

# Blockchain & Cryptocurrency Regulation

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## Definition

At the time of writing, there is no accepted global definition of a cryptoasset. The UK Cryptoassets Taskforce (the **Taskforce**), which comprises the Financial Conduct Authority (**FCA**), HM Treasury (**HMT**), and the Bank of England (**BoE**), defined cryptoassets as ‘*cryptographically secured digital representations of value or contractual rights that uses some type of distributed ledger technology and can be transferred, stored or traded electronically*’.<sup>1</sup> The Taskforce identified three broad types of cryptoassets:

- (1) **Exchange tokens**, often referred to as ‘cryptocurrencies’ such as Bitcoin and Ether, which utilise a distributed ledger technology (**DLT**) platform. They are not issued or backed by a central bank or other central body and do not provide the types of rights or access provided by security or utility tokens. They are used as a means of exchange or for investment.
- (2) **Security tokens**, which amount to a ‘specified investment’ as set out in the Financial Services and Markets Act (2000) (Regulated Activities) Order (**RAO**). These may provide rights such as ownership, repayment of a specific sum of money, or entitlement to a share in future profits. They may also be transferable securities or financial instruments under the EU’s Markets in Financial Instruments Directive II (**MiFID II**).
- (3) **Utility tokens**, which can be redeemed for access to a specific product or service that is typically provided using a DLT platform.

In a Policy Statement (the **Guidance**),<sup>2</sup> the FCA identified a fourth type of token, electronic money (**e-money**) tokens that meet the definition of e-money under the Electronic Money Regulations (**EMRs**). The FCA produced guidance on the extent to which different types of cryptoasset fall within the regulatory perimeter set by the Financial Services and Markets Act 2000 (**FSMA**) and the RAO.

The Taskforce has continued to try to cast light on this evolving area since its 2018 report:

- In 2019, the FCA published two qualitative research reports exploring the motivations and behaviours of consumers buying cryptoassets to help identify areas of potential harm.<sup>3</sup> At this time, cryptoassets were not widely bought or used and so harm was deemed minimal.
- In 2020, the FCA published consumer research, which found that the main use case for cryptoassets is speculative investment, and that 89 per cent of users knew that they are not subject to regulatory protections.<sup>4</sup>
- As more mainstream financial services firms entered this market, the potential harm was considered in findings of the House of Commons Treasury Committee’s inquiry into digital currencies in the UK.<sup>5</sup>
- In 2020, a BoE discussion paper considered what a central bank digital currency (**CBDC**) would look like as well as the opportunities and challenges it would present.<sup>6</sup>

- In January 2021, the FCA introduced a ban on the sale, marketing and distribution of derivatives and exchange-traded notes referencing ‘unregulated transferable cryptoassets’ in or from the UK to retail customers.<sup>7</sup> The ban does not apply to security tokens, which are within the FCA perimeter. Ninety-seven per cent of respondents opposed this FCA proposal, but the regulator opted to proceed. The FCA took the opportunity to adopt the Taskforce’s definition of cryptoassets in its Glossary definition of ‘unregulated transferable cryptoasset’ when introducing this prohibition.<sup>8</sup>
- In 2021, the FCA published its consumer research,<sup>9</sup> which found an increase in public awareness of cryptoassets and a rise in ownership.
- In April 2022, HMT published a response to its January 2021 consultation confirming its intention to develop policy, discussed below.

Regulators in the UK prefer the term ‘cryptoasset’, rather than ‘cryptocurrencies’, as it captures a broader range of tokens than just those intended to operate as a means of exchange. These terms may be used interchangeably, as well as terms such as ‘virtual asset’, ‘virtual currency’, ‘digital asset’ and ‘digital currency’.

### Regulatory approach

The UK’s approach to cryptoassets is evolving parallel to the market, and actively recognises that any rules should balance supporting innovation and consumer outcomes. The intangible nature of cryptoassets presents challenges to the regulatory perimeter and, as such, the FCA’s cryptoassets guidance (non-Handbook perimeter guidance) is designed to clarify where the perimeter lies.

