Consultation Response

FCA and BoE Discussion Papers on Stablecoins

February 2024

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on FCA "DP23/4: Regulating cryptoassets Phase 1: Stablecoins" and BoE DP "Regulatory regime for systemic payment systems using stablecoins and related service providers".

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.

Executive Summary

AFME welcomes the opportunity to respond to the Financial Conduct Authority (FCA) and Bank of England (BoE) discussion papers on stablecoins as part of the UK's future financial services regulatory regime for cryptoassets.

Overall, we remain concerned that the proposed approaches to the territorial scope of regulated custody activities and, related to that, the treatment of security tokens as cryptoassets for regulated custody activities represent significant deviations from current market practices and could negatively hamper the scaling of security token markets in the UK and the UK's ability to participate in these markets globally.

Regarding the proposals on regulated stablecoins, we remain overall supportive of the Government and regulators' intention to bring these instruments within the regulatory perimeter. In our response to these proposals, we would, however, like to highlight the following comments:

- In line with the need to preserve regulatory coherence, we believe that existing CASS rules should be maintained for the custody of digitally native traditional assets (including security tokens and tokenised deposits).
- We request clarification on the identification of clients and scope of regulated custody activities for assets backing stablecoins and believe that the proposals for backing asset criteria and redemption processes should be adapted to facilitate the issuance and use of stablecoins.
- It is imperative that the proposed treatment of overseas issued stablecoins continue to facilitate use by wholesale financial institutions. In this context, we believe that the FCA should reconsider the proposed requirement for a UK payment arranger in relation to wholesale payment chains or at a minimum delay its implementation until international frameworks and markets mature.

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FCA "DP23/4: Regulating cryptoassets Phase 1: Stablecoins" (FCA DP)

AFME welcomes the FCA's efforts to create a regulatory regime for fiat-based stablecoins and the custody of cryptoassets in the UK. We would like to offer the following high-level key comments on some of the issues raised in the discussion paper:

1. **We remain concern that the expanded territorial scope of regulated custody activities deviates significantly from market practice.** We note that the territorial scope of the UK's regulatory regime for cryptoassets (including security tokens) is a matter for HM Treasury (HMT) and that HMT has: (i) determined to require persons to obtain authorisation under the Financial Services and Markets Act 2000 (FSMA) where relevant cryptoasset activities are undertaken "*in or to*" the UK; and (ii) ruled out the availability of the overseas person exclusion (OPE) in Article 72 of the FSMA (Regulated Activities) Order 2001 (RAO) for this purpose.

   We disagree with this expanded territorial scope to capture relevant cryptoasset activities undertaken from outside of the UK solely because the activities involved a person located in the UK (i.e. was provided "*to*" the UK). This proposed treatment would represent a significant departure from the way the territorial scope for regulated financial services activities (including the custody of specified investments) is currently determined under FSMA. The policy justification for such a significant change to the UK regulatory regime is unclear[1] would bring significant negative consequences for the UK's position as a fintech centre and its ability to participate in global markets.

   Nevertheless, this newly expanded territorial scope is particularly problematic for wholesale markets, the custody sector and sub-custodian networks serving many UK institutional investors and wholesale market participants, which frequently access the services of overseas custodians without the custodian obtaining authorisation under FSMA[2].

   Access to overseas custodians is particularly important for:

   - UK custodians supporting both wholesale and retail markets (to enable the custodian to hold, or arrange for the holding of, a client's cryptoassets outside of the UK, including where required by the rules or market practice of an overseas jurisdiction). Such custodians also typically rely on access to overseas sub-custodians for the provision of such services; and

   - Wholesale markets generally (to enable banks, broker/dealers and other institutional investors to gain access to services of non-UK custodians as well as liquidity outside of the UK by participating in non-UK markets).

