The Regulator's Approach to Crypto Investment Firms- the way we understand it!

The rise of Cryptocurrencies

Cryptocurrencies, a type of decentralised digital currency have been around for over a decade with Bitcoin considered a pioneer in the space. With cryptocurrencies, the likes of Bitcoin and Ethereum delivering tremendous value growth at least until the 2017-2018 peak, and the rise of several Initial Coin Offerings (ICOs), it was no surprise that financial institutions started drawing attention to crypto assets as a viable asset class, albeit recognising the volatility and risks. But well ahead of the institutional interest, the retail market was already active with several brokers and exchanges offering crypto asset trading solutions.

Underpinning DLT technology gains Fintech attention and the FCA takes a closer look

As the Fintech sector started getting interested in the potential uses of Distributed Ledger Technology (DLT) underpinning crypto currencies, the FCA started taking a closer look at the crypto asset space in 2017 by launching discussion and feedback on DLT, Smart Contracts, and ICOs, as well as setting up the regulatory sandbox. Several innovative Fintech firms were looking at how DLT could be used beyond crypto currencies and applied to wider services such as digital asset trading, alternative financing, and DLT-based custodial services.

The FCA recognised the potential benefits as well as the challenges of DLT. However, no regulatory changes (as far as the FCA Handbook is concerned) came about as part of these initiatives. During 2017-2018 the FCA made it a point to warn consumers about the risks of ICOs (https://www.fca.org.uk/news/statements/initial-coin-offerings) but came short of regulating ICOs unless the assets traded were specified instruments (shares, bonds, etc) captured under the Financial Services and Markets Act Regulated Activities Order; cryptocurrencies such as Bitcoin were not in scope.

The rise of Crypto-derivatives and the FCA makes it clear that crypto-derivatives are regulated products irrespective of underlying unregulated crypto asset

The increased focus on Bitcoin and similar cryptocurrencies in the recent years gave rise to several investment firms already authorise and regulated by the FCA to add crypto currencies and crypto-derivatives to their investment services around brokerage, dealing, advising, and investment management. For example, regulated CFD Broker/Dealers started offering CFD's with a crypto-currency underlying as a type of derivative traded on leverage in 2017-2018 and continue to offers such products.

In light of the rise of firms offering Crypto-derivatives , the FCA issued a notice to make it clear that firms offering crypto-derivatives such as cryptocurrency futures, cryptocurrency CFDs, and cryptocurrency options, etc (https://www.fca.org.uk/news/statements/cryptocurrency-derivatives) required authorisation as the derivatives themselves are regulated products albeit the underlying asset (the cryptocurrencies) being unregulated.

Considering the high risk nature of crypto derivatives, the FCA started focusing on consumer protections by raising warnings and looking into the possible restrictions and ban of crypto derivatives for retail clients (https://www.fca.org.uk/news/news-stories/consumer-warning-about-risks-investing-cryptocurrency-cfds).

FCA imposes restrictions on sale of CFD and CFD-like options to retail clients

In line with ESMA's temporary restrictions imposed on the wider sale of CFD's to retail clients in 2018, the FCA confirmed permanent restrictions of a 2:1 leverage limit on CFDs and CFD like options along with several other restrictions that have been applicable from 1 August 2019 for CFDs and 1 September 2019 for CFD-like options, referencing cryptocurrencies (https://www.fca.org.uk/news/press-releases/fca-confirms-permanent-restrictions-sale-cfds-and-cfd-options-retail-consumers).

Crypto asset businesses required to register with the FCA for anti-money laundering and counter-terrorist financing (AML/CTF) purposes

Following implementation of 5MLD in January 2020, the FCA became the anti-money laundering and counter terrorist financing (AML/CTF) supervisor of businesses carrying out crypto asset activities in the UK and crypto asset firms are now required to register with the FCA for financial crime purposes for their UK business.

This registration applies to most unregulated crypto firms such as crypto exchanges, crypto P2P, crypto ATM operators, and crypto custodians. This registration is not to be confused with an authorisation for regulated activity. The registration is required in order to be compliant with the EU wide directive 5MLD and its UK implementation under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017, as amended (MLRs). Please see this link for information on registration (https://www.fca.org.uk/cryptoassets-aml-ctf-regime/register).

