UK Imposes Restrictions on the Sale of Cryptoassets and Related Products

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The U.K. Treasury and the U.K. Financial Conduct Authority (the FCA) have taken steps to restrict the sale of cryptoassets and ban the sale of derivatives referencing cryptoassets (crypto-derivatives) to U.K. investors. In the U.K., marketing and distributing financial instruments and the provision of related services are governed by the U.K. financial promotion regime. The U.K. Treasury has proposed new legislation expanding the financial promotion regime to cover unregulated cryptoassets. The addition of unregulated cryptoassets to the list of financial instruments covered by the financial promotion regime will affect the ability of service providers to distribute cryptoassets and market related services in the U.K.

On 6 October 2020, the FCA published a policy statement confirming that it had implemented an outright ban on the marketing, distribution and sale of crypto-derivatives in or from the U.K. to retail customers. Crypto-derivatives are already covered by the U.K. financial promotion regime, which limits the sale of such instruments to retail clients. However, the outright ban means that service providers will not be able to rely on limited exemptions from the financial promotion regime to market crypto-derivatives to retail clients, and even FCA-regulated service providers will not be able to sell these products to retail clients.

Proposed Extension of the UK Financial Promotion Regime

Under the Financial Services and Markets Act 2000 (FSMA), promotions of "controlled investments" and related "controlled activities" (*i.e.*, investment services) are permissible only if made or approved by entities that are regulated in the U.K. Certain types of promotions are exempt from these restrictions and are set out in the Financial Promotion Order 2005 (FPO). For example, promotions made to financial institutions or companies above certain size thresholds benefit from exemptions to the general restriction. The U.K. Treasury's proposals extend this general restriction on promotions, and the related framework of exemptions, to certain "unregulated cryptoassets".

The U.K. Treasury's consultation defines a "cryptoasset" as "a cryptographically secured digital representation of value or contractual rights that uses some type of distributed ledger technology and can be transferred, stored or traded electronically." The family of cryptoassets captured by this broad definition is further subdivided into "security tokens" and "unregulated cryptoassets". Confusingly, the term "security tokens" captures both instruments that replicate features of traditional financial instruments (such as shares and bonds) and e-money tokens, which are by definition not financial instruments but types of e-money. "Unregulated cryptoassets" are any type of cryptoasset that is not a security token, such as payment tokens and utility tokens. Security tokens are "controlled investments" for the purposes of FSMA and so are already subject to the U.K. financial promotion regime.

Under the U.K. Treasury's proposals, "qualifying" unregulated cryptoassets would be deemed "controlled investments" and therefore be made subject to the financial promotion regime. The cryptoassets that would qualify are "any cryptographically secured digital representation of value or contractual rights that uses a form of distributed ledger technology and which:

a. is fungible;

b. is transferable or confers transferable rights … ;

[…]"

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The characteristics of fungibility and transferability preclude some unregulated cryptoassets from the scope of the proposed changes. Instruments that can only be redeemed by the issuer, such as a loyalty points scheme arranged on the basis of a distributed ledger technology (DLT) system, would not be regarded as transferable. Additionally, central bank digital currencies (CBDCs) are specifically excluded.

The U.K. Treasury proposal also extends the scope of certain existing controlled activities to encompass "qualifying" unregulated cryptoassets. Under the proposal, the following activities, when carried out in respect of qualifying unregulated cryptoassets, would amount to a controlled activity:

- dealing in securities and contractually based investments;
- arranging deals in investments;
- managing investments; and/or
- advising on investments.

No new or expanded definitions of controlled activities have been proposed to cover arrangements specific to cryptoassets (such as cryptoasset exchange activities and periodic free transfers of cryptoassets to cryptoasset wallets), as these activities are already deemed to be captured by the controlled activities specified above.

Marketing of unregulated cryptoassets to U.K. investors will be curtailed as a result of the extension of the definitions of "controlled investment" and "controlled activity" described above. Service providers seeking to distribute such cryptoassets in the U.K. will (if the proposal is adopted) be required to rely on an exemption specified in the FPO, have their marketing material approved by an FCA-authorized entity before distribution or obtain authorization themselves before carrying out the marketing activity.

Prohibition of Sale of Crypto-Derivatives to UK Retail

The FCA's prohibition of the marketing, sale and distribution of crypto-derivatives will be implemented in the U.K. by the Conduct of Business (Cryptoasset Products) Instrument 2020 (FCA 202/34), with the final rules coming into force on 6 January 2021. Crypto-derivatives are already subject to the U.K. financial promotion regime, so the effect of the FCA's Policy Statement is to prohibit any use of exemptions from the financial promotion regime that may enable the sale of crypto-derivatives to U.K. retail clients by unregulated service providers, and to prohibit FCA-regulated service providers from marketing such instruments to U.K. retail investors. The prohibition will apply to both derivatives (*e.g.*, contracts for difference, options and futures) and exchange-traded notes referencing unregulated transferable cryptoassets, but it will not apply to derivatives referencing security tokens, which are outside the scope of the ban.

During the consultation process for this measure, 97% of respondents disagreed with the proposal to prohibit the sale of crypto-derivatives to retail customers. The respondents were from a broad range of backgrounds, including firms, trade bodies, retail clients and EU national competent authorities. The respondents argued that crypto-derivatives have intrinsic value, that retail clients are capable of valuing cryptoassets and that a ban would be disproportionate given the other means the FCA has at its disposal in order to achieve its objectives. The FCA disagreed with all of these arguments and maintained that a prohibition was appropriate and proportionate for the following reasons:

- Cryptoassets are opaque, complex and unreliable as reference assets for derivatives aimed at retail clients. In the FCA's view, cryptoassets have no "inherent value," unlike other reference assets that have physical uses, promise future cash flows or are legally accepted as money.
- Retail clients cannot value cryptoassets reliably, in part due to the lack of intrinsic value, but also due to the wide variance in valuation model inputs.
- Crypto-derivatives pose a high risk of financial crime and market abuse including fraud, particularly the risk of misappropriation and wash-trading in cryptocurrency markets.
- Crypto-derivatives do not serve a legitimate investment need for retail clients.

The result of the legislative and regulatory change is to significantly curtail access to the U.K. retail market for issuers and distributors of cryptoassets and crypto-derivatives. Given the ongoing proposals to develop a bespoke cryptoassets licensing and supervisory regime at an international level by the Financial Stability Board (FSB) and the European Union,[1] we can expect further developments in this area in the U.K.

[1] Proposals include the draft Markets in Cryptoassets Regulation and FSB, "Crypto-assets: work underway, regulatory approaches and potential gaps", May 2019.