A cryptoasset can be subject to financial regulation in the UK if it falls into the FCA’s regulatory perimeter established by FSMA, the UK Anti-Money Laundering (AML) regime, the Payment Services Regulations 2017 (PSRs) or the EMRs. The RAO contains an exhaustive list of ‘specified investments’, which determines what is regulated under FSMA. If a cryptoasset matches the definition of a specified investment, it will be categorised as a security token and most likely be subject to regulation. In the Guidance, the FCA outlines that cryptoassets may fall within the existing perimeter as a specified investment as set out in the RAO, as a financial instrument under MiFID II, as e-money (which is regulated under the EMRs and FSMA), and under the PSRs.

The FCA has used the Taskforce categorisation framework as a starting point to produce guidance on the extent to which different types of cryptoasset fall within the regulatory perimeter set by FSMA and the RAO. The table below summarises the UK’s position on the regulation of cryptoassets:

Status	Type	Characteristic
Regulated	Security tokens	<ul style="list-style-type: none"> <li>• Provide rights and obligations analogous to ‘specified investments’, like a share, as set out in the RAO and therefore within the FSMA perimeter.</li> <li>• Holder has some rights such as ownership, repayment of a specific sum of money or entitlement to a share in future profits. Such rights are associated with traditional regulated securities.</li> <li>• Potentially transferable securities under MiFID II.</li> </ul>
	E-money tokens	<ul style="list-style-type: none"> <li>• Meet the definition of e-money under the EMRs: ‘<i>Electronically (including magnetically) stored monetary value, as represented by a claim on the electronic money issuer, which is issued on receipt of funds for the purpose of making payment transactions; accepted as a means of payment by a person other than the electronic money issuer....</i>’</li> <li>• Where issued by a credit institution, credit union or municipal bank, such tokens are also within the FSMA perimeter.</li> </ul>

Status	Type	Characteristic
Unregulated	Exchange tokens	<ul style="list-style-type: none"> <li>Decentralised and used as a means of exchange for buying and selling goods without traditional intermediaries.</li> <li>Holder has no rights associated with specified investments.</li> <li>An alternative to fiat currencies but not backed by central authorities.</li> <li>Can be traded on a regulated market.</li> </ul>
	Utility tokens	<ul style="list-style-type: none"> <li>Holder has access to a current or prospective product or service within a discrete network or ecosystem typically provided using a DLT platform.</li> <li>Holder does not have rights that are the same as those granted by specified investments.</li> <li>Not to be used as a means of payment.</li> <li>May meet definition of e-money.</li> <li>Can be traded on a regulated market.</li> </ul>

To ensure compliance, firms should read the Guidance alongside the FCA’s Perimeter Guidance manual (**PERG**). If a firm acts within these guidelines, it will be treated as having complied with the relevant rule or requirement, but this is not binding on courts; therefore, judgments on whether a cryptoasset falls within the regulatory regime will be made on a case-by-case basis.

Where cryptoassets are not regulated, cryptoasset exchange providers (**CEPs**) and custodian wallet providers (**CWPs**) must register with the FCA to comply with the amended Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (**MLRs**).<sup>10</sup>

Stablecoins

A stablecoin is a cryptoasset that aims to maintain a stable value relative to a specified asset, or a pool of assets, by using a variety of mechanisms but typically through pegging the value of the stablecoin to an underlying asset or currency, such as gold or GBP. They are electronic, are not issued by central banks and are token-based. Stablecoins vary in their structure and arrangement, which makes it difficult to classify them as a single type of token. For example, stablecoins pegged to a currency (or other assets and which are used for the payment of goods and services) could meet the definition of e-money, and would therefore be regulated tokens. With appropriate regulation, stablecoins could provide an efficient means of payment and widen consumer choice.

In April 2022, HMT published a response<sup>11</sup> to its January 2021 consultation in which it proposed to bring stablecoins within the UK regulatory scope. The FCA and BoE would be handed appropriate powers over stablecoin issuers and other entities, including the customer-facing entity and wallet providers. Proposed changes include:

- amending the definition of ‘e-money’ and producing a definition for ‘payment cryptoasset’, or something similar, that brings into scope any cryptographically secured digital representation of monetary value;
- extending the application of Part 5 of the Banking Act 2009 to include stablecoin activities in cases where the risks posed have the potential to be systemic and so the threshold for BoE supervision is met; and
- extending the scope of the Financial Service (Banking Reform) Act 2013 to make stablecoin-based payment systems subject to appropriate competition regulation by the Payment Services Regulator.

