Outer Temple Chambers

Cryptoassets and the FCA's perimeter

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This article examines the Financial Conduct Authority ("FCA") perimeter and cryptoassets in the context of the FCA Handbook, the *FSMA Financial Promotions Order (SI 2005/1529)* ("FPO") and *The Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017* ("MLRs").

There have been calls for there to be more regulation of cryptoassets due to their price volatility and soaring popularity. For instance, Bitcoin in April 2011 was valued at £0.71 (USD$ 1) but on 26 May 2021 at £27,352 (USD$ 38,694.14). There is also a risk that criminals and terrorists may exploit cryptoassets. However, it is important not to stifle an innovative and international industry with too much regulation.

The FCA has sought to adopt a balanced approach to regulation by bringing only certain cryptoassets within its perimeter whilst others may be subject to the MLRs or else not regulated.

FCA Handbook

The FCA Handbook is a voluminous set of regulatory guidance which requires significant effort, time and money for firms to successfully navigate.

The question is whether cryptoasset firms are required to comply with the FCA Handbook?

Generally speaking, the FCA Handbook applies to "authorised persons". To be an "authorised person" a firm needs to apply for Part 4A ***Financial Services and Markets Act 2000*** ("FSMA") permission. An authorised firm will be subject to the FCA handbook.

S19 FSMA prohibits a person in the UK from carrying out regulated activities unless they are authorised by the FCA. It is a criminal offence, punishable with a fine and up to two years imprisonment, to carry out a regulated activity without authorisation, s23(1) FSMA. This is subject to the defence of taking all reasonable precautions and exercising all due diligence to avoid committing the offence, s23(3) FSMA.

An activity will be regulated if it is, s22 FSMA:

- an "*activity of a specified kind*" listed in Part I of Schedule 1 FSMA. This includes dealing in securities (paragraph 3), managing investments (paragraph 5), safeguarding and administering investments (paragraph 6); and
- relates to an "*investment of a specified kind*" listed in Part II of Schedule 1 FSMA and in the ***Regulated Activities Order 2001*** ("RAO"). This includes electronic money (paragraph 74A), shares (paragraph 76), instruments acknowledging indebtedness (paragraph 77). The FCA's guidance on specified investments in RAO is stated at PERG 2.6.

The FCA *Guidance on Cryptoassets Feedback and Final Guidance to CP 19/22* ("FCA Guidance") https://www.fca.org.uk/publication/policy/ps19-22.pdf sets out three categories of cryptoassets (paragraph 1.9):

- **Exchange tokens** which are described as:
  a) Not issued or backed by a central authority and used to buy or sell goods and services (paragraph 1.9).
  b) Used in a similar way to fiat currency but are more volatile than currencies and are not widely accepted as a means of exchange (paragraphs 39 to 41).
  c) Not granting the holder any of the rights associated with the specified investment.

- **Utility tokens** which grant holders access to a current or prospective service.

- **Security tokens** which provide rights and obligations akin to specified investments like a share or debt instrument.

The FCA Guidance states that exchange and utility tokens are outside the FCA's perimeter but security tokens are within the perimeter (paragraph 43).

The FCA Guidance explains (paragraph 43) that this "*is in line with* …[the FCA's] *approach to other assets that remain outside*…[the] *regulatory perimeter, but could nonetheless be purchased speculatively by some consumers with a view to realising profits if their value increase* (e.g. fine wine or art*)*."

It is worth noting that the FCA Guidance also makes clear (paragraph 60) that cryptoassets are not within the scope of the ***Payment Services Regulations 2017*** ("PSR")as this only regulates banknotes, coins, scriptural money and electronic money, Regulation 2 PSR.

The US approach

The United States Security and Exchange Commission ("SEC") adopts a broad definition of "securities" in Section 2(a)(1) of the ***Securities Act 1933*** which includes investments sold with a view to generating profits.

The FCA has expressly stated that it applies a more narrow technical meaning to the concept of "*securities*" than does the SEC and that this is an area where it accepts a divergence in approach. The FCA Guidance states (emphasis added):

3.4 One respondent gave the example of the regulatory treatment of tokens in the US where the broad definition
of securities means many utility tokens are captured under the securities regime. This focus on a 'harmonised approach' across jurisdictions was shared by several respondents.

3.6 Definition of security tokens
For our taxonomy, we specifically refer to security tokens as only those that reach the definition of specified investments under the RAO. The category has been slightly amended to specifically exclude e-money from this definition.

