The United Kingdom Cryptoasset Regulatory Framework

*James Burnie & Meghan Millward**

Abstract

An overview of the United Kingdom regulatory framework for cryptoassets, including current legislative position and expected changes in the near future. Currently, the key determinants of whether cryptoasset activity are twofold. Firstly, the features of a cryptoasset will determine whether it fits within the definition of being a specified investment for the pruposes of the traditional regulatory regime. Cryptoassets which, for example, function like securities would fall within this regime, and so certain specified activities in relation to such would require a licence from a UK regulator. Secondly the acts of exchanging, making arrangement with a view to the exchange of, and safekeeping cryptoassets require registration with a UK regulator if performed from an establishment in the UK. Recently, a regime requiring approval of financial promotions of fungible transferrable cryptoassets has come into force, and there will also likely be further new regimes in the future, for example in connection with stablecoins used for payment services.

Keywords: United Kingdom, cryptoassets, regulation, blockchain, safekeeping, securities.

In this article, we consider the UK regulatory framework for cryptoassets. The UK regime is developing separately to the regimes across the European Union, and in particular to move towards harmonization under the Markets in Crypto Assets (MiCA), regulation is not currently taking place in the UK.

* James Burnie, blockchain and Web3 partner at gunnercooke llp. James is a financial services and regulation partner at gunnercooke llp. He has been involved in crypto since advising on the first successful UK-based ICO and the first equity issuance settled on-chain. Recent work has included advising the Mauritius FSC, as well as three other regulators, on designing their legal and regulatory frameworks for cryptoassets. He has given evidence to the UK All-Party Parliamentary Group on Blockchain and Cryptoassets, is an advisor to the Law Commission's DAO panel, and a named contributor to the UKJT legal statement on cryptoassets and smart contracts. He is a co-author of both the RegTech and PayTech books. Meghan Millward is a trainee lawyer at gunnercooke llp. Meghan advises on wide a range of issues across Web3, DeFi and metaverses, including commercial contracts, SAFTs, staking, gambling, regulatory perimeter issues, the regulatory treatment of tokens, use of tokens for payments, international set-up considerations, and how to deal with issues when setting up and contracting with DAOs and exchanges. As regards crypto funds set-up, she advises on the full end-to-end fund launch process, document drafting, and overall project management to ensure cost and time efficiency. Meghan has published in the Journal of International Banking & Financial Law and assisted the Mauritius FSC with drafting its legal and regulatory framework for cryptoassets.

doi: 10.5553/EJLR/138723702023025001006

Activities in cryptoassets performed from establishments in the UK are broadly regulated under two different regulatory frameworks. The application of the first framework is determined by whether a cryptoasset meets the definition of a 'specified investment' under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO). The application of the second framework is determined by whether an activity in relation to a cryptoasset is a registrable activity under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (MLRs). While the Financial Conduct Authority (FCA) is the primary regulatory body under both regimes, they exist independently, and so a firm may be required to be both authorized by the FCA under the RAO and registered with the FCA under the MLRs in connection with the same business model, to the extent that a business model falls within the scope of both frameworks.

In addition, there is also a third framework which applies to those looking to advertise securities (including security tokens) in the UK, and there is a movement to extend the regulatory perimeter to also cover advertisements of certain fungible tokens (as well as separately stablecoins). We will consider each of these frameworks in this article.

A The RAO Framework

The RAO predates cryptoassets and as such does not explicitly deal with cryptoassets. Rather, the RAO applies to persons who by way of business perform 'specified activities' in relation to 'specified investments'. In order to be caught by the RAO, both the requirements must be satisfied, and, as such, performing the specified activity of 'arranging deals in investments' is not regulated if that activity is performed in relation to an asset which does not constitute a 'specified investment' – and so, for example, the act of 'arranging deals in bitcoin' is not a regulated activity, because bitcoin does not meet the definition of being a 'specified investment'.

I The FCA's Classification of Cryptoassets

Overlaying the RAO framework, to assist with interpreting its application to cryptoassets, is the FCA's classification of cryptoassets. Under this classification system, the FCA has divided cryptoassets into three types of tokens (see FCA Policy Statement 19/22, Guidance on Cryptoassets Feedback and Final Guidance to CP 19/3 (Policy Statement))[1]:

1 *Security tokens*: these are cryptoassets, other than e-money tokens (on which see below), with specific characteristics which mean they meet the definition of a 'Specified Investment' under the RAO.
2 *E-money tokens*: these are cryptoassets which meet the definition of e-money, in which case certain activities in relation to them, particularly those linked to payments, may be within the FCA's perimeter.