The changes are intended to encompass all stablecoins that reference fiat currencies, including single-currency stablecoins or stablecoins based on a basket of currencies, as they have the capacity to develop into widespread means of payment. Additionally, as

the role of the wallet provider is a key feature of cryptoassets, the government considers that regulation is required to ensure that the custody or the arranging body of the token is subject to the appropriate regulation. The government will set out in legislation how the new activity will be brought within regulation and the scope of the FCA's powers. Further details are expected in due course.

Further, the Financial Services and Markets Bill,<sup>12</sup> introduced to Parliament in July 2022, brings activities facilitating the use of certain stablecoins, where they are used as a means of payment, within the regulatory perimeter. This will be done primarily via amendments to the existing e-money and payment systems regulatory frameworks.

## Sales regulation

The sale of cryptocurrency in the UK is subject to sales regulations that fall into three broad categories: the financial promotions regime; prospectus regulation; and consumer protection and online/distance selling legislation.

### Financial promotions

There is no specific regulatory framework for cryptoassets, but the regulators often issue stark warnings for consumers, reminding them that there are no consumer protections for those who buy cryptoassets and non-fungible tokens (**NFTs**), that they are not protected by the Financial Services Compensation Scheme, and that consumers should be prepared to lose all the money they invest.<sup>13</sup> It is widely accepted that the FCA needs more powers to control how cryptoassets are marketed by bringing such activities into the regulatory financial promotion perimeter.

A financial promotion is an invitation or inducement that is communicated in the course of business to engage in investment activity. The financial promotion regime applies to communications with reference to certain activities involving 'controlled investments', such as shares, bonds or derivatives, and 'controlled activities', both of which are set out in an exhaustive list in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (**FPO**). Financial promotions capable of being effective in the UK must:

- (a) be issued by an FCA/Prudential Regulation Authority (**PRA**)-authorised person;
- (b) be approved by an FCA/PRA-authorised person; or
- (c) fall within an exemption from the financial promotion regime.

To determine whether the financial promotion regime applies to cryptoassets, one must determine whether the activities involve a controlled activity or controlled investment by referring to the FPO. Those marketing cryptoassets that are out of scope are reminded by the FCA that they must comply with the CAP Code and the Advertising Standards Authority (**ASA**) guidelines.<sup>14</sup> Firms must state that cryptoassets are not regulated by the FCA, not take advantage of consumers' inexperience or credulity, include all material information, and make clear that value can go down as well as up. Generally speaking, sales of classic cryptocurrencies should not engage the regime, nor will utility tokens or e-money tokens as they are unlikely to constitute controlled investments.

In 2022, there were two important developments relating to the marketing of cryptoassets in the UK. In January, HMT published its consultation response,<sup>15</sup> setting out new rules that would bring cryptoassets within the scope of the financial promotion regime. The exact definition of 'qualifying cryptoassets' has not yet been confirmed, but the current proposed definition refers to any cryptographically secured digital representation of value or contractual rights that is (i) fungible, (ii) transferable, (iii) not any other type of controlled investment, (iv) not within the definition of e-money, and (v) not currency issued by a central

bank or other public authority. This broad definition would cover most cryptocurrencies not already within the scope of the regime; therefore, financial promotions communications that are invitations or inducements to engage in such activities will no longer be permitted unless they are issued by an FCA/PRA-authorized person, are approved by an FCA/PRA person, or fall within an exemption from the financial promotion regime. Breaching this restriction will be a criminal offence.

Most UK firms in the industry do not have the relevant FCA authorisation to issue their own financial promotions. Consequently, firms will need to find an FCA/PRA-authorized firm with the relevant permissions willing to approve its financial promotions. This is likely to lead to additional costs and will have timing implications for token projects. Further, a separate proposal to introduce a new regulatory gateway, which states that FCA-authorized firms may only approve financial promotions for unauthorised firms if they have been assessed by the FCA to be suitable to do so, will result in a limited number of firms able to approve such financial promotions under the new regime.

These changes are yet to be adopted and will likely come with a transition period of ‘approximately six months’ from both the finalisation and publication of the proposed FPO regime and the complementary FCA rules. Until this period ends, enforcement remains in ASA’s remit.

