
Financial Conduct Authority Consultation Paper on “Guidance on Cryptoassets”

8th April 2019

LONDON - The Association for Financial Markets in Europe (AFME) welcomes the Financial Conduct Authority (FCA) Consultation Paper on “Guidance on Cryptoassets”.

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to respond to the FCA’s Consultation Paper on Guidance on Cryptoassets (referred to hereafter as “the Guidance”). AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

Following consultation with our members and other trade associations, AFME wishes to express its support for the response that has been prepared by UK Finance, with which AFME shares common interests and sentiment in this matter, as well as some overlap in our membership.

I. General comments

Executive Summary

AFME welcomes the FCA’s views in outlining the applicability of the regulatory perimeter to cryptoassets. It is key that authorities effectively identify, assess and address risks arising from this emerging activity in a coordinated fashion. AFME acknowledges the potential risks posed by cryptoassets, as identified by the FCA, including risks to consumer protection and market integrity. However, we suggest that the scope of the work is broadened to include all Digital Assets (definition provided below).

AFME welcomes that the guidance proposed by the FCA:

- **Remains technology neutral to the extent possible**, ensuring the same activities are subject to the same regulation irrespective of the way services are delivered, so that innovation is enabled and a level playing-field is preserved; however, technology enhancements should be taken into consideration to determine whether any changes to existing regulations are necessary (or whether new guidance should be provided).
- **Provides clear expectations regarding authorisation for market participants who wish to partake in cryptoasset related activity**, which is supported by case studies and relevant examples throughout. There may be benefit in expanding on the case studies provided in this Guidance, for example similar to those provided in the European Banking Authority (EBA)’s report

on Cryptoassets¹, which provided additional detail regarding how key characteristics of the Second E-Money Directive (EMD2)² and the Second Payment Services Directive (PSD2)³ should apply.

- **Aims to be consistent with other global and EU-wide initiatives on the treatment of cryptoassets**, such as the recent Financial Action Task Force (FATF)'s work⁴ to the G20 and materials from the European Commission⁵ and the European Securities and Markets Authority (ESMA)⁶.

AFME has identified the following high-level considerations for the FCA in response to this consultation:

- **AFME recommends the FCA, where possible, to consider how their analysis and guidance for cryptoassets fits within the broader scope of Digital Assets.** AFME believes the dematerialisation of financial assets (i.e. the digital representation and issuance of financial assets), such as fiat money or tradeable securities, goes beyond the scope of cryptoassets. For instance, dematerialisation encompasses tokens which are asset-backed and issued by central authorities (e.g. central bank digital currencies) or other assets that do not necessarily use cryptography and are not tokenised (i.e. off-chain digital representations of assets, such as the Certificateless Registry for Electronic Share Transfer (CREST) for equities). It is therefore AFME's view that this guidance should encompass all "Digital Assets".

- **AFME recommends the FCA to consider its role as a thought leader in relevant international forums to ensure that a harmonised regulatory framework is developed.**

As cryptoassets are cross border in nature the risk of fragmentation is particularly relevant. For instance, in Europe AFME is concerned that diverging views and interpretations across Member States regarding the application of the Second Markets in Financial Instruments Directive (MiFID II)⁷, PSD2⁸, EMD2⁹, the Fifth Anti-Money Laundering Directive (AMLD5)¹⁰ and other relevant directives may become unnecessarily burdensome for firms and thus may hinder future developments of cryptoassets.

As such, AFME urges the FCA to consider harmonising these Guidelines in coordination with the ESAs and other Member State NCAs and to engage in wider international forums such as the G20, G7, Financial Stability Board (FSB), Bank of International Settlements (BIS) and global standard setting bodies (e.g. the International Organisation of Securities Commissions (IOSCO)) to mitigate the risk of regulatory arbitrage. This is particularly necessary for regulated funds in the UK, EU and USA where investor protection is the duty and responsibility of trustees and managers. Detailed, international guidance will be needed to determine legal forum and/or jurisdiction and applicable law, as courts (and plaintiffs) will struggle to apply existing precedent to public and private blockchains and their international participants. In particular, IOSCO is an important organisation which the FCA should consider active contribution to, in which cryptoassets have been identified as the Board's first priority for 2019¹¹. Further, given the significant role the FCA

¹ <https://eba.europa.eu/documents/10180/2545547/EBA+Report+on+crypto+assets.pdf>

² <https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32009L0110>

³ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32015L2366>

⁴ <http://www.fatf-gafi.org/publications/fatfgeneral/documents/g20-fm-cbg-july-2018.html>

⁵ https://ec.europa.eu/commission/news/roundtable-cryptocurrencies-2018-feb-26_en

⁶ <https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection>

⁷ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>

⁸ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32015L2366>

⁹ https://ec.europa.eu/info/law/e-money-directive-2009-110-ec_en

¹⁰ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32018L0843>

¹¹ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD625.pdf>

has played in setting up The Global Financial Innovation Network (GFIN)¹², AFME encourages the FCA to consider how it could play a leading role in the sharing and testing of ideas and best practises for supervisors across jurisdictions.