   Even for FCA-regulated custodians, the FCA's Client Assets sourcebook (CASS) and Conduct of Business sourcebook (COBS) rules, among others, apply in relation to relevant activities carried on from an

[1] See AFME's Consultation Response – HM Treasury Future Financial Services Regulatory Regime for Cryptoassets: Consultation and Call for Evidence (28 April 2023), in particular the reply to Question 7, available here: https://www.afme.eu/Portals/0/DispatchFeaturedImages/AFME_HMT%20Crypto%20Consultation%20Response%2028.04.23.pdf.

[2] The existing FSMA approach of only requiring authorisation for activities undertaken "in" the UK allows an assessment of the characteristic performance of the regulated activities combined with relevant deeming provisions (e.g., Section 418 FSMA) and exclusions (e.g., in the RAO) to determine the specific territorial scope of each activity. For example, for the regulated activity of "safeguarding and administering investments" under Article 40 RAO, no deeming provisions or exclusions are relevant to an overseas custodian with no UK office/establishment and it is market practice for such overseas custodians to review the totality of the arrangements they have in place for the provision of custody services to assess whether, or to what extent, they may be involved in either the safeguarding and/or administration of relevant investments for the purpose of Article 40 RAO.

establishment in the UK. This is important for ensuring the activities of UK firms through their overseas offices are not brought within scope of the FCA rulebook in a way which could conflict with the rules and regulations of the jurisdiction in which that office is located or be contrary with the legitimate expectation of the clients and investors doing business through the overseas location. If HMT intends for overseas custodians to be authorised and subject to FCA regulation, we suggest that at least the existing territorial scope of CASS and COBS be retained such that the overseas custodian would comply with the custody and investor protection rules in its home jurisdiction.

Whatever approach the FCA takes to regulating the custody of cryptoassets, we would urge it to confirm that the currently accepted market practice for determining the territorial scope of regulated custody activities involving existing types of specified investments (including security tokens – see next point) has not changed and market participants need not read across from the cryptoassets regime.

In addition, we also note that the proposed approach could have possibly negative ramifications for the development and innovation of cryptoasset activities in the UK. In particular, we are concerned that the proposed approach could limit a custodian's ability to diversify its service providers across different geographic regions, which could have significant consequences from a resilience perspective. This in turn could impact how attractive the UK is seen as a destination for cryptoasset and stablecoin activity.

2. **The FCA's approach to regulating the custody of cryptoassets should distinguish between the custody of cryptoassets qualifying as specified investments (including security tokens) and the custody of other currently unregulated cryptoassets (including stablecoins).**: To do otherwise not only runs counter to the regulatory treatment of security tokens to date (and established market practice in both UK and global capital markets), which reflects that their characteristics are those of traditional assets, but is not justified by differences presented by their cryptographic form. Under current practices security tokens require robust governance controls in order to be issued and distributed. It cannot be assumed the risks they present are akin to currently unregulated cryptoassets, and it would be wrong to regulate on that basis.

   We strongly advocate for a technology-neutral approach to regulation, and we note that the FCA has specific concerns relating to the immutable nature of cryptoasset transactions and the custody of cryptoassets. We firmly believe that – as is the case for traditional assets held on infrastructures that are not based on distributed ledger technology (DLT) – a custodian is not responsible for events outside of its control. In other words, the use of DLT or other digital technologies to issue and record digitally native traditional assets (such as security tokens) in capital markets should not justify a new or different treatment of such traditional assets for the purpose of the FCA custody or client money rules in CASS. We support leveraging the existing custody provisions as the basis for rules on cryptoassets, and view that the approach should remain outcomes-focused. We believe this should be the case irrespective of whether the DLT being used is permissionless or permissioned.

   To illustrate, a custodian generally cannot control the DLT platform or blockchain on which a security token or other type of native digital asset is issued and exists and the extent to which any non-UK requirements may be applied to the constitution, holding or use of the asset. Investing in both digital and non-digital assets may require the use of specific platforms or networks and/or the application of non-UK legal and regulatory requirements and market conventions, the use or application of which may be outside the control of the custodian.