We agree the ideal is to have as harmonised a framework as possible for cryptoasset regulation to reduce the risks of firms gaming the system (regulatory arbitrage) or creating problems for firms that want to operate in different jurisdictions. However, there are some inherent structural differences in different jurisdictions' securities markets and legal/regulatory frameworks that equally affect securities in a tokenised form.

The FCA draws an analogy with fine wine or art neither of which is regulated but can be the subject of investment for profit (FCA Guidance Annex I paragraph 43).

Accordingly, cryptoassets will not be "*securities*" falling within the FCA"s regulatory perimeter just because they can bought as an investment with a view to generating profits.

Territoriality

Given the international nature of cryptoassets it is relevant to briefly comment on territoriality.

Only authorised activities which are undertaken taken in the UK will fall within s19 FSMA and the Handbook. An extended meaning to "*being in the UK*" is given by s418 FSMA. Further detail is provided in PERG 2.4. In brief, s418 FSMA states that a regulated activity which would otherwise be treated as conducted outside the UK will be treated as conducted in the UK if:

- The regulated activity is performed by a firm whose head office or registered office is in the UK; or
- The regulated activity is performed by a firm whose day to day management takes place in the UK

Article 72 RAO also contains an exclusion for an "*overseas person*". A person falling within this exclusion will not be treated as performing authorised activities in the UK and will not be subject to the Handbook.

Financial promotions

Even if a cryptoasset does not fall within the FCA Handbook it may fall within the FPO which will affect the manner in which it is marketed.

"*Controlled investments*" are defined in the FPO and are not necessarily the same as "*specified investments*" in RAO for the purposes of s19 FSMA, although there is considerable overlap.

Controlled investments include shares (paragraph 14), instruments creating indebtedness (paragraph 15) and instruments giving entitlements to certain investments (paragraph 17).

It is a criminal offence, punishable by a fine and up to two years imprisonment, to communicate an invitation to engage in investment activity without being authorised by the FCA, ss21 and 23 FSMA.

On 28 October 2020, in response to concerns that high risk cryptoassets were being marketed to retail clients, the FCA banned the sale of the marketing, distribution and sale in or from the UK to all retail clients (non-professional clients).

The ban only applies to derivatives and exchange traded notes that relate to unregulated, transferable cryptoassets, ***Prohibiting the sale to retail clients of investment products that reference cryptoassets***, PS 20/10 October 2020 https://www.fca.org.uk/publication/policy/ps20-10.pdf . Annex A Glossary of PS 20/10 provides guidance on whether a cryptoasset is likely to be a derivative or an exchange traded note:

- a cryptoasset which derives its value from an underlying it is likely to be a derivative.
- a cryptoasset which is a debt security may be an exchange traded note.

The Treasury has proposed going a step further and adding cryptocurrency to the FPO, see *UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence, January 2021* https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/950206/HM_Treasury_Cryptoasset_and_Stablecoin_consultation.pdf .

This would mean that an unauthorised person who promoted any cryptoasset, even to a professional non-retail client, would be committing a criminal offence.

The Treasury paper states at paragraph 3.4 (emphasis added):

"*government is therefore considering an approach in which the use of currently unregulated tokens and associated activities primarily used for speculative investment purposes, such as Bitcoin, could initially remain outside the perimeter for conduct and prudential purposes. At the same time, these would be subject to more stringent regulation in relation to*

consumer communications via the financial promotions regime (if adopted) and AML/CTF regulation."

The use of the word "initially" in the Treasury paper suggests that in the future exchange token cryptoassets may become specified investments and subject to the full FCA Handbook.

MLRs

The UK implemented the Fifth Directive in the MLRs https://www.legislation.gov.uk/uksi/2017/692/contents/made. Notably, Regulation 56 of the MLRs requires certain cryptoasset businesses to register with the FCA by 15 January 2020.

The FCA Guidance notes (paragraph 46) that the Fifth Directive applies to certain cryptoassets in relation to money laundering regulation. The FCA Guidance explains (paragraph 47) that the Fifth Directive "*refers to an AML regime and does not have the effect of bringing any participant into the full FSMA regulatory perimeter*".

This means that if a cryptoasset does not fall into the FCA Handbook or the FPO regime it may be subject to FCA regulation by virtue of the MLRs.

The MLRs apply to the following cryptoasset businesses:

- cryptoasset exchange providers, Regulation 8(j), which is defined by Regulation 14A(1)(a) as a firm ("*including ….as issuer of any of the cryptoassets involved*") which involved in "*exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets*."

- custodian wallet providers, Regulation 8(k) which is defined as (Regulation 14A(2) MLRs) a firm which "*provides services to safeguard….(a) cryptoassets on behalf of its customers; or (b) private cryptographic keys on behalf of its customers in order to holds tore and transfer cryptoassets*".