1 www.fca.org.uk/publication/policy/ps19-22.pdf.

European Journal of Law Reform 2023 (25) 1-2
doi: 10.5553/EJLR/138723702023025001006

3 *Unregulated tokens*: these consist of tokens that are not e-money tokens and are not security tokens. Dealing in these tokens does not require FCA authorisation under the RAO.

II Application of the RAO

The RAO takes a functional approach to whether a 'thing', such as a cryptoasset, constitutes a specified investment. As such, if a cryptoasset has the features of a specified investment, then it shall be regulated as such.

The list of specified investments is limited and defined and broadly consists of the following:

- Deposits
- Electronic money (also referred to as e-money)
- Contracts of insurance
- Shares
- Instruments creating or acknowledging indebtedness
- Alternative finance investment bonds
- Government and public securities
- Instruments giving entitlements to investments
- Certificates representing certain securities
- Units in a collective investment scheme
- Rights under a pension scheme
- Greenhouse gas emissions allowances
- Emission allowances
- Options
- Futures
- Contracts for differences
- Lloyd's syndicate capacity and syndicate membership
- Funeral plan contracts
- Regulated mortgage contracts
- Regulated home reversion plans
- Regulated home purchase plans
- Regulated sale and rent back agreements
- Credit agreement
- Consumer hire agreement
- Rights to or interests in certain specified investments

The specified investment of 'rights to or interests in certain specified investments' would capture certain types of tokenization. For example, under the traditional tokenized equity model, a Special Purpose Vehicle (SPV) will be set up to hold the equity in the company, and an electronic representation of that equity shall be created as a cryptoasset on the blockchain. The cryptoasset under such a model will therefore represent a right to/interest in the underlying equity, and therefore the tokenized equity shall itself fall within the definition of specified investment under the RAO.

While as a general rule it will often be clear whether a cryptoasset meets the definition of specified investment, the following specified investments are worth particular consideration:

– Units in a collective investment scheme
– Derivatives
– E-money

1 Units in a Collective Investment Scheme

Generally referred to as a fund, the definition of collective investment scheme is broad, as follows (bold in all excerpts by us for emphasis):

1 In this Part 'collective investment scheme' means *any arrangements with respect to property of any description*, including money, the purpose or *effect of which is to enable persons taking part* in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to *participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income*.
2 The arrangements must be such that the *persons who are to participate ('participants') do not have day-to-day control* over the management of the property, whether or not they have the right to be consulted or to give directions.
3 The arrangements must also have either or both of the following characteristics:
   a the *contributions* of the participants and the profits or income out of which payments are to be made to them *are pooled*;
   b the property is *managed as a whole by or on behalf of the operator of the scheme*.
4 If arrangements provide for such pooling as is mentioned in subsection (3)(a) in relation to separate parts of the property, the arrangements are not to be regarded as constituting a single collective investment scheme unless the participants are entitled to exchange rights in one part for rights in another.
5 The Treasury may by order provide that arrangements do not amount to a collective investment scheme (a) in specified circumstances; or (b) if the arrangements fall within a specified category of arrangement.

The breadth of the interpretation of this clause is demonstrated by the case law. For example, in *Financial Conduct Authority v. Asset Land Investment Plc*.,[2] in the context of land, it was held that if different plots of land were managed for different persons, that could constitute a collective investment scheme arrangement, even if each plot of land were separately identifiable and owned by different participants. The definition is, therefore, broader than in some EU countries, where there is more of an emphasis on the purpose of the arrangements and the intentions of the participants rather than simply the effect of the arrangements and the existence of management as a whole and the pooling of the underlying assets.

Any token which gives holders of that token a variable return as a result of holding the token will, therefore, need to be carefully considered in terms of

2 *Financial Conduct Authority v. Asset Land Investment Plc*. [2016] UKSC 17.

European Journal of Law Reform 2023 (25) 1-2
doi: 10.5553/EJLR/138723702023025001006

whether it would fall within the scope of a collective investment scheme. This is particularly problematic because running a collective investment scheme in the UK without the appropriate authorizations is a breach of the so-called 'general prohibition'.[3] A person who breaches the general prohibition is guilty of an offence, and liable to imprisonment for a term of up to two years or a fine, or both.[4] Furthermore, any investment into an illegal collective investment scheme may be voided, meaning that the person who made the investment can require that they are compensated as if the investment had not been made. The net effect of this provision is, in practical terms, to put the investor in the position they would have been in had they not invested. This has the effect that, if the collective investment scheme loses money, they have an incentive to get the arrangement declared illegal, in order to recoup the investment as if it had not happened.

