COMPLIANCY SERVICES
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Compliancy Services Ltd
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22/10/2020

Dear Sir/Madam,

Thank you for the opportunity to respond to your Consultations on Cryptoasset Promotions and the Regulatory Framework for Approval of Financial Promotions. I am one of Compliancy Services' Payment Services Consultants and a working member of the cryptoasset team. I would like to share with you our responses to the consultations and thank you for taking the time to review this document.

Compliancy Services are one of the UK's leading compliance consultancies with a dedicated cryptoasset team. We have been following cryptoasset regulation for a number of years, publishing our first guide on the subject in October 2018, and speaking about cryptoasset regulation at events such as the Innovate Finance Global Summit 2019 and Security Tokens Realised 2019.

We believe that the regulation of digital assets is totally necessary and welcome. Our view is that any changes in the regulatory landscape applicable to the cryptoasset sector should be done in a proportionate way considering the size and current business situation of firms in this space. Please find our thoughts, comments, and proposed actions in relation to the consultation questions below. If you have any questions regarding our response or would like to contact me directly, I have provided my contact information below.

Yours sincerely,

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Response to HM Treasury Consultations

Cryptoasset Promotions and Regulatory Framework for Approval of Financial Promotions

22 October 2020

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1. INTRODUCTION

On 20 July 2020, HM Treasury published two new consultation papers relating to cryptoasset regulation:

- Cryptoasset Promotions
- Regulatory Framework for the Approval of Financial Promotions

The consultations were brought out to seek views on a government proposal to bring the promotion of certain cryptoassets within scope of financial regulation.

Compliancy Services is one of the UK's leading providers of regulatory compliance consultancy and regtech services. We have a large client base spanning a range of sectors that includes the E-Money and Cryptoasset sectors. We published our first guide to cryptoasset regulation in October 2018 and we've spoken about cryptoasset regulation at a number of seminars and conferences, including the Innovate Finance Global Summit 2019 and Security Tokens Realised 2019.

In this document we offer our answers to the questions raised in the consultation papers. Overall, we believe that the regulation of digital assets is necessary and welcome, and that regulating the financial promotions of cryptoasset providers will constitute a step forward in terms of providing adequate protection to UK investors and users and ensuring responsible development of the cryptoasset market.

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2. CRYPTOASSET PROMOTIONS

In this section we answer the questions posed by HM Treasury's Consultation 'Cryptoasset Promotions'. These questions have been set out by HM Treasury seeking views on a government proposal to bring the promotion of certain types of cryptoassets within the scope of financial promotions regulations.

2.1. Q1: Do you have any comments on the proposed definition of qualifying cryptoassets?

We agree that tokens with the characteristics set out in paragraph 4.17 should be considered as 'qualifying cryptoassets' for the purpose of the Financial Promotions Order (FPO). This will capture most of the non-regulated exchange tokens existing in the market that are wrongly promoted as alternative investment products, and which do not issue proper risk disclaimers to retail clients.

We do, however, have concerns with stablecoins and their transferability. Not every stablecoin will meet the definitions of e-money or security token and some may not be transferable or confer transferable rights. This means they can only be redeemed via the issuer under the tokens' native ecosystem. In this case, it is likely that these stablecoins will be outside the scope of qualifying cryptoassets and would be backed by the users' or investors' funds (so they can be fungible). This presents a potential risk to market integrity, so should be brought into the scope of the FPO.

One option to include these specific cases within the definition of qualifying cryptoassets could be to enhance paragraph 4.17 part (b). The wording could clarify that tokens that are non-transferable but represent a monetary claim (in a fiat currency) on the issuer, (but not rights in respect of accessing specific products or services) may be considered as a qualifying cryptoasset.

2.2. Q2: Do you agree that the correct tokens have been excluded from scope under this proposal?

Yes, we agree that regulated tokens such as e-money, security tokens and limited-network utility tokens should be excluded from the scope of qualifying cryptoassets.

2.3. Q3: In your view, which of the controlled activities in Part 1 of Schedule 1 to the FPO correspond most closely to activities undertaken by firms in the cryptoasset space? Which firms are undertaking these, and what services are they providing in particular?