- **A globally consistent taxonomy is required to develop a common framework for analysis and a harmonised regulatory framework for the treatment of cryptoassets.**

Cryptoassets are truly digital and global in nature. As such, without a globally consistent taxonomy, AFME believes it will be difficult to provide the legal certainty required for market participants to foster innovation for new and existing market players by reducing barriers to entry and exposure to reputational risks.

While the FCA's guidance provides an initial outline to the classification of cryptoassets, AFME believes the following considerations will be key in the elaboration of a globally consistent cryptoasset taxonomy:

- *AFME requests that the categories of cryptoasset are made mutually exclusive at the point of issuance of the token agreement/contract/purchase, to provide legal certainty to market participants on where a firm's activity falls in respect to the regulatory perimeter. After an initial classification is decided, we propose this classification is evaluated regularly to ensure it is relevant and appropriate given new market developments.*
- *AFME requests that deeper analysis be conducted by the FCA to consider further delineating existing cryptoasset categories into sub-categories in order to support distinct risk assessments. This would allow for a more granular depiction of a token's specific risk profile. Key characteristics underpinning these categories such as: i) the intent; ii) the issuer; iii) the owner; may further separate cryptoassets to achieve a greater range of products. For a visual reference see the "money flower" Venn-diagram proposed by the BIS Committee on Payments and Market Infrastructures (CPMI) Markets Committee in its report on Central bank digital currencies (CBDCs)¹³;*
- *AFME requests that stablecoins be considered as a key additional component of this more detailed analysis due to their central issuance and unique volatility stabilising feature. AFME acknowledges that while stablecoins may reduce exposure to volatility risk, they do not exempt exposure to other sources of risk, such as market risks or the credit risks of the underlying issuing entity.*
- *AFME requests that the public and private sector begin a deeper collaboration to review and potentially adapt risk management frameworks currently in use for financial assets, due to the digital and global nature of cryptoassets (and more broadly Digital Assets). For instance, key questions include: how can market participants achieve settlement finality on a digital and decentralised network? How can they ensure records of ownership transfer are accurately maintained? What are the implications of the fractional ownership of financial assets? How will cross-border disputes be legally resolved? Addressing questions of this nature will require a deeper partnership between the public and private sector in order to complete a comprehensive and globally aligned analysis.*

¹² <https://www.fca.org.uk/publications/consultation-papers/global-financial-innovation-network>

¹³ <https://www.bis.org/cpmi/publ/d174.pdf>

- **AFME believes that a deeper and broader analysis of the applicability of existing regulations, and their potential limitations, should be developed as a matter of urgency, as currently this guidance does not cover significant regulations which may impact the treatment of cryptoassets.** For instance, regulations which are applicable to wholesale capital markets firms such as the Settlement Finality Directive (SFD)¹⁴, Central Securities Depository Regulation (CSDR)¹⁵, European Market Infrastructure Regulation (EMIR)¹⁶ and the General Data Protection Regulation (GDPR)¹⁷ (e.g. equivalent privacy laws) should be factored into the FCA's guidance. For instance, with regards to GDPR, this guidance should consider touch points between service providers (e.g. custodians, administrators, transfer agents and depositaries). Ideally, the existing regulations would also include guidance/Q&As their applicability for cryptoassets. There is a risk that the current regulatory framework may not neatly apply to this developing asset class, as its rules were not designed with cryptoassets in mind. A more extensive analysis will be necessary to identify how those rules could apply or require adaptation. For example, analysis in advice from the EBA¹⁸ and ESMA¹⁹ to the European Commission has suggested a deeper analysis should be conducted by the Commission regarding the application of the existing EU regulatory framework.

The need for this analysis is particularly important as the digital asset class matures and develops, in which these products may change characteristics throughout their lifecycle. Any regulatory framework must be able to account for these dynamics. In general, any further guidance should be drafted recognising that the current regulatory framework applicable to traditional assets should also remain applicable to their digital representations (i.e. Digital Assets). Further, a longer-term perspective should be used to provide some flexibility in interpretation and how regulatory compliance could be achieved, to prepare for the emergence of new technologies and ensure a level playing field is maintained.

