

The Distributed Ledger

Blockchain, Digital Assets and Smart Contracts

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A New UK Cryptoasset Framework: UK Government Publishes Consultation Response

On 30 October 2023, the HM Treasury (HMT) published its much-anticipated response (Consultation Response) to its March 2023 consultation paper (Consultation) on the UK's future financial services regime for cryptoassets.

Much of the intended new regime reflects the terms of the earlier Consultation, although those were at a high level and did not include proposed legislative text. The Consultation Response sets out firmer policy proposals to bring cryptoassets within existing financial regulation, introduce a new authorisation process, and set out a new disclosure and liability regime. These proposals are intended to be laid before Parliament in 2024.

See our 29 March 2023 client alert "[A Closer Look at the Proposed UK Cryptoassets Regulatory Regime](#)" for discussion of the Consultation. The HMT's subsequent proposal to regulate stablecoins was summarized in our June 2023 article "[EU and UK Move Forward With Comprehensive Regulatory Regimes for Cryptoassets.](#)"

We take a closer look at some of the key aspects of the Consultation Response below.

Bringing Cryptoassets Within Existing Financial Regulation

HMT has confirmed its plan to regulate cryptoasset activities within the existing legislative framework governing financial services. The UK government plans to adhere to the proposals in the Consultation, specifically, expanding the "specified investments" list in Part III of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2005 (RAO).

Cryptoassets will not be included within the separate definition of "financial instruments," which means that cryptoassets would remain outside of the scope of the Markets in Financial Instruments Directive (MiFID) regime and other related EU-derived legislation that has been retained in the UK post-Brexit. There are additional provisions governing financial instruments falling within the MiFID regime that will not apply to cryptoassets generally.

Incorporating cryptoasset activity into the existing Financial Services and Markets Act (FSMA) framework provides for a level playing field between digital assets and traditional finance and aligns with International Organization of Securities Commissions (IOSCO) recommendations, and the approach taken in other jurisdictions.

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Definition of Cryptoassets

HMT has clarified that firms should look to compare cryptoassets to similar products or activities within traditional financial products and services, and that cryptoassets not used within financial services markets or used as a financial services instrument (in the general sense), product or investment should fall outside the future financial services regulatory regime. This is a helpful clarification for the industry given the broad definition of “cryptoassets” in existing legislation, including the UK’s Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs) and the new financial promotion regime under the UK’s Financial Services and Markets (Financial Promotion) Order 2005 (FPO), which will form the basis for the new regime.

Further detail to differentiate tokens will be specified in upcoming secondary legislation and Financial Conduct Authority (FCA) rules. These rules will be key to confirming which are likely to be out of scope, such as utility tokens and non-fungible tokens (NFTs).

No Temporary or Streamlined FSMA Authorisation Process for Cryptoasset Firms

In response to the Consultation, industry participants requested a temporary approval regime for cryptoasset firms, or a streamlined approach to authorisation for appropriate firms. HMT rejected these requests. Specifically, it declined to:

- introduce a temporary permission regime (which would have allowed firms to continue business activities while awaiting authorisation);
- provide streamlined access to firms registered under the MLRs; or
- provide a streamlined variation of the permission process for firms already authorised under the FSMA regime, as is the case under the EU’s Markets in Crypto Assets Regulation (MiCA).

The FCA will be responsible for developing rules on the authorisation process. Noting industry feedback regarding difficulties in the MLR registration process, the expectation is that the FCA will:

- provide feedback on the quality of applications for the new regime as expeditiously as possible;
- contribute to regulatory clarity by engaging with applicants’ advisors and consultants; and
- provide data on the volume and outcomes of the applications received.

This may not adequately address the concerns of many cryptoasset firms that are reported to have experienced significant difficulties in obtaining MLR registrations.

Firms that are already authorised will need to apply for a Variation of Permission (VoP); they will not receive automatic upgrades to their permissions or exemptions for new cryptoasset activities. HMT explained that firms that are already currently authorised will benefit from their existing capabilities and supervisory history as they undertake the VoP process.

Extraterritorial Scope To Remain a Key Feature of the New Regime

As noted in our March article, the UK intends to extend the territorial scope of the rules to activity “in or to the UK,” which exceeds the territorial scope of traditional financial services. HMT intends to continue this broader approach despite some industry pushback. Further, HMT stated that it does not support expanding the overseas persons exclusion (OPE) commonly available for traditional financial services firms, allowing them to access the UK market on a cross-border basis. HMT also declined to comment on the availability of a reverse solicitation exemption, which is available under MiCA.