Given the open nature of cryptoassets, unlimited options are available in terms of controlled activities. The most common practice is the involvement of cryptoassets providers with the following activities:

- Exchanging, arranging, or making arrangements with a view to exchange cryptoassets for money or money for cryptoassets
- Exchanging, arranging, or making arrangements with a view to exchange one cryptoasset for another

- Operating a machine which utilises automated processes to exchange cryptoassets for money or money for cryptoassets
- Operating a platform under which users can exchange cryptoassets for money or money for cryptoassets on a peer-to-peer basis

The above activities have a direct connection with the following controlled activities in the FPO:

- Dealing in securities and contractually based investments
- Arranging deals in investments
- Managing investments
- Advising on investments
- Agreeing to carry on specified kinds of activity

Most of the activities above are currently carried out by cryptoasset exchanges (centralised and decentralised), cryptoassets brokers, crypto ATM operators and peer-to-peer platform providers.

In addition, it will be appropriate to consider additional controlled activities which are also relevant to cryptoassets services, such as:

- Safeguarding and administering investments
- Providing qualifying credit
- Arranging qualifying credit
- Advising on qualifying credit

Safeguarding and administering investments will apply to custodial wallet providers that either provide services to safeguard, safeguard and administer cryptoassets on behalf of their customers, or hold private cryptographic keys on behalf of their customers in order to hold, store and transfer cryptoassets. This is the current case for some cryptoasset exchanges, brokers and custodians that hold, store and transfer assets for their clients.

We are also aware of several firms that are providing (or planning to provide) crypto loans, which consist of the lending of a cryptoasset in exchange for interest being charged. This could also require a change in the definition of 'qualifying credit' in the FPO but as the spread of similar models is not yet significant, we are conscious that changes required could be disproportionate. Even if no changes are made in this instance, these activities will require further monitoring to properly assess their impact in the future.

2.4. Q4: Do you agree that the list of controlled activities under the FPO given at paragraph 4.29, above, best captures the activities undertaken by firms in the cryptoasset space which facilitate the buying, selling, subscribing for and underwriting of cryptoassets and whose activities are most associated with the risks this consultation seeks to mitigate? Do you agree that the government is therefore proposing to amend the correct set of controlled activities under the FPO?

We agree that the list of controlled activities given in paragraph 4.29 is closely related to the current cryptoasset commercial activity. We would suggest there are other important activities that should be considered by the government as high-risk in terms of consumer protection. These include:

- Safeguarding and administering investments (for custodial wallet providers)
- Providing, arranging and/or advising on qualifying credit (crypto loan providers)

2.5. Q5: In your view, would the activities described at paragraph 3.31, fall within scope of the FPO if the controlled activities under the FPO (particularly those at paragraph 3.29) were amended to apply to cryptoassets? Are there other important activities undertaken by cryptoasset firms that pose similar risks in relation to the purchase of cryptoasset that are unlikely to be captured by the controlled activities the government proposes to amend (paragraph 3.29 above)?

There are other activities (apart from those mentioned in paragraph 3.31) carried out by cryptoasset firms that pose similar market integrity risks to the activities described in 3.29, such as:

- Custodian wallet provider: safeguarding and/or administration of cryptoassets for clients
- Peer to peer providers: platforms that allow P2P transactions between users without the intervention of a system administrator
- Initial coin offerings (ICOs) and initial exchange offerings (IEOs): firms or exchanges issuing tokens that might fall within the scope of ‘qualifying cryptoassets’
- Crypto loan providers: A platform under which users can lend and borrow cryptoassets

Additionally, we think it is important to clarify that the term ‘cryptoasset exchanges’ as used in paragraph 3.31, refers to both centralised and decentralised exchanges.

2.6. Q6: Do you have any other comments on the proposed treatment of controlled activities?

We do not have any other additional comments.

2.7. Q7: Do you have any views on the government's proposed treatment of exemptions?

We agree that any exemption for qualifying cryptoassets should be consistent with the current approach for other controlled investments. However, we think that exempting 'white papers' for ICOs or IEOs to be distributed to vulnerable consumers without approval may not be an appropriate approach. There are several cases where ICOs have been promoted using misleading information contained in generic white papers, resulting in fraudulent schemes under which consumers and investors have lost thousands of pounds/dollars. We understand some white papers may be primarily focused on providing technical information associated to a particular blockchain project, but these could also involve a form of marketing communication.