AFME would welcome the opportunity to discuss our response to this consultation in further detail. Specifically, to identify opportunities where AFME can support this important initiative by leveraging our unique reach as a key participant in fostering deeper collaboration between public and private sector participants.

I. Responses to the consultation questions

Q1: Do you agree that exchange tokens do not constitute specified investments and do not fall within the FCA's regulatory perimeter? If not, please explain why.

AFME agrees that exchange tokens do not constitute specified investments and thus do not fall under the current regulatory perimeter in that regard, however we are of the view that if exchange tokens are used for

¹⁴ https://ec.europa.eu/info/law/settlement-finality-directive-98-26-ec_en

¹⁵ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0909>

¹⁶ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32012R0648>

¹⁷ https://ec.europa.eu/commission/priorities/justice-and-fundamental-rights/data-protection/2018-reform-eu-data-protection-rules_en

¹⁸ <https://eba.europa.eu/-/eba-reports-on-crypto-assets>

¹⁹ <https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection>

traditionally regulated activities such as regulated payments, those activities should also be regulated and the firms providing that service should have regulatory oversight. Further, we wish to seek some clarification on the regulatory treatment of exchange tokens in the Guidance.

AFME commends the FCA for beginning to classify between cryptoassets. However, we believe the current definitions for the three existing categories are too broad and require further clarification based on each token's characteristics. This is to provide greater clarity and legal certainty for market participants. It is of critical importance that the regulatory treatment of all tokens remains technology-neutral and that a principles-based approach is used to regulate these activities. Regulators should use this approach with an awareness that some types of tokens may inherently hold more risks to consumers and the market than others based on their characteristics, if the appropriate controls are not put in place. As such, regulators should conduct a risk assessment to assess what controls will be necessary based on these key characteristics. AFME suggests this can be done using a checklist approach, in that once the FCA classifies a token based on its purpose, the FCA should also further examine that token based on key attributes such as:

- Governance system (i.e. private/permissioned vs. public/unpermissioned);
- Source of value (i.e. paper native vs. digitally native);
- The issuer (i.e. centralised or decentralised).

This list, while not exhaustive, provides examples of key characteristics for all categories of tokens which should be considered when building a framework for risk assessment. AFME recommends the FCA to consult standard setting bodies who have already made significant progress in this area, such as the International Standards Organisation (ISO) Blockchain Group, who are drafting the ISO/TC 307 standards²⁰. The FCA should also consider creating a task force to continue to monitor and update the taxonomy, as the underlying technology is still nascent, and many more token variations will likely arise that will need to be accounted.

A more detailed taxonomy would allow for a greater analysis of the regulatory perimeter, as AFME believes the FCA's definition of exchange tokens does not give sufficient consideration to permissioned vs. unpermissioned networks where exchange tokens are issued.

For example, in para. 3.35 of the Guidance (page 22) it notes, "exchange tokens typically do not grant the holder any of the rights associated with the Specified Investments within our perimeter. This is because they tend to be decentralised, with no central issuer obliged to honour those contractual rights – if any existed". However, notary nodes/verifier nodes (i.e. nodes with specific right privileges) on a private/permissioned network could act as central issuers who could honour contractual rights.

Similarly, para. 3.38 (page 22) notes "exchange tokens currently fall outside the regulatory perimeter. This means that the transferring, buying and selling of these tokens, including the commercial operation of cryptoasset exchanges for exchange tokens, are activities not currently regulated by the FCA". Would this also include, for instance, a private/permissioned network run by a consortium of banks who themselves are already regulated by the FCA or similar? We are of the view that existing banking regulations could apply to those activities.

Further to this point, para. 3.54 (page 29) notes, "exchange tokens can be used to facilitate regulated payment services such as international money remittance". Therefore, the facilitation (i.e. the actual movement of cryptoassets) is not currently regulated under the Payment Services Regulations (PSRs) (the use of cryptoassets are not covered by the scope of the PSRs because they only cover activities with regards to funds

²⁰ <https://www.iso.org/committee/6266604.html>

which are defined as ‘banknotes and coins, scriptural money and electronic money’ (regulation 2 of the PSRs)). The Guidance also notes, “the PSRs cover each side of the remittance, but do not cover the use of cryptoassets in between which act as the vehicle for remittance”.

AFME understands that either side of money remittances is regulated, but not the actual transfer of cryptoassets in between the transfer of the fiat currencies. Yet in Sandbox case study 1, the Guidance notes, “exchange tokens can be used to facilitate cross-border payments which are regulated by the FCA such as money remittance services”. The firm in question, who facilitates the transfer of GBP to ZAR via cryptoasset is registered as a Small Payments Institution (money remittance) and is therefore regulated.