By way of further example, mutability risks may arise from either or both the DLT or other digital technologies deployed by the platform utilised to issue and maintain the asset and any legal or regulatory requirements that govern the existence or treatment of the asset. As a result, there may be investment risks associated with any given DLT platform or network on which a native digital asset exists, and the effectiveness of the legal/ regulatory regime for the protection of that asset and the ability to enforce court judgments against the issuer (or other owners) of the assets and/or the operator of the platform or network, as relevant. Again, the same types of risk exist in relation to the custody of traditional assets. In line with current risk-based practices, custodians should not be asked to assume these investment risks as they are practically outside the control of the custodian. It is rather for the issuers to disclose the necessary information to enable investors to assess these risks before deciding whether or not to invest in the relevant asset.

In addition, we view that the proposed approach would starkly contrast with the one taken by the EU regime set out in Markets for Crypto-Assets Regulation (MiCA)[3], provisions of which, including in relation to custody and administration, do not capture cryptoassets that qualify as "financial instruments" within the meaning of Markets in Financial Instruments Directive (MiFID).[4] Consequently, security tokens that will qualify as MiFID instruments will not be subject to the MiCA regime. In line with the technology-neutral approach, the recently amended MiFID definition of a "financial instrument" captures instruments issued by means of DLT. We fear, therefore, that this discrepancy would potentially put the UK at a competitive disadvantage and run counter to the stated objective of international competitiveness and growth for the UK financial markets.

3. **The FCA should leave the existing custody rules (CASS 6), client money rules (CASS 7) and client information rules (CASS 9) largely unchanged for the custody of cryptoassets that qualify as specified investments (incl. security tokens) and tokenised deposits**. These chapters of CASS are some of the most outcomes focussed in the FCA Handbook and take a balanced approach to articulating the expectation in relation to all assets, while providing guidance on particular asset types where it is needed. They also include various exemptions and exclusions which are important for the proper functioning of UK financial services and global capital markets more generally (e.g., for banks holding cash as deposits rather than as client money and for title transfer collateral arrangements, important for financing arrangements in global capital markets). It is not clear that there are any regulatory gaps in CASS which would justify the imposition of additional rules for the custody of cryptoassets that qualify as specified investments (e.g., in the context of the custody/holding of security tokens (currently subject to CASS 6 and 9) or tokenised deposits (currently subject to CASS 7 and 9)).

   For example, the FCA DP proposes that cryptoasset custodians should be required to make certain additional disclosures concerning safeguarding controls or liability for loss of a client's cryptoassets beyond those that CASS, and other FCA rules, already require. However, we strongly caution against this approach as the FCA already requires custodians, at least for cryptoassets that meet the definition of specified investments, to have a written agreement with each client and to disclose the risks associated with the firm's arrangements for holding client assets (e.g., see CASS 9.4.1F and COBS 6.1.7R).

   That said, we remain open to discussing whether minor additions to the FCA rules and/or associated guidance regarding the custody of cryptoassets generally (including both cryptoassets that meet the definition of specified investments and currently unregulated cryptoassets) might be helpful to clarify certain points including any specific steps FCA-regulated custodians should be taking to prevent the loss

[3] Regulation (EU) 2023/1114 of the European Parliament and of the Council of 31 May 2023 on markets in crypto-assets.
[4] Directive 201465/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments.

of cryptoassets belonging to clients when safeguarding access to those assets through cryptographic private keys (including where the custodian appoints a third-party to hold the private keys). See also our answers to Q16 and Q17 for another example of where guidance may be helpful.

Following the perimeter and pattern of the existing CASS regime would be consistent with the "same risk, same regulatory outcomes" approach.

4. **We would welcome some clarity on the identification of clients and use of the term custody in relation to the holding of assets backing stablecoins**. There are a number of sub-points here:

   - It needs to be clarified who the backing assets are held for. If the backing assets are held as a pool for the stablecoin holders as a whole, whether under a statutory trust or not, we are concerned the FCA will consider this to constitute a collective investment scheme and we do not think the applicable rules will lend themselves to the scenario. We believe HMT should consider creating an exclusion in the Financial Services and Markets Act 2000 (Collective Investment Schemes) Order 2001.