In August 2022, the FCA published stronger final rules relating to the financial promotion of high-risk investments (**HRIs**).<sup>16</sup> These rules follow its January consultation.<sup>17</sup> Among other rules, the FCA introduced the categories of Restricted Mass-Market Investments (**RMMIs**) and Non-Mass-Market Investments (**NMMIs**) for financial promotions, which are to be accompanied by stronger risk warnings. For first-time investors in RMMIs and NMMIs, there should be a personalised risk-warning pop-up and a 24-hour cooling-off period. There will also be a ban on inducements to invest in these; e.g., ‘refer a friend’ bonuses. All rules will be effective from 1 February 2023, but rules related to risk warnings for the financial promotions of HRIs will take effect from 1 December 2022.

These new rules will not be applicable to cryptoasset promotions as was intended. Rather, the regulator stated it will publish new rules on those once the relevant legislation to bring qualifying cryptoassets within the financial promotion regime has been made. There is indication that the rules are likely to follow the same approach as for other HRIs, as cryptoassets remain high-risk.

The promotion of a financial service or product is not a regulated activity; however, unauthorised firms that market such services and products relating to regulated tokens must comply with the financial promotion restriction under section 21 FSMA. Section 21 imposes a general restriction on the communication of financial promotions and when an unauthorised firm wishes to communicate a financial promotion, the promotion must be approved by an authorised firm. Further, the FCA’s financial promotion rules might apply to their marketing even if they are not authorised.

Promotions of regulated tokens must adhere to the FCA rules for investment business in chapter 4 of its Conduct of Business Sourcebook (**COBS**), the main requirement that promotions be clear, fair, and not misleading.

### Prospectus Regulation

FSMA and the onshored UK Prospectus Regulation require firms to make available an approved prospectus to the public, before (i) transferable securities are offered to the public, or (ii) a request is made for transferable securities to be admitted to a regulated market situated or operating in the UK.

Such requirements relate to transferable securities and so, to see whether this regime is applicable to cryptoassets, it must be established whether the relevant cryptoasset is a transferable security. If a cryptoasset token is a transferable security and is offered to the public or admitted to trading on a regulated market, the issuer must publish a prospectus.<sup>18</sup> Transferable securities are those captured in the definition set out in the UK Markets in Financial Instruments Regulation (**MiFIR**).<sup>19</sup> Exemptions apply; for example, public offers made to qualified investors or fewer than 150 persons.

The Guidance sets out that only security tokens may be transferable securities. Cryptocurrencies such as Bitcoin and Ether are likely categorised as exchange tokens rather than security tokens and so the prospectus requirements would not apply to their sale. In any event, neither of these assets has an issuer.

#### General advertising, online/distance selling and consumer protection legislation

Outside the requirements of the UK financial regulatory framework, other legislation may be relevant to the sale or offering of cryptocurrency and services related to them:

- The Consumer Rights Act 2015 and the Consumer Protection from Unfair Trading Regulations 2008 apply in relation to consumers (individuals acting outside of their trade, business, craft or profession) and provide them with statutory rights and remedies against suppliers of goods, services and digital content. Further restrictions are imposed on the kinds of contractual terms that can be enforced against consumers.
- The Electronic Commerce (EC Directive) Regulations 2002 apply more generally and impose requirements on businesses that offer or provide goods or services digitally. Whether the legislation applies depends on whether the business being conducted is subject to UK regulation.

### **Taxation**

At the time of writing, there is no specific tax regime to govern how cryptoasset transactions are taxed; therefore, the current tax rules must be considered and applied (although some uncertainty remains as to their application). The UK tax authority, HM Revenue and Customs (**HMRC**), uses the same definition of cryptoassets adopted by the Taskforce, identifying four types of cryptoassets, namely: exchange tokens; utility tokens; security tokens; and stablecoins. The classification of cryptoassets is not necessarily determinative of their tax treatment, which will depend on the nature and use of the cryptoasset in question.

HMRC has published some guidance relating to the taxation of cryptoassets, focusing on the taxation of exchange tokens. It is important to note that HMRC is not bound by its published guidance, but it is useful to see how it might approach a case that will be decided on its facts.

HMRC does not treat exchange tokens as money or fiat currency; therefore, tax rules that apply to fiat currency do not apply to exchange tokens. Additionally, exchange tokens contributed to pension funds would not be treated as a tax-relievable contribution.