If the regulatory amendments seem disproportionate to mitigate the potential risks from ICOs and IEOs, using existing rules and regulations (or a modified version of those) applicable to other market participants could help to increase customer and investor protection. For example, the Prospectus Regulation and the Disclosure Guidance and Transparency Rules, could provide helpful guidance to structure a sensible set of rules for cryptoasset issuers.

2.8. Q8: Do you agree with the government's assessment of the risks in the cryptoasset market, as summarised above and as outlined in detail in the Cryptoassets Taskforce report??

We agree that, in principle, the main risks outlined in the Cryptoassets Taskforce report remain:

- Risks of financial crime. This has been in part mitigated with the implementation of the Fifth Money Laundering Directive under the supervision of the Financial Conduct Authority (FCA)
- Risks to consumers and to market integrity, which is partly addressed by this consultation
- Risks for financial stability. The cryptoassets market is still evolving and cryptoasset activities are on the rise. We would suggest the market needs to be closely monitored by the government and regulators, especially considering the potential future impact of widely accepted 'stablecoins'

2.9. Q9: Do you agree with the government's assessment of alternative policy options?

We feel that in order to properly mitigate all the current and future risks that these activities could pose to the market and the economy, the best option is expanding the scope of the RAO to designate 'qualifying cryptoassets' as 'specified investments'. Additionally, firms should be subject to FCA regulation and supervision when carrying out these activities. This would be the most effective approach rather than using fragmented pieces of existing regulation and law to try to address risks as they arise.

The industry has been asking for regulatory clarity for some time and most firms we have dealt with agree that these activities should be formally regulated. This will help promote the healthy and responsible growth of the cryptoassets market and provide greater consumer clarity and protection. As a result, we anticipate that extending the regulatory perimeter to include cryptoasset activities would be well-received by many market

participants and consumers alike. Furthermore, with the current discussion at European Commission level about potential draft regulations for markets in cryptoassets, it would seem to be an appropriate opportunity for the UK to bring these activities into the scope of regulation.

We also understand the challenges that formal regulation will represent for the industry, especially for smaller firms. We think it is appropriate to consider cryptoassets firms' feedback on this to avoid a situation where regulation could disrupt innovation.

One aspect that will need to be considered further before fully regulating the sector is how firms can have access to the financial services (Banks or authorised Custodians) required to safeguard customers' assets. A similar approach as exists for payment services under regulation 105 of the PSRs could potentially be used here, but that would be part of the wider discussion to have with the industry.

A government effort to promote industry self-regulation would be useful to establish 'best practice' standards. However, we feel that this would work best if it complemented formal regulation and supervision, rather than a definitive solution to mitigate potential risks in this currently unregulated space.

2.10. Q10: Do you have any views on the government's proposal not to provide for a transitional period?

This will depend on the policy option chosen by the government. Evidence from similar regulatory changes in other areas of the financial services industry suggests that transitional periods are beneficial for both firms and regulators to ensure a smooth implementation of the new requirements. As a recent example, under the implementation of the Fifth Money Laundering Directive existing cryptoassets firms in the market were required to comply with the new requirements from January 2020, but permitted to continue operations until January 2021. In this sense, we propose that a transitional period of at least twelve months be introduced to allow firms to properly adjust their practices to the required standards.

2.11. Q11: Do you have any views on the proposed approach to territoriality?

We support the government's approach of not adjusting the FPO's territorial scope. This is the correct way to protect UK consumers from misleading promotions issued by UK cryptoasset firms and overseas companies (which can be more aggressive in terms of promoting their services to vulnerable consumers in the UK).

2.12. Q12: Do you have any additional comments to make on the proposed approach?

We commend the government's efforts to address the potential risks that these activities pose for the UK market and consumers and we hope that the approach resulting from this consultation helps to provide protections to consumers without deterring innovation.

The cryptoassets industry seems to be providing signals of being ready and keen to be regulated, so this may be a perfect opportunity to bring these activities into the scope of the UK's regulatory perimeter.

3. REGULATORY FRAMEWORK FOR APPROVAL OF FINANCIAL PROMOTIONS

This consultation has been put introduced as there is currently no specific process through which a firm must be assessed as suitable and competent before they can approve the financial promotions of other, unauthorised firms. The government proposes a regulatory gateway which firms must pass through to approve financial promotions and this consultation has set out to gather views of stakeholders as to how this could be implemented by answering the following questions. The consultation itself can be accessed here.