   - Where the backing assets are securities or other existing types of safe custody/designated investments (i.e. assets other than cash), it is not clear why it should be necessary to create a statutory trust to ensure protection of the assets when this does not exist for the custody of securities or other non-cash assets subject to CASS 6. If a trust were to be created, we assume the trustee would be the issuer or the independent custodian, if appointed/required, depending on which party is responsible to the stablecoin holders for the safeguarding and administration of the non-cash backing assets.

   - Where the stablecoin issuer or independent custodian, if appointed/required, is a PRA-authorised credit institution, it should be permitted to hold any backing assets that constitute money as banker, rather than as client money or under an equivalent trust structure with a third-party bank. We note that the backing assets for a stablecoin used in a systemic payment system will have to be money. In these circumstances, the primary regulatory safeguards afforded to the stablecoin holders and/or issuer, as relevant would be: (i) disclosure of the client's exposure to the credit risk of the bank issuer (as is the case in the FCA's existing client money rules for the banking exemption where a bank holds money becoming to a client, e.g., in CASS 7.10.22R); (ii) the PRA's prudential and organisational rules for banks; and (iii) any available depositor protection scheme (e.g., depending on the specific arrangements, the status of the underlying coinholders and any future adaptation of the Financial Services Compensation Scheme).

Consultation Response
Please find below our responses to selected questions raised in the FCA's Discussion Paper:

Chapter 2: A new UK stablecoin regime
Q1: Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.

We think the differentiation for the proposed regime between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes should remain under consideration. We support, for example, that the FCA tailor the regime for the use of stablecoins by wholesale clients as is the case in the application of client classification with regards to traditional financial instruments. This is due to the sophistication of wholesale clients in managing risk and resilience.

There are numerous wholesale use cases for regulated stablecoins, some of which have already been tested or are already in production. The FCA has identified settlement of both the cash and asset leg of the transaction. We would add the following:

- A medium of exchange for cross border payments, eliminating the need for intermediaries;
- A viable alternative to facilitate interoperability of payments between DLT-based platforms, without the use of bank or traditional payment rails;
- A form of collateral for use in both exchange and OTC transactions.

It is important that wholesale market participants are able to access and use stablecoins for such purposes from the UK to avoid them undertaking this business elsewhere in the world when this activity can be adequately risk managed. We view that the availability of regulated stablecoins for wholesale uses is urgently needed to catalyse tokenisation of securities and other real-world assets and can therefore accelerate UK to the Government's stated objective of becoming a global centre for fintech.

We also note the importance that any resulting stablecoin regulation should not be conflated with the use of DLT or blockchain infrastructure for existing, regulated financial services and processes. For example, stablecoins should explicitly exclude tokens that are used solely for the internal bookkeeping records of a financial institution ("Book Entry Tokens").

Chapter 3: Requirements for issuers: backing assets and redemption
Q4: Do you agree with our proposed approach to regulating stablecoin backing assets? In particular do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.

We do not agree with the FCA's suggestion to limit the acceptable backing assets to government treasury debt instruments and short-term cash deposits. We are of the view that the scope of eligible backing assets should be wider otherwise it may create undue compliance challenges for issuers. Furthermore, allowing a wider array of highly liquid and secure assets as backing assets could also contribute to the market demand for such instruments. Rather than limiting the scope of eligible backing assets to certain pre-defined types of instruments, we would suggest adopting an approach based on qualitative criteria and setting out the parameters within which different assets can be used. At a minimum, assets qualifying as high-quality liquid assets (HQLA) should be permitted as backing assets, as is the case under EU MiCA. This would give issuers more flexibility in establishing and maintaining the reserve of assets and allow for more innovation and healthy competition. An alternative approach could be using risk weightings for alternative assets in order to

mitigate the higher risk resulting from the use of such assets. In addition, we view that requiring interest-free cash deposits as backing assets could also impact the commercial viability of issuing stablecoins. In addition, as we have noted above, we view that where the stablecoin issuer is a PRA-authorised credit institution, it should be permitted to hold any backing assets that constitute money as banker, rather than as client money or under an equivalent trust structure with a third-party bank. We are also concerned with the differences between the FCA's and the Bank of England's (BoE) proposals concerning the backing assets. The current lack of consistency between the two regimes creates significant challenges to the transition into use in a systemic payment system and disincentives for a UK issued stablecoin to aspire to that goal. Please also see our answer to Q11 in the BoE DP below.