In April 2022, the government announced that it will explore ways of enhancing the competitiveness of the UK tax system to encourage development of the cryptoasset market.<sup>20</sup> This includes:

- a review of how decentralised finance (or **DeFi**) loans (where holders of cryptoassets lend them out for a return) are treated for tax purposes;
- a consultation on extending the scope of the Investment Manager Exemption (**IME**) to include cryptoassets; and
- negotiation on a new OECD Crypto-Asset Reporting Framework, ensuring enhanced tax transparency and enabling a level playing field in tax reporting globally.

The IME is a statutory concession, which provides that a UK-based investment manager will not be treated as a UK representative of a non-resident fund, if certain conditions are met. These conditions include limits as to the types of transaction that can qualify for the IME. A list of qualifying transactions is set out in the investment transactions list (ITL). In May 2022, HMRC published a consultation to consider adding transactions in cryptoassets to the ITL.<sup>21</sup> The consultation also considers whether this change should extend to those fund tax regimes that use the ITL to define the transactions.

### Taxation of individuals

In relation to how individuals who hold exchange tokens are to be taxed, HMRC guidance contains the following helpful general points:<sup>22</sup>

- buying and selling cryptocurrency would most likely amount to personal investment activity (as opposed to trading activity) such that capital gains tax (CGT) would be payable on any gains an individual realises on disposal;
- if an individual is involved in a ‘trade’ of exchange tokens, any trading profits would be subject to income tax, rather than CGT; and
- exchange tokens received as a form of payment from an employer would be subject to income tax and National Insurance contributions.

Disposals include (but are not limited to):

- selling exchange tokens for money;
- exchanging one type of cryptoasset for a different type of cryptoasset;
- giving tokens away to another person; and
- using exchange tokens to pay for goods or services.

A UK tax-resident but non-domiciled individual who claims the remittance basis of taxation is normally only subject to UK income tax and CGT in respect of non-UK-sourced income and capital gains (arising from the disposal of non-UK-situated assets), respectively, that have been remitted to the UK. HMRC guidance treats the situs of exchange tokens as being the jurisdiction in which the individual beneficial owner of the exchange tokens is tax-resident. Therefore, UK tax residents, regardless of their domicile status, would be subject to UK income tax or CGT in respect of any non-UK-sourced income and capital gains (arising from the disposal of non-UK-situated assets), respectively, regardless of whether such income or gains have been remitted to the UK.

Individual taxpayers should keep detailed records in respect of every cryptoasset transaction.

### Taxation of businesses

In respect of how transactions involving exchange tokens undertaken by companies and other businesses (including sole traders and partnerships) would be treated, HMRC has indicated the following:<sup>23</sup>

- corporation tax (CT) legislation, which relates to money or fiat currency, would not apply to cryptoassets as HMRC does not consider exchange tokens to be money;
- where activity such as buying and selling exchange tokens amounts to a ‘trade’, the receipts and expenses of the trade will form part of the calculation of the trading profit in respect of that business for CT purposes;
- where the activity does not amount to a ‘trade’, and is not charged to CT in another way, the activity might be treated as the disposal of a capital asset such that any gain arising from the disposal would be charged to CT as a chargeable gain;
- value-added tax (VAT) is due in the normal way on the supply of goods or services sold in exchange for cryptoassets;

- stamp duty and stamp duty reserve tax is unlikely to be chargeable on the transfer of exchange tokens. However, every case will be considered on its own facts and circumstances; and
- stamp duty land tax is not payable on transfers of exchange tokens as such transfers are not considered by HMRC to be land transactions; however, if exchange tokens are given as consideration for a land transaction, the tokens would fall within the definition of ‘money or money’s worth’ and would be chargeable to stamp duty land tax.

## Anti money laundering requirements and money transmission laws

### AML requirements

The MLRs impose a general duty on cryptoasset businesses to maintain appropriate risk-based policies and procedures to prevent situations where their systems might be used for money laundering or terrorist financing. The MLRs transposed the provisions of the Fourth Money Laundering Directive ((EU) 2015/849) (**MLD4**) into UK law and their scope further widened in January 2020 when the Fifth Money Laundering Directive ((EU) 2018/843) (**MLD5**) was also incorporated into UK law.<sup>24</sup> This brought businesses carrying on cryptoasset activity in the UK into scope of the MLRs, and a requirement to be registered with the FCA.

