury to the Collective Investment Schemes

Order. This would include an express carve-out from the definition of a collective investment scheme for the activities of staking, liquidity provision, and yield farming.

36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

We believe that to the extent that DeFi is to be subject to regulation, it will be an entirely different system of regulation: the essential characteristics of its infrastructure are not at all comparable to centralised finance. As a starting point, the UK's approach to financial regulation begins by looking at the ability of centralised entities to comply with regulation as a whole (beginning with the Threshold Conditions), individual accountability for managers through the SM&CR, and meeting sectoral conduct of business obligations. These are simply inapplicable to protocols that are decentralised in nature, and borderless. This framework may also be inapplicable to truly decentralised entities within the DeFi value chain.

We understand the instinct to look at DeFi from the perspective of traditional financial services regulation. We note, however, that financial services regulation has largely succeeded in the UK because of its focus on outcomes, rather than on prescriptive rules. In line with this outcomes-focused approach, DeFi should be considered holistically, considering its unique characteristics, benefits, risks and challenges as a whole. DeFi signals a transition from trusting a set of concentrated number of corporations, to a set of transparent and open-source protocols (and the eco-system built around such protocols).

Desirable outcomes include the promotion of safety and soundness of the financial services system, protection for consumers and competition amongst firms. We believe that the transition from CeFi to DeFi will be in service of these outcomes. This will provide certain benefits – openness, interoperability, and composability – which are not possible in the traditional financial services context. Risks around the misuse of customer assets, or around conflicts of interest, will be mitigated because protocols do not involve placing trust in third parties. There will also be unique risks to DeFi, and these risks will likely require a novel framework to be managed.

As identified by HM Treasury in the Consultation, where access to a protocol is intermediated by interface providers or applications, and are provided by businesses or centralised entities, then it may be appropriate to consider the regulation of these business and centralised entities. These can be regulated precisely because they have some degree of centralisation and can be required to meet the standards and laws of the various jurisdictions of the customers that they wish to serve. However, the risks posed by these interface providers and application operators are inherently different from centralised financial service providers. For instance, such providers and operators often do not take custody of assets or have the power to act on potential conflicts of interest. However, such providers and operators may engage in predatory marketing practices or offer services that warrant risk factor disclosures. Any regulation should therefore be tailored to DeFi and the participants in such an ecosystem, which is fundamentally different than CeFi.

In considering how to regulate DeFi, the threshold issue must be identifying risks specific to DeFi. Otherwise, the development of DeFi will be stifled, and innovation will stall. We believe that this will require looking outside of the current regulatory toolkit – existing prudential or conduct of business requirements are unlikely to suitably address new risks. Only once DeFi is further developed will its risks be clear. This is also the point at which a range of solutions must

be considered, and such solutions may need to be considered firstly by multinational organisations.

There is currently some ambiguity as to whether DeFi could be considered in-scope of the current regulatory ruleset and, by extension, under Phase 2. Any such ambiguity should be resolved by the government to remove true DeFi from the current scope of regulation to provide certainty and allow DeFi to grow and mature in the coming years.

38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?

Please see our answer to question 36.

We agree with the approach of seeking the same overall outcomes for the financial services system. Given that DeFi involves decentralised participants in the crypto ecosystem – from decentralised exchange protocols to apps – without the same "hooks," we do not believe that much of the existing regulatory ruleset will be instructive in creating tools to arrive at these outcomes. We believe that looking to develop global and uniform standards for the treatment of DeFi will be particularly important given the borderless nature of DeFi.

39. What indicators should be used to measure and verify "decentralisation" (e.g., the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?

The term "decentralisation" has many different meanings in the context of blockchain technology. The critical assessment is whether "decentralisation" obviates the risks that a given regulation is intended to address. As discussed above, in the context of decentralised cryptoassets of blockchain and smart contract protocols and primary and secondary transactions, the measurement of decentralisation necessitates an analysis of the drivers of value of the cryptoasset. Meanwhile, when distinguishing the risks of CeFi and DeFi, the most obvious distinction is the lack of intermediaries in DeFi. As a result, it is reasonable to conclude that in the context of DeFi, "decentralisation" obviates the need to apply regulations tailored for CeFi if the DeFi protocol does not have intermediary-based risks. The most critical measurement of decentralisation in this regard is whether any individual or group controls a protocol such that they would be able to exert control over user funds (either through an ability to remove them from the smart contracts of the protocol or by directing them to an address not selected by the user).

Additional indicators to measure and verify decentralisation for protocols include: (i) whether the protocol is deployed on a blockchain with a high number of unaffiliated validator nodes; (ii) whether the protocol is reliant on any single third party for any services or maintenance; (iii) whether user's funds or assets are held by a single party or custodian, or in a user's own wallet or bank accounts and (iv) whether user data is owned and retained by the user.

If a protocol's governance has the ability to interfere with user funds or change the risk profile with respect to a user's user of such protocol, then governance mode factors to review could include: (i) whether the governance is performed via numerous unaffiliated participants, or only by a few participants (who may be acting in concert); and (ii) the separation of roles and powers within decentralised organisations including between a governance function and a treasury function.

We agree with the government that CeFi posing as DeFi should be subject to the same regulatory ruleset as set out in Phase 2 of the Consultation, for example, where a few participants act in concert.

40. Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?

Please see our answer to question 36.

41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

CCI is currently drafting a White Paper proposing a regulatory framework for DeFi. We will share this with the government in due course, if it would be helpful.

42. What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

Please see our answer to question 41. We will provide examples of this as part of our proposed regulatory framework.

44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

It is not clear that regulating mining or validation activities would provide any benefits to UK customers, or the UK's cryptoasset ecosystem.

Cryptoasset mining does not have any of the risks or benefits associated with traditional financial services activities. This is also the case with validation activities. Protocols already have mechanisms to reduce incentives for validators to act in bad faith. However, further penalties for validators acting in bad faith, fraudulently, or with intent of harming the functioning of protocols or exchanges could be achieved through new civil and criminal offences.

45. Should staking (excluding "layer 1 staking") be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

Please see our answer to question 35.

As discussed, staking does not involve the same risks as cryptoasset lending and so should not be regulated the same way. It is not clear to us that staking presents risks to the financial system.

46. What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g., the staking pools or the validators themselves)?

Please see our answers to questions 35 and 45. We do not think it is appropriate to regulate layer 1 staking activity.

We conclude our submission by reaffirming our support for the steps HM Treasury is taking to advance and develop the cryptoassets industry in the United Kingdom. We would welcome the

opportunity to engage further on our responses and the development of the proposed new regulatory regime. We and our members look forward to the United Kingdom fostering and growing a world-leading cryptoassets regulatory framework that promotes innovation, drives economic growth and opportunity, and protects consumers.

Yours sincerely,

Crypto Council for Innovation