Separately, irrespective of whatever limits are applied on acceptable backing assets, we note a custodian typically would have no responsibility for ensuring the type of assets placed with it meet the regulatory requirements of the person who has deposited the assets with the custodian.

Q5: Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business-as-usual or firm failure scenarios if multiple currencies are used?

One potential use case for allowing other currencies than the denomination of the regulated stablecoin could be to support the movement in government treasury debt instruments or currency when the UK domestic market for those debt instruments or currencies is closed.

Q6: Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?

Yes, and this generally would be consistent with the current position in CASS regarding interest earned on client money bank accounts (e.g., see CASS 7.11.32R to 7.11.33G).

Q7: Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not? In particular: i. Are there any practical, technological or legal obstacles to this approach? ii. Are there any additional controls that need to be considered? iii. Do you agree that once a regulated stablecoin issuer is authorised under our regime, they should back any regulated stablecoins that they mint and own? If not, why not? Are there operational or legal challenges with this approach?

As indicated above, we do have concerns with how the CASS regime is intended to be applied to cryptoassets. Consistent with the "same risk, same regulatory outcome" principle we believe that the most important guiding principle should be that the backing assets are held in a bankruptcy secure manner. AFME members would expect the CASS regime already to apply to the safeguarding and administration of government debt securities and to any FCA regulated custodians with whom relevant banking assets may be deposited.

Q8: We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following: i. Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets? ii. What are the benefits and risks of this model? iii. Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?

We do not believe stablecoin issuers should be mandated to appoint an independent custodian. Instead, whether an independent custodian is appointed should be the commercial choice of the issuer, subject to appropriate disclosure of the arrangements and risks to the stablecoin holders. We think there will be a number of variations as to how many roles a stablecoin issuer will wish to perform itself and which functions it may wish to appoint a third party to perform. We therefore think it is important that the CASS rules are drafted in such a way that they do not mandate particular structures but allow all parties to comply with the obligations that relate to their roles.

Where a stablecoin issuer holds backing assets subject to CASS by depositing them with a third party (such that the custodian's client is the issuer and not the underlying coin holders), it would be helpful if the FCA clarified that the custodian may offer other independent services (subject to the management of any conflicts of interests), such as:

- acting as paying/transfer agent or administrator in connection with redemptions on behalf of the issuer; or
- monitoring and/or similar accounting/reporting services for the issuer in order to support the issuer's obligations to appropriate manage the backing assets.

Where the stablecoin issuer appoints an independent custodian to hold the backing assets for stablecoin holders (such that the custodian's client is the coin holder and not the issuer), it would be helpful if the FCA clarified the extent to which it expects the custodian to be responsible for the "managing" the reserve assets (as referenced in Paragraph 3.37 DP, to the extent not a typo). In a typical custody arrangement, the custodian would act solely on instruction of its clients (in this scenario, the coin holders or, if acting as agent of the coin holders, the issuer) and would not otherwise be involved in the management of the relevant assets (i.e. involved in making decisions as to which assets to hold and when to acquire/dispose of the same).

Q9: Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular: i. Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations whether this might this be difficult to deliver? ii. Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate. iii. Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain. iv. What costs associated with our proposed redemption policy do you anticipate?