3.1. Q1: Do you agree that a gateway should be established enabling the FCA to assess the suitability of a firm before it is permitted to approve the financial promotions of unauthorised persons?

A gateway must be in place so the FCA can properly assess the quality of the financial promotions of cryptoasset firms and monitor the quality on an ongoing basis. Although we understand that this could be seen, in principle, as an additional regulatory burden for cryptoasset firms, we think it is an essential element to provide adequate protection for retail customers in the UK market.

This is supported by the findings of the recent FCA's Cryptoasset Consumer Research 2020, which indicates that crypto adverts can influence consumer sentiment along with traditional media and online news. According to the report, 45% of all current and previous cryptocurrency owners said they had seen adverts relating to cryptocurrency and 35% (approx. 400,000) stated it made the purchase more likely. Additionally, 16% of current and previous cryptocurrency owners said they were influenced by an advert. Most significantly, it was discovered that those who were influenced by advertising were more likely to subsequently regret their purchase. So, this is a clear indication that further regulatory supervision is indeed required.

However, it is not clear from the consultation under which capacity authorised firms will be approving the financial promotions of cryptoasset firms. In principle, pure cryptoasset providers are not themselves appointed representatives or authorised firms. Therefore, some firms will need to engage an authorised firm to get their financial promotions approved by the regulator and this will have further commercial and financial implications for these firms. In this regard, we feel that it is adequate, and more effective, to allow cryptoasset firms to apply directly to the FCA for financial promotions consent/approval and further supervision.

3.2. Q2: What are the risks and benefits of each of the two policy options put forward? Would there be any unintended consequences resulting from implementation?

Both policy options will enhance the current process under which financial promotions of unauthorised persons are approved and overseen. However, cryptoasset firms will need to rely on an authorised person to be able to communicate their own financial promotions which, in some cases, might not work for the best interest of both cryptoasset firms and retail customers. As indicated in Q1 above, it is essential to determine what type of access cryptoasset firms will be required to provide to authorised persons to get their financial promotions approved. It

may be the case that best approach is to provide a gateway for cryptoasset firms so they can directly apply to the FCA for consent and supervision.

3.3. Q3: If the government was to proceed with one of the two policy options, which would be your preference and why?

In line with our feedback in Q1 and Q2, we think that the best approach will be a modified version of the proposed "option 2" under which the RAO is amended to make the approval of financial promotions communicated by cryptoasset firms a regulated activity under the Financial Services and Markets Act (FSMA). Firms can then apply for Part 4A permission from the FCA to retain responsibility for their own financial promotions. This would require more significant changes than intended, but we feel it is the best way to ensure cryptoasset firms can control their own financial promotions framework. This will also strengthen the ability of the FCA to properly supervise the financial promotions of cryptoasset firms in accordance with its rules and guidance.

It is important to clarify that we are not proposing to change the role that authorised firms play in overseeing the financial promotions of unauthorised persons, as we are aware that this will still be relevant in some cases. We are however suggesting a different approach that may only apply for cryptoasset firms in line with their previously unregulated/unsupervised nature.

4. ABOUT COMPLIANCY SERVICES

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Compliancy Services is one of the UK's leading providers of compliance consultancy and regtech services.

Our award winning services help firms become authorised by the Financial Conduct Authority or the Prudential Regulation Authority; to manage their ongoing compliance and regulatory obligations; and empower their staff with focused compliance training.

Our team of ex-regulators, industry practitioners and subject matter experts help to minimise the regulatory burden, offering practical, usable advice and solutions that work for your business and the regulator. It's through the breadth and depth of their collective expertise and experience that we provide an outstanding service and ensure that compliance makes a positive contribution to your business.

By using our proprietary online client portal, Compliance Select, clients get access to regtech apps and time saving features that include their compliance monitoring plan, document library and management, automated task reminders, compliance registers and summaries of regulatory changes that affect their business.

With a dedicated cryptoasset team, we are well positioned to help firms navigate the regulatory environment and prepare for the changes and additional obligations that increased regulation brings. We published our first guide to cryptoasset regulation in October 2018 and we've spoken about cryptoasset regulation at a number of seminars and conferences, including the Innovate Finance Global Summit 2019 and Security Tokens Realised 2019.

www.compliancy-services.co.uk/compliance/sectors/cryptoassets/

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