AFME requests the FCA to clarify specifically whether they will regulate the actual transfer of exchange tokens or only the activities on either end. Currently when using a traditional currency, the inter-bank aspects of activity are not regulated under the PSRs Schedule 1 Part 2, so it would seem to be at odds for this aspect of the activity to be regulated due to the use of cryptoassets. A deeper analysis is required in respect of what elements in the end-to-end process of buying from fiat, exchanging and selling back into fiat would currently fall into the FCA’s scope and be covered by the EMD, PSRs and 5AML. We request further clarification from the FCA on those points.

In addition, under the section “*Can cryptoassets be considered e-money* (pages 30-32)” it is noted, “Exchange tokens like Bitcoin, Ether and other equivalents are unlikely to represent e-money (para 3.60, page 31) ... However, it is important to note that any category of cryptoasset has the potential to be e-money depending on its structure and whether it meets the definition of e-money explained above (para 3.61, page 31)”. Does this mean the FCA will regulate those exchange tokens which qualify as e-money? In which case, it seems in contradiction to the previous statement commenting that “Exchange tokens currently fall outside the regulatory perimeter (para 3.38, page 22)”.

AFME requests that the guidance in para. 3.58-3.63 (page 30-31) be strengthened to provide further detail on where a cryptoasset would become e-money, in order to limit a firm from providing the services an e-money provider could provide without being appropriately regulated.

In addition, in para. 4.12 (page 40) of the Guidance, the FCA suggests that the stabilisation of a cryptoasset, by pegging its value to a fiat currency, could deem the cryptoasset a potential security or e-money instrument, bringing it within the scope of the FCA perimeter, including the PSRs and EMRs. AFME requests further clarity regarding at what point the stabilisation of an exchange token would cause it to fall within the scope of the FCA perimeter or payment regulation. This is particularly important as the underlying sale of the cryptoasset into fiat (and vice versa) would likely fall within the FCA’s scope.

Regarding Anti-Money Laundering/Counter-Terrorist Financing (AML/CTF) obligations, the AML/CTF risk associated with exchange tokens is often considered to be high. For instance, exchange tokens like Bitcoin or Ether can in some (but not all) instances be used to transfer funds between parties on an anonymised basis and this activity currently falls outside of the regulatory perimeter. It is an important and welcome step that the AMLD5 will bring relevant cryptoasset activities into the existing EU AML/CTF framework²¹, so that cryptoasset providers will be required to develop surveillance and monitoring systems where suspicious transactions can be reported.

Therefore, it is important that those responsible for developing the AML/CTF rules for cryptoassets consult with businesses providing cryptoasset services to ensure relevant regulation is proportionate and appropriately targeted, with due consideration to potential opportunities for surveillance through use of the

²¹ https://ec.europa.eu/info/policies/justice-and-fundamental-rights/criminal-justice/anti-money-laundering-and-counter-terrorist-financing_en

underlying technology. AFME welcomes the proposed consultation by HMT later in 2019 where we understand these considerations, and the transposition of the 5AMLD, will be analysed in greater detail. To that effect, AFME believes further clarity should be provided on the scope and applicability on the AML/CFT regulation to the specific risks identified (e.g. such as cryptoassets custodian wallet providers) rather than ambiguous actors/terms (e.g. such as “non-custodian wallet providers that function similarly to custodian wallet providers” which are referenced by the UK’s Cryptoassets Taskforce in its recent report²²).

However, AFME believes market abuse risks associated with exchange tokens will still be present whilst this activity remains outside the regulatory perimeter. As a next step, AFME recommends, the FCA consider the Japanese, French and the US Commodity Futures Trading Commission (CFTC)’s approach, where standards have been developed and implemented to prevent market abuse in cryptoasset activity, in which the UK/EU could apply similar levels of standards.

Q2: Do you agree with our assessment of how security tokens can be categorised as a specified investment or financial instrument? If not, please explain why.

AFME welcomes the definition provided by the FCA, as well as the development of specific examples for the most relevant specified investments. Although there is no single standalone definition of a “security” within the European Union (including the U.K), we believe that securities, as an asset class, have a number of key characteristics which are globally recognised and need to be considered when defining a security token. It is also important that these characteristics enable market participants and regulators to clearly distinguish “security tokens” from other types of tokens.

We believe that the key characteristics which define a security token would include:

- The digital representation of an instrument that is issued on an underlying digital platform;
- Where the holder has contractual or property rights to the security, and entitlements to proceeds (e.g. dividends, coupon), and/or other entitlements such as voting rights; and
- It is not an instrument used for payment and is not a means of exchange or means of money transfer.