We generally agree with the proposed approach towards the redemption of stablecoins, subject to the following clarifications:

i. Operational challenges: We are concerned that the timeframe is unrealistic considering the ability to redeem is subject to banking rails and a chain of intermediaries. Moreover, any timeframe should not commence until the issuer is satisfied with all AML/CTF checks based on the documents provided to it by the coin holder. By way of comparison, under the EU MiCA regime, it is up to the issuers of asset-referenced tokens to establish a policy on a permanent right of redemption, including the relevant timeframes for holders of such asset-referenced tokens to exercise their right of redemption.

ii. Outsourcing: While we think this option should be available to issuers, subject to existing FCA standards on outsourcing, governance and third-party oversight, we do not think it is obvious that custodians of backing assets will want to or should be required play a role in redemption. We strongly view that there should be no obligation on custodians to be part of redemption activity apart from the transfer of assets

and delivering them on time. AFME members have discussed that a third party might not be able/willing to perform any role in redemptions where, for example, there is more than one issuer and/or redeeming entity minting and burning tokens and the third party has no client relationship with the person requesting redemption.

iii. Restrictions to redemption: AFME has no further comments.

iv. Costs: AFME views that: (i) BAU costs could arise from operating the ID/KYC processes, where even if mostly automated, exceptions will require manual intervention; (ii) there could be one-off costs in a stress scenario, for example where redemptions requests exceed the issuer's BAU capacity; and (iii) there could be disproportionate transaction costs if BAU redemptions required the sale of backing assets – but this later cost could be reduced if issuers were allowed to hold a small number of backed coins on a propriety basis to allow them to "manage the box", similar to the arrangements the FCA permits for fund managers, or required to hold a sufficient proportion of backing asset in cash to cover BAU redemptions.

Chapter 5: Custody requirements

Q13: Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.

We do not agree that individual client wallet structures should be mandated for certain situations or activities. We do not see any risks arising from omnibus client wallet structures to be so great to require the prohibition of their use. Moreover, where custody chains exist (e.g. a UK custodian needs to appoint a third-party custodian to safeguard and/or administer a given cryptoasset, including security tokens), individual client wallet structures may not be practical in all circumstances and could be cost prohibitive.

Moreover, as the existing CASS rules are outcome focused, they already address the risks associated with holding and/or registering title to client assets on either an omnibus or individual segregation basis. This existing flexibility, along with the existing risk mitigants, including, where appropriate, client discourse or consent, should be sufficient to regulate the use of individual versus omnibus client wallet structures for digital assets using DLT technology.

Q14: Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.

See our answer to Q13. We think the existing general disclosure obligations of custodians in CASS 6 and 9 and COBS 16/16F generally should be sufficient.

Q15: Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?

We expect clients, including wholesale market participants, will seek to use cryptoassets (including security tokens) in the same way that they use other traditional asset classes and existing investments today, including

as collateral for other transactions or as part of financing transactions, such as in lending and sale and repurchase markets.

See also our answer to Q1 in relation to use of regulated stablecoins.

Q16: Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.

We generally agree. Nevertheless, we view that the following areas may benefit from further technical assessment and discussion with industry:

- when conducting internal custody record checks (such as reconciliations or system evaluations) when the custodian holds the relevant assets directly (i.e. other than through a sub-custodian or FMI, where the custodian would continue to comply with the existing CASS 6 rules for both internal custody record checks and external custody reconciliations between its records and those of the sub-custodian or FMI).

- the need for/or practically of real-time external reconciliations, depending on when the record created by the DLT or blockchain is considered final and/or whether a sub-custodian has been appointed to participate in the relevant DLT ledger or blockchain platform; and

- for any custody rules governing "on-chain activity" (e.g., regarding recording ownership and conducting record checks/reconciliations), this means activity the custodian conducts itself directly on either a public or private blockchain, rather than the scenario in which the custodian appoints a separate sub-custodian or FMI to carry out on-chain activity for it with the custodian complying instead with the rules around the appointment of that third party (e.g., the rules governing the depositing of safe custody assets with third parties in CASS 6.3).

Q17: Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?

See our answer to Q16.

Q18: Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

Yes. See also above our high-level comments on the territorial scope of the regulated activities of custody.

CASS already adequately addresses any associated risks to holding client assets with third parties. This includes for cryptoassets that already are regulated in the UK as traditional assets, such as security tokens, certain commodity-linked tokens, tokenised deposits and e-money.