In-scope cryptoasset businesses are expected to have been complying with the MLRs since 10 January 2020. The MLRs define a cryptoasset ‘*a cryptographically secured digital representation of value or contractual rights that uses a form of DLT and can be transferred, stored or traded electronically*’.<sup>25</sup>

New obligations on firms include:

- A new regime for changes in control of cryptoasset businesses, in force from 11 August 2022.
- New requirements concerning proliferation financing and changes to reporting requirements, in force from 1 September 2022.
- Amended requirements on reporting material discrepancies in information obtained from certain registers, to be in force from 1 April 2023.
- A new regime for cryptoasset transfers, to be in force from 1 September 2023.

The MLRs apply to businesses identified as being most vulnerable to the risk of being used for money laundering and terrorist financing purposes. In-scope businesses are referred to as ‘relevant persons’ in the MLRs and are listed in regulation 8(2) and (3). The implementation of MLD5 brought CEPs and CWPs (defined below) within scope of the MLRs as relevant persons; consequently, any person carrying out cryptoasset business that is captured in the definitions below are impacted.

A CEP is a firm or sole practitioner who, by way of business, provides one or more of the following services, including where the firm or sole practitioner does so as creator or issuer of any of the cryptoassets involved, when providing these services:

- (a) exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets;
- (b) exchanging, or arranging or making arrangements with a view to the exchange of, one cryptoasset for another; or
- (c) operating a machine that uses automated processes to exchange cryptoassets for money or money for cryptoassets.

The FCA makes clear that businesses operating cryptoasset automated teller machines and peer-to-peer providers are in scope of the MLRs, as well as businesses that issue new cryptoassets such as initial coin offerings (**ICOs**) or initial exchange offerings (**IEOs**).<sup>26</sup>

A CWP is a firm or sole practitioner who, by way of business, provides services to safeguard, or to safeguard and administer, either of the following when providing these services:

- (a) cryptoassets on behalf of its customers; or
- (b) private cryptographic keys on behalf of its customers to hold, store and transfer cryptoassets.

The FCA has stated that it will consider the commercial element, commercial benefit, the relevance to other business by the relevant firm, and the regularity/frequency of activities as factors impacting its decisions on whether cryptoasset activity is carried on.<sup>27</sup>

Notably, a person might be a CEP or CWP, irrespective of whether they are otherwise regulated in the UK, if they carry on cryptoasset business that is in scope of the new definitions. Therefore, MLR requirements for cryptoasset businesses apply to both regulated and unregulated cryptoasset businesses in the UK.

To adhere to the MLRs, businesses must comply with various obligations, such as: making a registration; ongoing risk assessments; maintenance of appropriate policies; controls and procedures; staff training; customer due diligence; record keeping; and reporting. For example, on 30 August 2022, the Office of Financial Sanctions Implementation (OFSI) updated its guidance<sup>28</sup> for financial sanctions under the Sanctions and Anti-Money Laundering Act 2018 (SAMLA) to reflect reporting obligation measures coming into force.<sup>29</sup> The regulations extend the definition of 'relevant firms' that have financial sanctions reporting obligations to include CEPs and CWPs, and they are therefore required to notify OFSI of certain information.

The Joint Money Laundering Steering Group published guidance<sup>30</sup> that further clarified how the MLRs relate to cryptoassets. The guidance highlights the AML risks relevant in the sector and considers how CEPs and CWPs should interpret the AML requirements in an appropriate manner relating to cryptoassets.

### Money transmission laws

The PSRs and EMRs govern money transmission laws in the UK, forming a regulatory framework that applies to persons performing payment services and issuing e-money. The framework is triggered if the service provided falls under the definitions under the PSRs and EMRs.

Under the PSRs, payment services necessarily involve funds. Cryptoassets are not considered funds for these purposes, as activities involving only cryptoassets will not usually involve payment services. However, where the FCA identifies products or services related to e-money tokens (for example, the issuing of a stablecoin that constitutes e-money), then the EMRs may apply and further, providing wallet services relating to the stablecoin would trigger the PSRs, as e-money is a form of fund.

## **Innovation**

There are a number of initiatives that strive to encourage innovation in this area, most of which are supported by the FCA, which established an Innovation Division in November 2018.

The FCA's Innovation Hub aims to provide direct support to innovative firms that are trying to launch into the market. It does so through several initiatives:

- The **Regulatory Sandbox** provides an opportunity for businesses of all sizes, authorised and unauthorised, to pilot the commercial and regulatory viability of their innovative products and services in a live environment in a supervised space.