AFME would recommend the FCA further delineate sub-groups within this token category similarly to the way it outlines different Specified Investments in the Guidance (p 23-28 e.g. Shares, Warrants, Units in collective investment schemes, Debt instruments etc.) where possible and reflecting the existing regulation on these instruments. This delineation is important, as just as there are different types of paper securities, security tokens should similarly be categorised based on the above traits. Market participants require this level of granularity and clarity in order to have legal certainty regarding their regulatory treatment.

The FCA must also consider in its risk assessment that, similarly to our answer for question 1, some security tokens may hold more risks than others based on certain characteristics such as the underlying governance network (see a more detailed list in our response to question 1). To reflect the FCA’s words in the Guidance, “while our tech-neutrality means we’re agnostic about the type of technology used, the choice of technology may influence the way in which regulation applies. While the use of a certain technology won’t usually have an impact on the permissions the firm requires, it might have an impact on the unique risks associated with the carrying on of certain regulated activity”. We support this approach to the regulation of all types of tokens.

²² https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf
(para 5.7 page 41)

This group will have additional characteristics to consider, including whether the token represents a derivative. Para. 3.50 (page 28) notes, “products that reference tokens, like derivative instruments, are very likely to fall within the regulatory perimeter as Specified Investments (either as options, futures or contracts for difference under the Regulated Activities Order (RAO)). These products are also capable of being financial instruments under MiFID II.” The FCA should provide further clarity on what constitutes a cryptoasset derivative and how it will treat those derivatives. Importantly, AFME recommends the FCA does not take a one-size-fits-all approach to the regulation of derivatives for retail and wholesale market participants.

The risk of regulatory fragmentation in the EU is particularly problematic for security tokens due to the inconsistent transposition of MiFID II across member states. There may be discrepancies in how different types of securities tokens will be categorised as types of Financial Instruments. We are concerned that these inconsistencies will not only hinder innovation but will create a risk of regulatory arbitrage. Therefore, AFME recommends the FCA align where possible to the advice from the EBA and ESMA (referenced further above) to the European Commission on cryptoassets and Initial Coin Offerings (ICOs), which provide greater detail regarding MiFID II requirements. However, it is also critical to achieve a global framework to govern cryptoasset activities, as cryptoassets are truly digital and global in nature. We urge the FCA to harmonise, wherever possible with global standard setting bodies such as the IOSCO Committee on Regulation of Secondary Markets (OICV-IOSCO)²³ and regulators across jurisdictions. In addition, the FCA has the opportunity to be a policy thought-leader in the regulation of cryptoassets globally, where the GFIN offers an excellent opportunity to facilitate discussion with other jurisdictions.

AFME requests that the FCA provide in this Guidance, a deeper analysis on the implications of applying existing regulation to cryptoasset activities. For instance, ESMA’s report²⁴ notes, “The Regulatory Technical Standards relative to various data reporting and record keeping requirements (e.g., transaction reporting, instrument reference data, transparency and DVC data, orderbook data, etc.) will likely need to be revisited, as they were designed to capture traditional instruments and not crypto-assets” (para 128, page 28). It also identifies technical issues with the Settlement Finality Directive that may arise from the use of cryptoassets (see section “VII.5 The Settlement Finality Directive and the Central Securities Depositories Regulation”, page 30), whereas this Guidance does not go into such detail.

Further, ESMA’s report notes that MiFID II was not designed with cryptoassets in mind, and as such there are gaps and issues in the current rules which leave certain risks or unaddressed or that may not account for the new characteristics of cryptoassets. For instance, there may be new and more efficient methods of fulfilling MiFID II reporting requirements using the underlying technology. Also, there may be a need for EU policymakers to clarify the type of investment services/activities that hybrid platforms may provide and the rules that apply to them. The FCA’s Guidance currently does not highlight similar gaps and issues in existing regulation, so AFME requests that the FCA conduct a similar level of gap analysis for the transposition of MiFID II and the application of the RAO for security tokens.

Further guidance or clarity is requested on the following:

- *The treatment of certain tokenised assets*, such as credit agreements issued in token forms (e.g. loan risk sub-participations or sub-syndication of loans in the secondary loan market). Any issued guidance should reflect the existing regulatory treatment of credit agreements, in which they are not currently treated as transferrable securities.