Noting concerns about the availability of global order books for internationally active cryptoasset firms, HMT is exploring deference/equivalence arrangements with other jurisdictions. This includes engagement with standard-setting entities like IOSCO and the Financial Stability Board (FSB) to devise a suitable set of standards. However, the requirements for such equivalence are not yet established and are unlikely to be useful to cryptoasset firms operating in the UK in the near term.

There may, however, be an interim solution that allows access to global liquidity pools under certain conditions, such as when the liquidity pool operates in a jurisdiction adhering to international standards. One solution proposed by HMT is to allow non-UK firms that manage regulated cryptoasset trading platforms in foreign jurisdictions to request branch authorisation rather than subsidiarisation in the UK. Such authorisation might specifically oversee trade matching and execution activities. Market participants will continue to monitor these developments closely.

NFTs and Other Collectibles

HMT confirmed that it generally views NFTs as digital collectibles or artwork rather than financial products. Hence, in the same way that art sales are not regulated as financial services, most NFT-related activities would fall outside of scope of the new regulatory regime.¹

¹ We note, however, that art sales are regulated in the EU and UK under the current money laundering framework.

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That said, HMT acknowledges the evolving landscape of the crypto markets, in particular where tokens labelled as NFTs might possess functionalities that make them more than collectibles. Those features may bring such tokens back into scope of the regulatory perimeter.

In determining whether an NFT falls within scope, the emphasis will be on evaluating the core usage of the token. Specifically, HMT will assess whether the NFT aligns with one of the listed in-scope cryptoasset activities HMT proposed in the Consultation, or if it functions as a financial services instrument or product, rather than just accepting a self-proclaimed designation as an NFT. Issuers, exchanges and other market participants will therefore need to consider carefully the substance of a token that is being issued, marketed or traded.

Decisions Deferred on Decentralised Finance (DeFi)

HMT acknowledged input from industry participants regarding issues relating to DeFi, stating that, at this stage, it would be premature and ineffective for the UK to regulate DeFi activities. HMT sees a potential role for fully decentralised DeFi models in future financial services, but this demands thorough risk management and international collaboration.

HMT also noted that, should DeFi models become widely adopted, it will need to meet regulatory standards akin to traditional finance. This marks a broad acknowledgment of the role by HMT DeFi may play in the crypto markets, albeit while deferring the determination of its regulatory status. Some may view this as a missed opportunity for the UK to adopt a more proactive stance in relation to DeFi models.

Clarifying the Position on Staking

Industry feedback regarding staking included concerns relating to (i) the difference between staking and lending; and (ii) the importance of staking within proof-of-stake (PoS) blockchains. HMT views the operation of a validator node with on-chain staked cryptoassets primarily as a technical function essential for the security and operation of a PoS blockchain, rather than as a financial service activity.

HMT noted, however, that some activities carried out by intermediaries in the pooled staking sector, such as custody of pooled cryptoassets and the issuance of liquid tokens, carry risks for consumers. The risks of these activities, however, may be covered by other regulatory regimes, including those for financial promotions, custody, lending and intermediation, without the need for additional regulation.

HMT also responded to industry feedback regarding the broad scope of the “collective investment scheme” (CIS) regime by proposing to exclude specific forms of staking from the CIS rules, provided the risks are otherwise adequately addressed in regulation, or introducing a separate regulatory framework for operating a staking platform outside of the CIS framework.

HMT is also accelerating work with industry to develop a clear definition of staking, to establish a taxonomy of PoS staking businesses and to identify how to mitigate risks and take advantage of potential benefits from a defined perimeter. This is to be welcomed given the broad use of the term to describe a range of activities. The industry will also welcome clarity on the CIS analysis given the liability consequences of non-compliance with the CIS regime.

New Rules for Issuance, Trading and Disclosure

The UK government plans to implement its initial proposed approach on the issuance, trading and disclosures relating to cryptoassets, which would:

- regulate the admission of cryptoassets to a crypto trading venue;
- regulate the making of a public offer of cryptoassets;
- give crypto trading venues responsibility for defining content requirements for cryptoassets to be traded on-venue; and
- place liability for disclosure contents on trading venues.