In particular, firms should be permitted to use overseas sub-custodians without the overseas sub-custodian becoming subject to FCA regulation and being required to be FSMA authorised to provide such services to UK persons, in particular to wholesale market participants, such as other FCA-regulated custodians. In many

cases, as is the case for traditional financial assets, use of a local custodian or financial market infrastructure located outside of the UK often can be a requirement of local laws and rules applicable to the asset.

Nevertheless, AFME members have discussed that further consideration may be given to the development of additional market standards and guidance for conducting due diligence on the IT security aspects of the use of DLT generally or a particular blockchain or type of blockchain. However, it should remain subject to the discretion of each firm to decide on what is necessary in terms of conducting a due diligence investigation.

Q19: Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

Generally, we agree with those proposals. New entrants to financial services markets that provide custody services for cryptoassets should be subject to the same general standards to which existing market participants that provide custody services for traditional assets are already subject.

Q20: Should cryptoasset custodians undertaking multiple services (eg brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

We do not agree with this proposal, and we do not believe this is necessary or desirable in all circumstances. Separation of dealing/brokerage activities and custody services into different legal entities generally is not required in existing financial markets, subject to segregation of duties and management of conflicts of interest. For example, UK banks and broker-dealers, both in the wholesale and retail markets, already provide their clients dealing/brokerage and custody services through the same legal entity and we do not see any reason for this practice to change solely as a result of the use of DLT and or a given blockchain or type of blockchain.

Q22: What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

Assuming the custodian is acting in the traditional sense of holding the assets for the issuer rather than as independent custodian for stablecoin holder, we would expect the custodian's role to be limited to ensuring the settlement proceeds were directed appropriately to the account nominated by the Issuer or it's agent, including any relevant insolvency practitioner – presumably with client money status or under banking exemption as currently set out in CASS 7.

That said, this should not prevent custodians from agreeing with the issuer to provide it other services independent of their custody offering such as acting as paying/transfer agent or administrator in connection with redemptions. However, at all times, we would expect that it is the issuer who should have regulatory responsibility for ensuring any redemptions comply with applicable regulatory requirements, with the custodian's paying/transfer agent and/or administrator role typically being limited to acting on instruction of the issuer.

Chapter 6: Organisational requirements

Q24: Do you agree with our proposal to apply our operational resilience requirements (SYSC 15A) to regulated stablecoin issuers and custodians? In particular: i. Can you see how you might apply the operational resilience framework described to your existing business (eg considering your important business services and managing continuity)? Please set out any difficulties with doing this. ii. What approach do you take when assessing third

party-providers for your own internal risk management (such as responding to, testing and managing potential disruption)? iii. Are there any minimum standards for cyber security that firms should be encouraged to adopt? Please explain why.

We generally agree with the proposal to apply the operational resilience requirements to regulated stablecoin issuers and custodians. To the extent that stablecoin issuers and custodians are already subject to operational resilience requirements, they should be able to leverage existing arrangements. In line with the importance of adopting a technology-neutral approach, we support regulation that appropriately governs permissionless and permissioned networks, while still encouraging responsible innovation. Furthermore, it is important that permissionless blockchains and protocols should not be misconstrued as third-party service providers to custodians, as custodians have no control over, or any ability to influence, such blockchains and protocols. For public blockchains and protocols, custodians should not be responsible for losses caused by public blockchains and protocols beyond their reasonable control.

Chapter 8: Prudential requirements

Q31: Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the following areas: i. Capital requirements and quality of capital ii. Liquidity requirements and eligible liquid assets iii. Group risk iv. Concentration risk v. Internal risk management

We generally agree with the proposed prudential requirements for regulated stablecoin issuers and custodians. We strongly maintain the view that in relation to the future development of prudential rules by the FCA, it is imperative to take an off-balance sheet approach to custody of cryptoassets as set out in the Basel Committee's standards on the prudential treatment for banks' exposures to cryptoassets. It is essential that any capital and liquidity requirements associated with cryptoasset custody do not make custody unfeasible at scale for banks and prevent qualified and regulated institutions from providing institutional-grade solutions that address identified risks of new asset classes.