²³ https://www.iosco.org/about/?subsection=display_committee&cmtid=13

²⁴ <https://www.esma.europa.eu/press-news/esma-news/crypto-assets-need-common-eu-wide-approach-ensure-investor-protection>

- *What qualifies as “freely traded on cryptoasset markets”* (page 26 of the Guidance). This is particularly important for regulated funds (under the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive²⁵ and the Alternative Investment Fund Managers Directive (AIFMD))²⁶. Is this akin to freely transferable and the definition of transferable security in Financial Services and Markets Act (FSMA) 2000²⁷?
- *The definition of safekeeping and custody of cryptoassets*, as according to Annex B of MiFID II, the safekeeping and custody of cryptoassets which qualify as financial instruments would be a regulated ancillary service. As such, further clarity is necessary regarding how these expectations would apply to firms who provide these services.
- *Minimum disclosure of risks in assessing the suitability and appropriateness of security token investments*; AFME understands these obligations will automatically apply to financial instruments under the FCA’s Conduct of Business (COBS) rules²⁸ and the MiFID II suitability²⁹ and appropriateness obligations³⁰, however due to the specific characteristics of tokens (e.g. global and digital), AFME believes investors (both institutional and retail) should be made aware of these specific and additional risks that are associated with cryptoassets. AFME therefore requests additional guidance from the FCA on how it will address suitability and appropriateness for tokens which qualify as financial instruments or specified investments.

Q3: Do you agree with our assessment of utility tokens? If not, please explain why.

Whilst AFME generally supports the FCA’s assessment of utility tokens, we would like to raise two additional considerations (besides the above points on classification which are also applicable throughout).

First, AFME would like to seek clarification on the term “consumer” in the sentence “utility tokens provide consumers with access to a current or prospective service or product” (para 3.51, page 28). Indeed, utility tokens may not qualify as specified investments, as the legal definition may differ at national and EU level, where even at EU level there are differences between “retail investors” and “consumers” with regard to the general consumer protection rules.

Second, AFME would also like to highlight the risk of fragmentation on the treatment of utility tokens. AFME urges the FCA to open dialogue with other jurisdictions, perhaps by discussing regulatory treatment through IOSCO, to align supervisory responses and reduce the risk of regulatory arbitrage. A checklist approach is an example of a pragmatic method for supporting supervisory convergence on a single taxonomy. This would provide clear guidance for market participants and provide exclusivity between classifications. Currently this category seems to often act as a ‘catch-all’ for tokens which do not fit in either the exchange or security token classifications. For instance, the FCA should make clear the differences between an exchange and a utility token, perhaps by enumerating the characteristics both require to be classed as such and to avoid potential overlaps between categories.

²⁵ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A02009L0065-20140917>

²⁶ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32011L0061>

²⁷ <https://www.legislation.gov.uk/ukpga/2000/8/contents>

²⁸ <https://www.handbook.fca.org.uk/handbook/COBS/>

²⁹ <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-mifid-ii-suitability-requirements>

³⁰ <https://www.handbook.fca.org.uk/handbook/COBS/10/2.html>

Q4: Do you agree with our assessment that exchange tokens could be used to facilitate regulated payments?

Please see AFME's response to question one regarding regulated payments. Further to previous comments, we reiterate that this assessment requires broader depth, equivalent to the level of detail of the EBA's advice regarding the application of EMD2 and PSD2. This is especially relevant when considering more secure private/permissioned networks run by regulated financial services institutions.

Q5: Are there other use cases of cryptoassets being used to facilitate payments where further Guidance could be beneficial? If so, please state what they are.

AFME recommends that more guidance be provided outlining minimum disclosure requirements from payment service providers regarding the indirect risks that consumers may incur when using these services (i.e. risks associated with exchange tokens such as volatility, fraud or even market abuse). As regulated payments, even assuming the transfer of exchange tokens is unregulated, regulated payments firms should still be bound by the FCA's Principles for Businesses³¹, "2. Skill, care and diligence: A firm must conduct its business with due skill, care and diligence" and "9. Customers: relationships of trust: A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment".

Q6: Do you agree with our assessment of stablecoins in respect of the perimeter?

AFME welcomes the efforts made in the Guidance to classify stablecoins, but AFME suggests further analysis is required in contemplating whether the characteristics among varying stablecoins neatly fit within the current categories of cryptoassets. As an example, throughout the Consultation the term "stablecoin" appears in paragraph 3.37 in the exchange token section, paragraph 3.65 in the E-Money section, and in paragraph 4.12 in the security token section. Accordingly, the definition of stablecoins may encompass groups of heterogeneous cryptoassets. In that respect, we suggest the FCA to contemplate if stablecoins features are sufficient to establish a set of mutually exclusive characteristics (at the point of issuance).