- The **Digital Sandbox** allows firms to test and develop proofs of concept in a digital testing environment. Its aim is to support early-stage proof-of-concept development through access to a digital testing environment, where firms can develop, collaborate, and test new products and solutions.
- The **Global Financial Innovation Network (GFIN)** is an international network of financial regulators and related organisations committed to supporting financial innovation in the best interests of consumers. The aim of the network is to provide a more efficient way for innovative firms to interact with regulators as the firms look to scale new ideas.
- **TechSprints** form part of the FCA's regulatory toolkit to bring together market participants, including regulators (from across and outside financial services), to collaborate on shared challenges to develop technology-based ideas or proofs of concept to address specific industry challenges. As well as exploring solutions, TechSprints are intended to act as a catalyst for change to help unlock the potential benefits of technology innovation.
- **CryptoSprint** events were held by the FCA in May and June 2022, providing an opportunity to explore potential UK policy solutions for the regulation of cryptoassets. This is the first time that the FCA had gathered views from industry and other stakeholders to help it understand emerging cryptoasset market practices and help shape future policy in this innovative and adaptative way.

Additionally, in April 2022, the Centre for Finance, Innovation and Technology (**CFIT**) published terms of reference<sup>31</sup> announcing that the CFIT model will comprise a 'coalitions' approach striving to support the growth of the sector. The CFIT will be a virtual body that will enable enhanced connectivity across the regions and provide research and data capabilities in financial technology and innovation. The government also announced plans to introduce a 'financial market infrastructure sandbox' to enable firms to experiment and innovate in providing the infrastructure services that underpin markets, in particular by enabling DLT to be tested. It further wants to establish a Cryptoasset Engagement Group to work closely with the industry.

All the above are part of government's plan to make the UK a global hub for cryptoasset technology, with the measures helping firms to invest, innovate and scale up in the UK.<sup>32</sup>

### Ownership and licensing requirements

Two important publications are seeking to improve clarity around digital assets, though they do not purport to change regulatory aspects.

In August 2022, the Law Commission for England and Wales (the **Commission**) launched a detailed consultation<sup>33</sup> that contains reform proposals to better recognise and protect digital assets, especially crypto-tokens, which encompass cryptoassets and NFTs.

The Commission's key recommendation is the explicit recognition of a new, third category of personal property, 'data objects'. This would supplement the two existing categories of 'things in possession' and 'things in action'. To qualify as a data object, digital assets must:

- be composed of data represented in an electronic medium, including in the form of computer code, electronic, digital, or analogue signals;
- exist independently of persons (who may claim to own them) and the legal system (which could be relied on when trying to enforce rights relating to them); and
- be rivalrous, that is, their use by one person inherently prevents simultaneous use by another person.

Divestibility would act as an indicator as to whether a digital asset could be a data object. This means that a transfer of the object must entail the transferor being deprived of it. The Commission recognises that crypto-tokens and cryptoassets can, generally, satisfy this criteria. The Commission has also proposed a new concept of control through the common law, intending to strike a balance between recognising the unique features of data objects while keeping the benefits of the law of possession. Control would depend on the factual ability to determine use that a person has over the data object, rather than on any legal rights they might have in relation to it. A person in control of a data object can exclude others from it, use it, transfer it, and identify themselves as the person able to carry out these things. As with the existing legal concept of possession, however, there is no requirement of intention. The Commission acknowledges that this concept might not be able to deal with complex legal mechanisms and arrangements, such as custody arrangements and collateral arrangements. The Commission's consultation draws on the conclusions of the UK Jurisdiction Taskforce (UKJT) Legal Statement<sup>34</sup> published in 2019 on the Status of Cryptoassets and Smart Contracts, which stated that: (i) cryptoassets are property; (ii) cryptoassets can, at least to some extent, be owned, transferred, assigned, and made the subject of security interests; and (iii) smart contracts are capable of being contracts under English law. This has been adopted and upheld by the High Court of England and Wales when it held that particular cryptoassets were capable of being a form of property.<sup>35</sup> In April 2021, the UKJT published its Digital Dispute Resolution Rules,<sup>36</sup> which were to be incorporated into on-chain digital relationships and smart contracts. This established an arbitration regime for settling disputes related to cryptoassets, smart contracts or other novel digital technologies.

In early August, the UKJT launched a consultation and announced that it will issue a Legal Statement<sup>37</sup> on digital securities, planned for release in December 2022. The main purpose of the project is to clarify whether English law supports the issuance and transfer of equity or debt securities using a system deploying blockchain or DLT.