Chapter 11: Overseas stablecoins used for payment in the UK

Q39: What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?

We believe it is important to find a way to allow at least the wholesale market to continue to use overseas stablecoins, including USDC. Some financial institutions may already use these to settle tokenised securities, both in the UK and overseas, and making it more difficult to do so from the UK is only likely to push these activities to other countries. Given the high barriers to developing a domestic stablecoin for use in the wholesale market as indicated by the BoE DP, the ability to use overseas stablecoins is particularly important to maintain UK competitiveness and for access by UK investors and clients.

The payment arranger proposal is unattractive because it appears to require at least one person per payment chain to become authorised to approve the stablecoin and to actually approve it, which exercise may be difficult to achieve without obtaining a fair amount of information and cooperation from the issuer. Even if a person takes all the proposed steps, it is unclear who can then use the stablecoin and for what purpose. However, if this is limited, this seems like a burdensome and inefficient process; if not, we query why any person would want to make this effort for the benefit of the stablecoin. This is an expensive process (including the cost of an independent auditor) and the reward does not seem to match the risk. Even once an overseas stablecoin has been approved, the payment arranger has to monitor the stablecoin on a weekly basis. We

believe that the proposed regime can result in the UK finance industry being isolated from the international financial markets especially if the UK stablecoins regulation turns out to be materially more restrictive than the corresponding regulation in other developed financial markets.

We have considered potential alternatives, and it seems to us that some form of equivalent or mutual recognition of stablecoins regulated in other jurisdictions would be helpful, but we accept that this is difficult before the key jurisdictions regulate stablecoins. We would propose that the UK authorities do not impose this regime in relation to wholesale payment chains at all, or at least delay its implementation until this regulation develops and it becomes clearer what overseas stablecoins will develop and how the wholesale sector wants to use them.

Q40: What are the barriers to assessing overseas stablecoins to equivalent standards as regulated stablecoins? Under what circumstances should payment arrangers be liable for overseas stablecoins that fail to meet the FCA standards after approval, or in the case where the approval was based on false or incomplete information provided by the issuer or a third party?
See our answer to Q39.

BoE DP "Regulatory regime for systemic payment systems using stablecoins and related service providers" (BoE DP)

AFME has provided answers to selected questions below. We would also urge the BoE to consider our response to the FCA DP above, as many parts are relevant to both.

Part 2: Further details of the Bank's proposed regulatory framework
Question 11: Do you agree with the Bank's assessment of the important role of backing assets in ensuring the stability of value of the stablecoin?

We agree with the important role of backing assets for a stablecoin used in systemic payment systems as articulated by the Bank. However, we consider that limiting the eligible assets to central bank deposits is overly restrictive and go further than that required by CPMI IOSCO and the example set by MiCA. We query whether it is commercially viable given that (a) it appears to limit those that can issue such stablecoins to banks and create an uncompetitive barrier to entry, (b) it means a coinholder who may have been using the stablecoin to avoid reliance on banks is still exposed to their credit risk, (c) it limits the basis on which different stablecoins can complete with one another, (d) we query how different stablecoins will be from a potential central bank digital currency. We also are disappointed by the lack of coherence with the FCA's proposals for non-systemic fiat backed stablecoins and in particular the fact that it necessitates a fundamental change in structure when a stablecoin becomes systemic: a stablecoin with such aspiration cannot set itself up to allow for a smooth transition. We would suggest the Bank provides for a more flexible approach by setting out a series of factors it will consider, allowing different types of assets up to particular thresholds if necessary, and reconsidering the inclusion of HQLA.

Question 13: Do you agree with the Bank's proposed requirements on the redemption process, including the role of all firms in the payment chain?

In addition to our response to Q11, we view that the requirement for backing assets to be central bank deposits introduces uncertainty for the redemption process in practice.

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