2 Derivatives

Derivatives are split into forwards, options and contracts for difference:

- A future is in board terms a right under a contract for the sale of property of any description under which delivery is to be made at a future date and at a price agreed on when the contract is made.
- An option is an option to acquire or dispose of certain types of asset, broadly: (a) a designated investment; (b) fiat currency; (c) palladium, platinum, gold or silver; (d) certain types of commodity; (e) certain financial instruments; or (f) an option to acquire or dispose of an option specified in (a), (b), (c), (d) or (e).
- A contract for difference is in broad terms a contract where the purpose or pretended purpose of which is to (i) secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or an index or other factor designated for that purpose in the contract or (ii) a certain type of derivative instrument for the transfer of credit risk.

Derivatives are particularly relevant both to SAFTs and to cryptoassets which are linked to an underlying asset. Certain types of derivatives are also banned for the UK retail market (on which see below).

a) SAFTs

A Sale Agreement for Future Tokens (SAFT) is in broad terms an arrangement under which an investor provides funding to an enterprise in order to obtain cryptoassets in the future. This is a common mechanism of fund raising, as the effect is to enable the token creator to have the funds in place to create the cryptoassets, without having to sell equity in the company, and in return the investor is able to obtain tokens at a discount when they are created.

The issue is whether the SAFT arrangement, generally, may fall within the definition of a derivative. For example, if an investor spends a specific amount upfront in order to obtain a specific number of cryptoassets at a future date, then this might well constitute the investor buying 'a right under a contract for the sale

3 Section 19, the Financial Services and Markets Act 2000.

4 Section 23, the Financial Services and Markets Act 2000.

doi: 10.5553/EJLR/138723702023025001006

of property of any description (i.e. cryptoassets) under which delivery is to be made at a future date (i.e. when the cryptoassets exist) and at a price agreed on when the contract is made (i.e. the amount paid under the SAFT)'. Because the reason for entering into the arrangement is often for a speculative investment purpose, exemptions reliant on the transaction being for a commercial rather than speculative investment purpose are not helpful. This could create an issue for the token designer, since, as is the case for a collective investment scheme, there is a risk therefore that the instrument could be in breach of the general prohibition (which is an offence and which renders the instrument void). Instead, therefore, a more prudent approach is to deliberately draft the SAFT as an option to acquire tokens – the nature of the token being such that it is an asset that does not cause the option to be treated as a regulated option.

b) Tokens Linked to Assets

Another area worth discussing are tokens which represent an underlying asset, as there is a common misconception that these somehow constitute a derivative; however, this is not the case. For example, a common cryptoasset model is a token linked 1:1 to gold, whereby each token can be redeemed for a specific amount of gold. In such case:

– There is no future, as there is no element of a commitment of making any kind of delivery at any future date. Rather, the holder of the token already owns the gold and may or may not decide to take delivery of it.
– There is no option, as there is no optionality regarding whether to acquire or dispose of the gold. Rather, the token holder already owns the gold and has bought it – it is simply being stored on their behalf and they can decide whether to take delivery.
– There is no contract for difference, as there is no contract where the purpose or pretended purpose of which is to (i) secure a profit or avoid a loss by reference to fluctuations in the value or price of property of any description or an index or other factor designated for that purpose in the contract or (ii) create a certain type of derivative instrument for the transfer of credit risk.

As such, simply linking a token to an asset in this way does not involve any derivative in the regulated sense, even though the value of the cryptoasset will derive from the asset it is linked to in the more general dictionary sense.

3 E-money

Another area of misconception is sometimes as regards cryptoassets whose value is linked 1:1 to fiat money and whether this constitutes e-money. E-money is defined as:

> electronically (including magnetically) stored *monetary value as represented by a claim on the electronic money issuer* which is:
> a issued on receipt of funds *for the purpose of making payment transactions* as defined in Article 4(5) of the Payment Services Directive; and
> b *accepted by a person other than the electronic money issuer*;

doi: 10.5553/EJLR/138723702023025001006

> but does not include [certain exclusions]:

A key point here is that the cryptoasset must be 'for the purpose of making payment transactions', and as such the mere fact that a cryptoasset is 1:1 to a fiat currency does not mean that it is necessarily e-money, because it may have been issued for a different purpose. This is the basis on which, for example, USD Coin (USDC) may be considered not e-money.