HMT emphasises the need for consistent disclosure for all cryptoassets, including both established tokens with a significant trading history, like Bitcoin, and newer ones, and would not differentiate between tokens that have a centralised issuer and those that do not. Acknowledging the desire from the industry for more prescriptive rules on content, HMT is supportive in principle of the idea of a centralised coordinating body (e.g., an industry association) to coordinate this effort with FCA oversight.

More guidance was given as to the nature of liability arising out of disclosure documents. This included clarifying HMT’s view that exchanges should not be liable for all consumer losses linked to a token where the exchange has adequately outlined the risks. Where losses stem from issues with the underlying protocol or network outside the exchange’s control, liability is unlikely to fall on the exchange.

Additionally, future-oriented statements, like projections of the potential token use cases, should have different liability standards than past factual statements, like claims about code audits conducted, which should be held to a higher standard. Liability for predictive statements would require proof of recklessness or

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dishonesty, while liability for factual statements would be based on a negligence standard. Disclosure documents are expected to be concise and tailored to their purpose, and they are not expected to resemble lengthy, equity prospectus-style documents.

While the nuance on liability standards identified by HMT is likely to be welcomed by the cryptoasset industry, exchanges will remain very concerned that they, rather than token issuers, may be required to assume liability for disclosures. This contrasts with issuances of financial instruments, where liability rests predominantly with issuers. The direction HMT is signalling with regard to disclosure rules may discourage the listing of large numbers of tokens by exchanges. The liability regime may also discourage token issuers and/or exchanges from making predictive statements to reduce potential liability.

Custody

HMT intends to move forward with its previously proposed approach to the custody of cryptoassets, based on the existing framework for traditional finance custodians under Article 40 of the RAO. However, HMT noted the importance of making suitable modifications to accommodate unique cryptoasset features or putting in place new provisions where appropriate.

The novel and unique scenarios, risks and technology solutions that were raised in the feedback will be taken onboard as the UK authorities proceed with secondary legislation, detailed consultations and rulemaking. Given the unique differences between the custody of traditional financial services instruments and cryptoasset custody, it will be interesting to see whether such rules end up being fundamentally similar.

Further, the availability of Financial Services Compensation Scheme (FSCS) protection for cryptoassets will be determined by the regulators under their usual rulemaking powers, as opposed to being brought in through the legislative process. We will need to await for further details on these protections as a result.

A Growing Focus on Stablecoins

Stablecoins are intended to be regulated under Phase 1 of the government's overall proposals for the regulation of cryptoassets. After industry participants raised concerns about the definition of regulated stablecoins, which would capture only

stablecoins used as a "means of payment", HMT published [a separate update addressing stablecoins on 30 October 2023](#). Under the FSMA 2023, HMT is empowered to bring fiat-backed stablecoins within the financial services regulatory perimeter and it intends to act on this by early 2024.

HMT plans to:

- establish a regulated activity under the RAO concerning the issuance of fiat-backed stablecoins within or from the UK;
- introduce a regulated activity under the RAO for the custody of UK-issued fiat-backed stablecoins;
- collaborate further with the industry and the FCA before introducing legislation; and
- regulate payment chains for:
 - mixed stablecoin payments (where a payment begins with a stablecoin, converts to fiat within the chain, and concludes in fiat, or the reverse process).
 - pure stablecoin payments (where both the start and end of the payment chain are in stablecoins, with the entire value transfer occurring in stablecoins).

Following this, in a joint package of publications released on 6 November 2023, the Bank of England, the FCA and the Prudential Regulation Authority (PRA) [outlined their proposed regulatory approaches](#) to (i) payment systems and related service providers that use stablecoins; (ii) stablecoin issuers and custodians; and (iii) the safe deployment of digital money and money-like instruments, including stablecoins. They also jointly released a roadmap laying out the interaction between these proposed regimes. We will release a separate note summarising these developments shortly.

Next Steps for UK Cryptoasset Regulation

In response to the evolving landscape of cryptoassets, the Consultation Response gives much-needed clarity in a number of key areas as well as revealing the direction and details of upcoming legislation. It reflects a considered and measured approach to developing legislation that will encourage the crypto industry but with adequate regulatory safeguards. There remains significant work to do, however, developing secondary legislation and in fast-growing areas such as DeFi. We will continue to closely monitor these developments and keep you informed of further steps in this area as they are introduced.