### Licensing

A person will be required to be authorised to perform activities in relation to cryptocurrencies if they are conducting 'regulated activities' as defined in FSMA, or payment services/e-money activities requiring authorisation under the PSRs or EMRs. There is also a registration requirement for cryptoasset businesses under the MLRs.

Establishing, operating, marketing, or managing a fund that offers exposure to unregulated cryptocurrencies by way of business is an activity that might trigger licensing requirements in the UK even if the underlying cryptocurrency is not a specified investment. It is also notable that cryptocurrencies are unlikely to be permissible for inclusion in fund products that require FCA approval, such as exchange-traded funds. The Taskforce firmly held that unless the FCA has confidence in the integrity of the underlying market and regulatory criteria for funds authorisations are met, then it will not issue authorisation or approval for the listing of a transferable security or fund that references exchange tokens.

### **Mining of cryptoassets**

How cryptoassets are 'mined' (i.e., the creation of a particular cryptoasset by way of reward as a result of validating transactions on the blockchain) depends on the consensus mechanism adopted by a particular blockchain. For example, transactions are validated on the Bitcoin blockchain via the proof-of-work consensus mechanism,<sup>38</sup> and this was also the case for Ether until early September 2022.

After years of anticipation, the original execution layer of the Ethereum blockchain merged with a new proof-of-stake consensus layer, which subsequently resulted in transactions being validated via a proof-of-stake consensus mechanism (the **Merge**). The Merge seeks to solve one of the biggest issues with proof-of-work by significantly reducing the energy used upon transaction validation. However, whilst this may solve one issue, it may potentially give rise to another: regulatory considerations due to staking.

Participating nodes and validators operating on a proof-of-stake network are required to lock a certain amount of tokens in order to be eligible to validate transactions. Generally, nodes have an increased chance of being selected as the next validator by virtue of the amount of tokens staked in the network (i.e., the larger the stake, the higher the chances). There are entities that provide services whereby institutions or individuals can have the option to stake their tokens to a particular node, in order to increase its chances of being chosen as a validator for the next transaction and subsequently earning mining rewards as a result (**Validator Service Providers**).

Staking activities via Validator Service Providers may fall within the definition of a collective investment scheme pursuant to section 235 of FSMA (**CIS**). Certain elements of the definition may be satisfied, for instance: participants not having day-to-day control over the management of cryptoassets locked into a validator; the pooling of assets of different participants; expectation of profits by way of participation; and cryptoassets being managed by the Validator Service Provider as operator of the scheme. It is important to note, however, that each project must be taken on a case-by-case basis and there are additional elements to the CIS definition (not mentioned above) that may or may not be satisfied by a project, depending on its mechanics and how it operates.

Notwithstanding the above, the relationship between staking and CIS has not yet been fully explored. Since the UK lacks a financial regulatory regime for cryptoassets, mining of cryptoassets is not restricted in the UK and is not an expressly regulated activity. It does not fall within the existing UK financial regulatory perimeter.

HMRC considers that the profits of mining are taxable for individuals and businesses either as trading profits, or under the miscellaneous income provisions.

### **UK border rules**

Upon arrival in the UK, individuals who carry more than £10,000 in cash must declare the fact to HMRC. There are currently no border restrictions and no obligations to declare cryptoasset holdings, as they are not regarded as cash in this situation. Cryptoassets are not considered money, nor are they seen as equivalent to fiat currency in the UK.

### **Reporting requirements**

Reporting requirements contained in financial regulation or AML legislation may apply in relation to cryptocurrency transactions. The MLRs also contain a broad reporting requirement applicable to CEPs and CWPs, which means that they must produce information that the FCA requires relating to their compliance with the MLRs.

### **Estate planning and testamentary succession**

HMRC has confirmed that it considers cryptoassets to be property for the purposes of inheritance tax. UK-domiciled (or deemed domiciled) individuals for tax purposes are

subject to UK inheritance tax on their worldwide estates. Non-UK-domiciled individuals are, subject to exceptions, subject to taxation of any assets held and situated in the UK.

A testator should instruct their personal representative on how to acquire the cryptographic keys and details of wallet service providers, otherwise the value of cryptoassets left to beneficiaries of an estate will be lost.

\* \* \*

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