AFME proposes to define a "stablecoin" as a digital representation of a medium of exchange, a means of value transfer, a unit of account, and/ or a store of value using a digital platform which is issued by a central issuer and thus redeemable, being partially or entirely backed by an underlying asset or asset basket. The key characteristics associated with this type of token include the following:

- Attempt to provide a stabilisation functionality by pegging the token's price to an underlying asset. It is important to note that "price stability" or "pegging" does not necessarily mean that stablecoins may not also exhibit price volatility. Their stability is ultimately dependent on the price volatility of the underlying asset (price also being a function of credit risk of the issuer), effectiveness of the algorithmic balancing and the impact of market forces. Acknowledging market forces may even attempt to break that peg.
- Typically backed by some underlying or basket, such as fiat currency, non-cryptoassets or cryptoassets. However, in some cases, stablecoins can be partially backed. In the case of a stablecoin that is partially or not asset-backed, algorithms may be integrated into the token to help facilitate its stabilisation functionality.

³¹ <https://www.fca.org.uk/about/principles-good-regulation>

- Typically redeemed at par or, if traded, at the price traded on an exchange.
- We also note that stablecoins are typically issued by a central authority that also determines the rights of the holder, including redemption rights.

Currently, there are a number of stablecoins, which include:

- Fiat backed;
- Non-cryptoasset backed;
- Cryptoasset backed;
- Algorithm-driven (backed by either cryptoassets or non-cryptoassets); and
- Algorithm driven (not backed by either cryptoassets or non-cryptoassets).

For the algorithmic and partially collateralised stablecoins we suggest the FCA to consider stress testing the mechanisms used to provide price stabilization, as well as appropriate disclosures to consumers, including redemption rights and guarantees and the risks of non-redemption at par.

We note that further analysis is required when assessing stablecoins. We suggest that the FCA consider the following non-exhaustive list:

- The underlying digital platform under which the stablecoin is issued (e.g., permissioned or public forms of DLTs and whether their consensus mechanism is probabilistic or deterministic);
- The purpose for which the stablecoin is issued (e.g., as a claim against the issuer, as a medium of exchange, as a deposit of money, etc.);
- The issuer of the stablecoin (e.g., whether the issuer is a financial technology entity, a commercial entity, a regulated financial entity, a credit institution, etc.);
- The users of such stablecoins (e.g., permissioned users under compliant onboarding and know-your-customer (KYC) and anti-money laundering (AML) standards or general public);

AFME considers that there are two high level classifications of stablecoins:

- Bank issued stablecoins (“Bank Coins”)
- Non-Bank issued stablecoins

Bank issued stablecoins (“Bank Coins”)

A bank account balance reflects the balance of liabilities between the account holder and the relevant account bank with respect to the account. A positive bank account balance is a deposit liability of the relevant bank to the account holder. Transfers of bank account balances operate to decrease or extinguish the deposit liability of the bank with respect to the transfer or/and increase or create a fresh deposit liability for the transferee against its bank when the account balance on the transferee increases.

A “Bank Coin” (e.g. “Bank Coins”) is a digital record of an account balance, with the account in the form of a “wallet” recorded on a blockchain, with an authorised deposit-taking entity, and a means of instructing transfers of that balance. Just as a bank statement may record such an account balance, so too a record on a blockchain is capable of doing so. The technology deployed does not change the legal substance of the arrangements.

Therefore by definition, a “Bank Coin” balance held in the “wallet” of an account holder on a blockchain is a record of the deposit liability of the relevant bank to the account holder of the amount deposited in such wallet.

Transfers of a “Bank Coin” operate in the same way as transfers of bank account balances, i.e. by decreasing/extinguishing bank’s deposit liability to the transfer or/and increasing/creating the deposit liability of the transferee’s bank to the transferee.

Further, the issuance of a “Bank Coin”, according to our proposed definition (e.g. a record of a deposit), amounts to the regulated activity of accepting deposits, and the issuer must be authorised accordingly. This also brings other regulatory requirements imposed on deposit-taking institutions, including capital requirements and KYC/AML obligations.

A depositary bank’s activities, with respect to “Bank Coins”, should be regulated in the same manner as other cash depositary and payment activities, or other activities that such Banks may currently engage in which are already regulated, which may be supplemented with the use of a “Bank Coin”.

Non-Bank issued Stablecoins

A non-bank issued stablecoin is a digital asset issued by a central issuer, which is not a bank or authorised deposit taking firm, that is either backed by an underlying asset or basket or uses a reliable and stress tested price stabilisation mechanism. The asset is used as a unit of account, and/ or a store of value and confers redemption rights. These assets are typically redeemed at par and can be bought/sold at an exchange, if traded.

