

## REGULATORY INTELLIGENCE

**Busy times in fintech: outline of recent regulatory developments**

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Over the last three weeks, financial services regulators have been busy publishing a range of initiatives which will impact on the fintech industry worldwide. The common theme across all the publications is the regulators' quest to strike the right balance between encouraging innovation on the one hand and ensuring an appropriate level of consumer protection on the other.

From the UK's Financial Conduct Authority (FCA), there has been a ban on the marketing and distribution of crypto-derivatives to retail investors, together with support for fintech innovation via its latest sandbox schemes opening to new applications. In the EU, there has been seen a pilot scheme for distributed ledger technology (DLT), the introduction of an EU-wide passport for crowdfunding platforms (and a proposal to do something similar for cryptoasset services) together with new investor protection rules requiring the provision of investor information sheets and limits on how much retail investors can invest. Looking at things from a wider perspective, the Financial Stability Board has recommended the regulation and supervision of stablecoin arrangements.

In this series of articles, each of these developments will be looked at in turn, starting in this article with the UK Financial Conduct Authority.

**UK Financial Conduct Authority's ban on the marketing and distribution of crypto-derivatives to retail investors**

On October 6, 2020, the FCA [published](#) rules prohibiting the marketing, distribution and sale of derivatives and exchange traded notes that reference "unregulated transferable cryptoassets" to retail investors by firms in, or from, the UK. These final rules follow the FCA's [consultation](#) on the proposals back in July 2019. It is worth noting that the ban does not apply to professional or eligible counterparty clients, derivatives that reference other tokens or collective investment undertakings (funds).

In the FCA's view, retail investors cannot reliably assess the value and risks of crypto-derivatives due to the:

- nature of the underlying assets, which have no inherent value and so differ from other assets that have physical uses, promise future cash flows or are legally accepted as money;
- presence of market abuse and financial crime (including cyberthefts from cryptoasset platforms) in cryptoasset markets;
- extreme volatility in cryptoasset prices; and
- inadequate understanding of cryptoassets by retail consumers and the lack of a clear investment need for investment products referencing them.

The FCA thinks retail investors will potentially suffer harm from sudden and unexpected losses if they buy these products. It estimates that the ban could reduce overall consumer losses by between £19 million and £101 million per year, with the annualised net benefits to consumers towards the middle of this range at £53 million. This estimate is significantly lower than the estimate in [CP19/22](#) with the reduction being attributed to additional client data and the leverage limits imposed on contracts for differences (CFDs) trading by European Securities and Markets Authority (ESMA) and the FCA.

In terms of products within the scope of the ban, the prohibition is intended to include derivatives (i.e. contracts for difference, options, and futures) and exchange traded notes (ETNs) that reference exchange tokens and utility tokens. It does not include derivatives or ETNs that reference:

- security tokens, because these tokens already qualify as specified investments (and are therefore regulated by the FCA) and they do not pose the same risks as exchange and comparable utility tokens since they will have a basis for valuation according to the legal rights or promise of payment they will provide;
- tokens that are not widely transferable (e.g. tokens used on a private network that can only be redeemed with the issuer);
- e-money tokens; and
- crypto-commodities and Central Bank Digital Currencies. Even though these products are not available today, the FCA believes that capturing them would unnecessarily undermine innovation and competition.

The FCA's new rules apply to the following firms (when marketing, distributing or selling crypto-derivatives in, or from, the UK to retail investors):

- MiFID investment firms, including CRD credit institutions;
- MiFID optional exemption firms;
- UK branches of third-country investment firms; and
- EEA MiFID investment firms which continue operating in the UK after January 6, 2021 under the temporary permissions regime or the financial services contracts regimes.



These firms must cease their retail investor crypto-derivative marketing, distribution or selling activities by January 6, 2021. Retail investors with existing holdings can remain invested following the prohibition until they choose to disinvest. There is no time limit on this, and the FCA does not require or expect firms to close out retail investors' positions unless the investor asks them to do so.

The FCA's supervisory activities will focus on attempts to avoid the effect of the new rules, for example, inappropriately 'opting up' retail clients to become elective professional clients or moving retail clients to associated non-UK entities – the FCA has said it will also work with international regulators to monitor the risks of firms seeking to move UK clients to entities outside the EU to circumvent the measures. The FCA will also consider the conduct of inward passporting firms operating under the Temporary Permissions Regime. Where the FCA sees firms not complying with the rules it has said that it will consider taking action using its supervisory and enforcement powers.

The FCA has said that it will keep the prohibition under review. Affected firms must now ensure that their business operations are ready for the January 6, 2021 deadline.

### **FCA's Regulatory Sandbox and Digital Sandbox are open to new applications**

On October 5, 2020, the FCA opened applications for Cohort 7 of its Regulatory Sandbox and its first Digital Sandbox pilot. The FCA's continued focus on financial innovation has contributed to the success and popularity of its sandbox in recent years.

The focus of both sandboxes is to support products and solutions that are looking to deliver genuine innovation in the UK financial services market and will deliver clear consumer benefit. The three key areas where the FCA is particularly interested in seeing new products and solutions emerge are:

1. detecting and preventing fraud and scams;
2. supporting the financial resilience of vulnerable customers; and
3. improving access to finance for small and medium-sized enterprises.

For the Regulatory Sandbox, the FCA has not limited applications to these three areas and will consider proposals intended to help with the consequences of coronavirus or indeed any innovative financial services venture. For the Digital Sandbox pilot, however, the FCA has taken the decision to focus only on these three areas so that it can provide the necessary support for each, in terms of supplying relevant data sets and expertise.

As with previous cohorts, applications for the Regulatory Sandbox can be made by authorised and unauthorised organisations, including technology businesses, who are looking to deliver innovation in the UK financial services market. The Regulatory Sandbox enables successful applicants to test their proposed solutions and products in a controlled environment, with real consumers. Firms with propositions that are genuinely innovative, show clear consumer benefit and meet all of the FCA's eligibility criteria are encouraged to apply. Applications are open until December 31, 2020.

The Digital Sandbox, which is launching for the first time is aimed at supporting innovative firms and organisations in an earlier stage of development and offers an alternative for organisations which do not meet the testing requirements of the Regulatory Sandbox, and thus provides a wider scope of opportunity for applicants. To apply to the Digital Sandbox, applicants must have a proposition aimed at tackling challenges related to, or exacerbated by, coronavirus in relation to: (1) fraud and scams; (2) vulnerable customers; and (3) SME lending.

Successful applicants for the Digital Sandbox will have access to synthetic data sets, an innovation ecosystem, an API marketplace, an integrated development environment and the ability to showcase their solutions. The products in the Digital Sandbox are expected to be still in development and not at the stage where they are ready to be tested with consumers or in a live product environment.

All applications should be submitted through the Digital Sandbox website by October 30, 2020. Firms or individuals which do not have a proposition to test in the Digital Sandbox, but who want to observe or potentially be involved with a team, can register an account on the Digital Sandbox website to stay up to date.

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The logo for CMS, consisting of the letters 'C', 'M', and 'S' in a bold, blue, sans-serif font. Each letter has a diagonal slash through it, with the slash extending upwards and to the right.

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