4 Banned Products for UK Retail

In addition to the general framework under the RAO, the FCA has banned the sale of derivatives (i.e. contracts for difference, options and futures) and exchange traded notes that reference certain types of cryptoassets to retail consumers, in particular those that reference unregulated transferable cryptoassets such as Bitcoin, Ether or Ripple. The rationale for this ban is that such products cannot be reliably valued by retail customers.[5]

B The MLRs Framework

The MLRs apply to all cryptoassets, depending on whether particular activities are undertaken in relation to them by way of business from an establishment in the UK. Specifically, there is a registration requirement if acting as either or both of:

- 'cryptoasset exchange provider' or
- 'custodian wallet provider'.

The process of obtaining registration with the FCA under the MLRs is onerous, meaning that firms seeking to obtain this should factor in a substantial cost and time commitment.

I Cryptoasset Exchange Provider

A cryptoasset exchange provider is defined as:

> 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 such 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 which utilises automated processes to exchange cryptoassets for money or money for cryptoassets.

5 www.fca.org.uk/news/press-releases/fca-bans-sale-crypto-derivatives-retail-consumers.

doi: 10.5553/EJLR/138723702023025001006

The focus of this activity is as regards to arrangements in relation to cryptoassets and money. The activities of exchanging cryptoassets for goods or services, as well as for example airdropping cryptoassets for free, will not be caught by the activity, and so would not require FCA registration.

While the origin of this activity is the 5th Money Laundering Directive; importantly, the UK has gold-plated the Directive by adding the activity of 'making arrangements with a view to' an exchange. There is little guidance on the scope of this additional activity, and so its parameters are unclear, and we are seeing a range of different interpretations being applied.

In particular, there is a question regarding whether the interpretation of this wording should be in line with the broad approach to 'making arrangements with a view to' in the context of the securities framework set out in the RAO. While an argument can be made on the basis that this would give consistency of interpretation, the legislative frameworks are different, and in particular there are various exemptions available to certain activities applicable to the RAO activity, which are not replicated in relation to the MLRs framework. Furthermore, the guidance of the Joint Money Laundering Steering Group (=JMLSG Guidance=), which does directly apply to the MLRs, also suggests that a narrower approach is intended:

> 22.11 The definition is broad, providing for exchanging as well as 'arranging or making arrangements with a view to the exchange'. This may include activities relating to a dedicated peer-to-peer platform. *However, it is not intended to capture a firm that only provides a forum where buyers and sellers can post their bids and offers, such as a bulletin board where the availability of the assets are merely made known and the parties trade at an outside venue either through individual wallets or other wallets not hosted by the forum or a connected firm*. Such business models will, however, be considered on a case-by-case basis.

This suggests that a model under which, for example, a company merely provides a link to a crypto exchange on its website would not be acting as a cryptoasset exchange provider – as it would only be acting so that 'the availability of the assets are merely made known' – whereas such an activity would tend to be caught under the RAO. Further clarification is generally required on this issue, however, as the position is unclear.

II ATMs

While we note that operating an ATM in the UK would require FCA registration under the MLRs, no cryptoasset firm that has sought to be registered with the FCA has been approved by the FCA to offer crypto ATM services, and as such this activity is effectively not currently permitted in the UK.[6]

III Custodian Wallet Provider

A custodian wallet provider is defined as:

6 www.fca.org.uk/news/news-stories/warning-illegal-crypto-atms-operating-uk.

European Journal of Law Reform 2023 (25) 1-2
doi: 10.5553/EJLR/138723702023025001006

a firm or sole practitioner who by way of business provides services to *safeguard, or to safeguard and administer*:
d cryptoassets on behalf of its customers, or
e private cryptographic keys on behalf of its customers in order to hold, store and transfer cryptoassets, when providing such services.

The definition of custodian wallet provider, unlike cryptoasset exchange provider, does not have a concept of 'arranging'. As such, a business model that consisted of arranging for cryptoassets to be held with other entity would not in itself trigger FCA registration under the MLRs.

Furthermore, the registrable activity is focussed on catching those providing safeguarding – not those providing the software by which a person can safeguard their own cryptoassets. This means that providing a software as a solution service would not trigger a requirement to register with the FCA, if no responsibility is taken for safeguarding the cryptoassets.

IV In the United Kingdom

An important point to note regarding the MLRs is that they apply to activities performed from an establishment in the UK. As such, if cryptoassets are, for example, sold into the UK on a cross-border basis from outside the UK, then the registration requirements will not apply to that activity. Any firm looking to do this should, however, make clear that they are not a UK entity and warn potential consumers of the risks involved, including the fact that capital is at risk if buying cryptoassets and that there is a potential for a total loss of the value of the capital invested. Such activities may still be caught, however, by the advertising frameworks.