Apart from their unique stabilisation functionality, there are a number of other characteristics that the FCA may attach to “Non-Bank issued Stablecoins” which affect whether the stablecoin falls within or outside of the regulatory perimeter. We also recommend the FCA to consider how these non-bank issued stablecoins are reserved whether 1:1 is always ensured and verified, where the reserve is kept, the rights of the holders, etc.

AFME recommends that central banks carefully monitor those stablecoins issued by non-financial firms (e.g. “Non-Bank issued Stablecoins”) that purport to create digital forms of money outside of the regulated financial system, as this may impact money supply and the ability of central banks to control monetary policy. Some mechanisms of stablecoins have not yet been tested at scale, and as such there may be unintended consequences, which have not yet been considered.

Q7: Do all the sections above cover the main types of business models and tokens that are being developed in the market?

AFME would like to highlight a number of examples of hybrid business models or tokens that the FCA should consider or reference in the Guidance. These examples illustrate that cryptoasset related activity does not always map neatly or directly to traditional securities activities and therefore the application of the existing regulatory perimeter requires more in-depth analysis.

One example is Ripple³², which provides both a payments platform and issues an exchange token: XRP. XRP is used for transfers between both fiat currencies and other cryptoassets and is transferred on the Ripple network between trusted participants. This activity is similar to the sandbox case study 3.57 (page 30) of the Guidance, in which a firm acts as a money remittance Small Payments Institution. However, one key difference is that in the sandbox example, the firm converts the fiat currency into a cryptoasset and back, so there is

³² <https://ripple.com/>

ultimately limited risk to the payer or payee. Using Ripple, a user would be potentially exposed to additional volatility exchange due to the conversion of the currency they hold into XRP at the gateway.

Another example would be an asset-backed stablecoin that uses DLT to facilitate post-trade settlement and clearing for global financial institutions. This token would be fully backed by cash assets held at a central bank and convertible at parity with a bank deposit in the corresponding major currency. This token does not fit neatly into the existing taxonomy of exchange, security and utility tokens that the Guidance provides.

Q8: Are there other significant tokens or models that we haven't considered?

Please see comments provided in response to Question 7.

Q9: Are there other key market participants that are a part of the cryptoasset market value chain?

AFME welcomes Figure 2 in section 3.73 (page 34) in building a visual of the cryptoasset ecosystem, however AFME recommends that trade finance platforms and all custodians (i.e. both traditional custodians and native third party crypto-custody providers) should be added to the list of key market participants in the cryptoasset market value chain. Other non-traditional market participants to be added include cryptocurrency ATM Operators and Tumblers/Mixers (e.g., services which scramble cryptoasset transaction history). Whilst central banks may not currently be directly a part of the cryptoasset market value chain, it is important to consider tertiary impacts to these actors, for instance in their ability to manage liquidity. It is also important to consider a regulatory framework which will be able to account for a larger role they may play in the medium and long term.

Q10: Are there activities that market participants carry on in the cryptoasset market that do not map neatly into traditional securities?

AFME recommends the FCA consider non-traditional forms of cryptoasset activity such as 'air drops' (the usually free distribution of a token to a large number of wallet addresses as a marketing strategy) or 'forks' (the splitting of software protocol to create a new protocol, cryptoasset or community) which do not occur for traditional financial services today.

Cryptoassets are evolving rapidly, and a product can move across the regulatory perimeter more than once within its lifecycle. As a result, it will be necessary to continuously monitor the evolution of cryptoassets, keeping in mind that existing regulation may not apply neatly to these products, which could hinder innovation in this area. AFME supports ESMA's conclusion that a bespoke regime at the EU level will likely be necessary to account for the complexity of cryptoasset-related activity. Any new regulation should be flexible enough to match the pace of technological change, but specific enough that market participants can have legal certainty in how and where their activities fall under the regulatory perimeter and the consequent obligations.

In particular, AFME would request that additional analysis be undertaken in understanding how regulatory obligations for how the SFD³³, CSDR³⁴ and EMIR³⁵ would apply for cryptoasset activity, considering that these regulations were designed without cryptoassets in mind. Issues relating to safekeeping and custody, as mentioned, are also present. We would request that regulators give particular focus to monitoring network

³³ https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/settlement-finality_en

³⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0909>

³⁵ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32012R0648>

governance, including interaction with other external parties such as exchanges, counter-parties, clearing houses and brokers, including within permissioned networks. A fit for purpose regulatory framework will not only ensure financial stability and reduced risks to consumers, but it will foster innovation across the cryptoasset value chain.

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About AFME

AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia. AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.