Cryptoassets which fall within the MLRs become "*relevant persons*" and are required to comply with the obligations in the MLRs including:

- identifying and assessing the risks of money laundering and terrorist financing regarding customers, geographic areas, products or services, transactions and delivery channels, Regulation 18;

- establishing and maintaining polices, controls and procedures to mitigate the risks of money laundering and terrorist financing, Regulation 19;

- carrying out customer due diligence which requires the firm to identify and verify the customer's identity, and the purpose of the business relationship Regulations 27 and 28;

- registering with the FCA under Regulation 56.

  Persons who "*falls within regulation 8 solely as a result of that person engaging in financial activity on an occasional or very limited basis*", Regulation 15(2) MLRs are exempted from complying with the MLRs. Broadly speaking, the requirements of Regulation 15 are that the cryptoasset activity is ancillary and directly related to the person's main activity, and that:

- annual turnover of the cryptoasset activity does not exceed £100,000, and does not exceed 5% of the person's annual turnover;

- each cryptoasset customer transaction does not exceed 1000 Euros ;

- the cryptoasset activity is provided only to customers of the main activity of the person and is not offered to the public.

A cryptoasset exchange provider and a custodian wallet provider falling within the MLRs can only continue to operate if they are registered with the FCA, Regulation 56(1)(f)(g) MLRs. Acting without authorisation is a criminal offence punishable by up

to two years imprisonment and a fine, Regulation 78 MLRs. In addition there are various civil penalties that the FCA can impose.

Territorial jurisdiction of the MLRs

Regulation 9(3) states that a firm will be treated as carrying on a cryptoasset activity in the UK for the purposes of the MLRs if:

- its registered or head office is in the UK; and
- the day to day management of carrying on its business is the responsibility of that office or another establishment maintained in the UK

The FCA has produced a flowchart "Do I need to register with the FCA for carrying on cryptoasset activity" https://www.fca.org.uk/publication/documents/cryptoasset-registration-flowchart.pdf

The Flowchart contains a box entitled " *is the activity carried on by way of business in the UK?"*. This contains the following questions:

- whether the cryptoasset business has:

a) "*a registered or head office in the UK*" which carries on

b) "*day-to-day management of these activities from this office irrespective of where geographically the cryptoasset activity is conducted*". This encapsulates the requirements of Regulation 9 (2) MLRs;

- whether the relevant person has "*any UK presence that is engaged in or facilitates cryptoasset activities*". This is wider than Regulation 9 MLRs.

The FCA has expressly stated that the mere fact a customer is based in the UK is insufficient to bring a cryptoasset within the MLRs.

Regulation 9(5)(b) MLRs states that (emphasis added) *" it is irrelevant where the person with whom the business is carried on is situated*."

The Flowchart states (emphasis added): "*if you have no UK office or other activity in the UK beyond having a client in the UK we are likely to consider that you are not carrying on business in the UK*".

This means for instance that an overseas custodian wallet holder would not be treated as carrying on business in the UK just because it stored a cryptoasset belonging UK customer.

Although Regulation 9(3)(a) uses the word "*and*" which implies that both a UK registered address (or head office) and management from the UK is required to qualify as conducting business from the UK, the Flowchart suggests that any "UK presence" which is "*engaged in or facilitates cryptoasset activities*" is sufficient to trigger the application of the MLRs. This is wider than Regulation 9 MLRs.

A UK parent, subsidiary or third party company which assists an offshore cryptoasset business may itself be treated as being a relevant person under Regulation 8(j) and (k) MLRs and falling within the MLRs.

Conclusion

The perimeter of the FCA and cryptoassets is a complex area which is likely to change in the future as the FCA and the Treasury seek to regulate more cryptoasset activity.

The following quick analysis can be performed as a guide as to whether cryptoassets are currently likely to fall within FCA regulation:

1) FCA Handbook

- Does the cryptoasset provide rights akin to a share or debt instrument? If so, it is likely to be a security token and within the FCA Handbook.

- Currently cryptoassets which are a utility or exchange token are unlikely to fall within the FCA Handbook.

2) Retail ban

- Is the cryptoasset a derivative or an exchange

traded note? If so, it may fall within the FCA's ban on sales to retail clients.

3) MLRs

- Is the cryptoasset a custodian wallet holder or a cryptoasset exchange provider? If so, it may fall within the MLRs unless it is conducting cryptoasset business on an occasional and very limited basis.

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15 June 2021