C The Advertising Frameworks

I Security Tokens

A financial promotion is in broad terms an invitation or inducement to engage in investment activity. Financial promotions of securities, which would therefore encapsulate security tokens, are subject to the restrictions on financial promotion, in the same way as for traditional securities.[7] The financial promotion rules include various requirements, which relate to disclosure requirements, and import a requirement that advertisements in securities are required to be signed off by an FCA-authorized firm.

There are, however, various exemptions to the restrictions on financial promotions, set out in the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (*FPO*). These exemptions may, for example, apply to certain financial promotions made to investment professionals, high-net-worth individuals and sophisticated investors.

7 Section 21, the Financial Services and Markets Act 2000.

doi: 10.5553/EJLR/138723702023025001006

II Fungible Tokens

On 8 October 2023 an amendment to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 came into effect. This amendment means that the financial promotions to retail customers of cryptoassets which are both fungible and transferable will generally fall in scope of the UK restrictions on making invitations or inducements to invest in certain controlled investments.[8] This new regime will not apply to Non Fungible Tokens (NFTs) (given their non-fungible nature).

Such financial promotions will be required to be approved by someone authorized by the FCA, or will need to fall within an exemption to the requirement for approval (for example there are exemptions that may apply if promoting to FCA authorized fund managers and large companies. However it is worth noting that the exemption for self-certified professional investors is not available). In addition to the sign-off requirement, in-scope cryptoassets are will be classified as restricted mass market investments. This forms part of a new framework for categorizing the financial promotion of products and means that the promotion of in-scope cryptoassets are subject to the following requirements:

- Retail participants are limited to investing no more than 10% of their net assets into such cryptoassets.
- There are specific disclosure requirements, including a standardised risk warning and a personalised risk warning pop-up.
- First-time buyers need to complete a new 24-hour cooling-off period before being able to invest.
- There is a ban on providing inducements to invest.
- New appropriateness rules will need to be complied with when selling in-scope cryptoassets.

III Stablecoins

Another area of potential legislative change is as regards stablecoins when they are used as a means of payment with the aim of creating a legislative framework for such stablecoins, to enable the UK to become a hub for them.

The proposals are currently in the consultation phase,[9] and the current proposals are aimed at a 'same risk, same regulatory outcome' approach to regulation. The focus is, therefore, on issues such as reliability (e.g. the ability to convert the token into its fiat value), and, from a payments perspective, there is likely to be quite a lot in common with the existing payment services rules (set out in the Payment Services Regulations 2017 and the Electronic Money Regulations 2011). Other requirements include capital and liquidity requirements, requirements in relation to accounting and audit, maintenance and management of reserve assets, and orderly failure and insolvency requirements.

8 www.fca.org.uk/publication/policy/ps23-6.pdf

9 www.gov.uk/government/consultations/uk-regulatory-approach-to-cryptoassets-and-stablecoins-consultation-and-call-for-evidence.

European Journal of Law Reform 2023 (25) 1-2
doi: 10.5553/EJLR/138723702023025001006

IV Other Potential Developments

Currently, the primary regulatory focus on cryptoassets in the UK has been the FCA, and this has reflected the nature of the business involved. As things develop, however, there will be greater scope for the Prudential Regulation Authority (PRA) and the Bank of England to get involved, for example, in terms of the approach large financial institutions such as banks and insurers should take in dealing with their exposure to cryptoassets, as well as whether there might be systemic economic risks which arise from cryptoassets in the future. In this respect, it is worth noting that the Bank of England has already started work on assessing the role of cryptoassets in the UK financial system.[10]

Work is also on-going in terms of harnessing the potential benefits of cryptoassets for the UK economy, and an example of this is the move towards looking at how a UK central bank digital currency (CBDC) might work.[11] The benefits of a UK CBDC could include faster settlement times for certain activities, as well as greater transparency for the regulator.

While the position in the UK is currently not settled, therefore, and indeed the UK has a relatively high barrier to entry in terms of which firms are accepted for FCA authorization/registration, what is clear is that the current direction of travel is towards seeking to make the UK an attractive destination for cryptoasset businesses, while not compromising on regulatory protections and standards.

10 www.bankofengland.co.uk/financial-stability-in-focus/2022/march-2022.

11 www.bankofengland.co.uk/research/digital-currencies.

doi: 10.5553/EJLR/138723702023025001006