The registration requires several documents to be prepared such as a Regulatory Business Plan, Financial Forecasts, Risk and Internal Governance Documents, IT and Outsourcing arrangements including a detailed assessment of IT systems for bespoke IT systems, etc and the process is not to be underestimated in terms of time and effort that may be required depending on the business model. Firms will also be required to report on financial crime data annually through the FCA Gabriel reporting system.

FCA issues policy statement on Crypto Assets and establishes crypto asset categories

Whilst accepting that the crypto asset space is a small, evolving, and complex market covering a broad range of activities, the FCA issued a crypto asset policy statement in July 2019 where it categorised crypto assets into three categories by type of token, to help firms understand which type of tokens are regulated and which are not.

- **Exchange tokens (unregulated):** These are not issued or backed by any central authority and are intended and designed to be used as a means of exchange. They tend to be a decentralised tool for buying and selling goods and services without traditional intermediaries. These tokens are usually outside the regulatory perimeter. Examples are cryptocurrencies such as Bitcoin and Ethereum. Whilst unregulated, firms offering exchange tokens are still required to be registered with the FCA under 5MLD for AML/CTF purposes.
- **Utility tokens (Regulated if tokens are e-money tokens):** These tokens grant holders' access to a current or prospective product or service but do not grant holders rights that are the same as those granted by specified investments (shares, bonds, etc). Although utility tokens are not specified investments, they might meet the definition of e-money in some circumstances. In this case, activities involving them may be regulated as e-money tokens. So basically, there are two categories of utility tokens; unregulated utility tokens and regulated e-money tokens.

- **Security tokens (regulated as akin to specified investments like shares, bonds, futures, etc):** These are tokens with specific characteristics that mean they provide rights and obligations akin to specified investments as set out in the Regulated Activities Order (RAO), like a share or a debt instrument. These tokens are within the regulatory perimeter. For example, security tokens on shares and bonds are within the regulatory perimeter. However, there has been very little traction from the industry in this area.

Possible ban of sale of crypto derivatives to retail clients

Considering factors such as the high risk nature, limitation in valuation and price formation, extreme volatility, a lack of customer understanding, etc the FCA issued consultation in July 2019 to look at the possibility of banning the sale, marketing and distribution of crypto derivatives (such as CFDs, options and futures) and ETNs that reference unregulated transferable crypto assets to retail clients by firms acting in, or from, the UK.

Note that the possible ban only applies to retail clients and derivatives with an unregulated underlying token; exchange tokens and utility tokens (excluding e-money). Derivatives referencing regulated tokens; security tokens and e-money tokens will be exempt from the ban as they are within the regulatory perimeter.

The following conditions must apply for the ban to apply: tokens that are:

- unregulated tokens (exchange tokens and utility tokens excluding e-money tokens)
- capable of being traded on or transferred through any platform or other forum, and
- is not limited to being transferred to its issuer or a network operator in exchange for a good or service

The ban will exclude:

- derivatives that reference regulated e-money tokens
- derivatives that reference regulated security tokens
- tokens that are unregulated but are not widely transferable for example, tokens used on a private network where they can only be redeemed with the issuer and cannot be exchanged between third parties via platforms
- investment funds- generally UCITS and non-UCITS retail schemes (NURS) cannot currently invest in unregulated crypto assets directly due to restriction on eligible assets for investment. Qualified investor schemes (QIS) and unauthorised alternative investment funds (AIFs) can however invest in derivatives referencing unregulated tokens. Unauthorised AIFs could also invest in the tokens themselves if permitted by their investment mandate. However, QIS and unauthorised AIFs are subject to existing rules that restrict promotion of non-mainstream pooled investments to certified high net worth or sophisticated retail clients. The FCA views these measures as sufficient to protect retail clients who can access them and hasn't included investment funds in the ban.

The Policy statement and handbook rules were set to be issued in 2Q2020 but are yet to be published by the FCA at the time of writing this article.

The buzz in the market

Kraken owned Crypto Facilities became the first Crypto Futures MTF (a type of Trading Venue under MIFID) to be authorised in the UK by the FCA in July 2020. There were no truly regulated 'exchanges' in the crypto space until this authorisation of Crypto Facilities, which may now give rise to more similar authorisations.

How we can help

Contact us if you would like to discuss your crypto business model and authorisation. Our Consultants have worked with crypto firms, MTFs, and firms using DLT technology as part of regulated business activity. We can also help you with your 5MLD registration with the FCA. Please do get in touch with us should you require our support.