HM Treasury
1 Horse Guards Road
SW1A 2HQ

28 April 2023

Future financial services regulatory regime for cryptoassets: Consultation and call for evidence.

Dear Sir/Madam,

Executive Summary

Binance welcomes HM Treasury's (HMT's) consultation on the future financial services regulatory regime for cryptoassets. All regulatory frameworks should provide certainty and a safe space for innovation, and drive consumer trust, market order, clarity and impact. The framework needs to provide the foundations necessary to ensure financial stability and consumer protection, and to provide the confidence users and providers need to innovate together.

The regulation of cryptoassets should introduce robust governance and comprehensive systems and controls proportionate to the nature, scale and complexity of the risks inherent across the industry.

Particular consideration should be given to consumer protection, market integrity and financial stability solutions as the industry and technology continues to mature. Disproportionate regulation may inadvertently stifle innovation and growth, remove choice and competition, and potentially drive consumers to unregulated markets or operators. Achieving this balance is not easy.

Our detailed response is below. However, we would like to highlight the following key points:

- **Same risk, same regulatory outcome**: is the right and best approach, as new technology changes the balance of risks across areas including clearing and settlement, auditability, transparency and governance. Any regulation should take account of this.

- **FCA rules should be consistent with HMT’s intended policy framework and objectives**: We agree that HMT should seek to use legislative and regulatory mechanisms to put in place equivalent or similar safeguards where cryptoassets present similar risks to financial instruments. This should also consider the nuances of cryptoassets, and identify when and where these existing rules should be adapted to accommodate cryptoassets and the technology that underpins it.
- **Pragmatic disclosure rules**: Admission and disclosure requirements should provide the right information to consumers, with cryptoasset trading venues responsible for administration, as well as performing due diligence on the entity admitting the cryptoasset. However, in cases where there is no issuer we would query whether trading venues can take on the responsibilities of the issuer in a traditional sense.

- **Cryptoasset Market Abuse Regime (MAR)**: We are supportive of introducing standards to manage and mitigate the risk of market abuse specific to the challenges of cryptoassets. Prohibitions against market abuse should be broadly similar to those in the existing MAR. The introduction of formal regulatory admission practices, coupled with greater market surveillance and regulation in general, will help to mitigate market abuse going forwards.

- **Clear categorisation of what DeFi is to allow for effective regulation in the future**: DeFi needs to be carefully defined. Given the uncertainty around its future development, DeFi may also disrupt markets differently, its differences must be considered and accommodated when drafting legislation and policy.

Please do not hesitate to contact us if you have any questions about our response or require any further information.

Yours faithfully,

Binance
Responses as submitted via e-mail:

Q1. Do you agree with HM Treasury’s proposal to expand the list of “specified investments” to include cryptoassets? If not, then please specify why.

Yes, we support expanding the list of specified investments to include cryptoassets. Where there is doubt, and this is due to innovation and technology in particular, HMT must ensure that the overarching policy objectives and principles set out at paragraphs 1.11 and 1.12 are maintained.

The proposed definition of cryptoasset is intentionally broad, to capture all forms of existing cryptoasset and ensure the definition keeps pace with market developments. In principle, we agree with the intent behind this, but would highlight that Part (b) of the definition extends beyond the internationally agreed definitions in FATF and MiCA by introducing the concept of “recording or storage of data”.

Given the intent is to regulate the cryptoasset financial services ‘activity’ through the RAO, and not regulate the underlying crypto ‘asset’ itself, Part (b), which could apply widely to many financial services activities, could be removed without impacting the intended regulatory outcome. This would be consistent with the policy intent of ensuring technology neutrality, whilst not capturing any underlying non-financial services activity.

The likelihood of regulatory duplication, confusion or ‘scope creep’ by referencing the underlying technology or the "recording or storage of data" is, in our view, unnecessary and will no doubt introduce more legal complexity and potential unintended consequences.

As with many traditional finance rules, the regulation of cryptoasset financial services can improve where domestic approaches align with globally consistent terminology and definitions based on Global Standard-Setting Bodies and international best practices, such as FATF/IOSCO/Basel.

Q2. Do you agree with HM Treasury’s proposal to leave cryptoassets outside of the definition of a "financial instrument"? If not, then please specify why.

Yes. It is important not to compel an explicit read-across consistent with the overarching policy objectives and principles in this consultation, and with globally consistent definitions and terminology.

Q3. Do you see any potential challenges or issues with HM Treasury’s intention to use the DAR to legislate for certain cryptoasset activities?

We welcome the inherent flexibility the DAR regime provides to ensure the responsible development of the cryptoasset ecosystem for UK consumers and firms, including those
in financial services. However, this flexibility, and the powers of the regulators, should only be exercised in a manner consistent with the policy objectives and principles outlined throughout the consultation document.

Overall, we support the approach of defining and regulating the financial services activities of cryptoassets, including:

- a power to update the definition of cryptoasset by way of secondary legislation.
- ensuring the future financial services regulation of cryptoassets created using HMT powers will typically apply to a particular subset of cryptoassets depending on the matter being regulated, and will accordingly use a narrower definition to capture these;
- that the government’s intention that activities will be regulated, rather than the asset itself;
- that the proposed regulatory framework for cryptoassets is not intended to impose regulation on any underlying non-financial services activity which a cryptoasset might be used for;
- that if the activity is non-financial in nature this may be covered by other laws or regulations (e.g. fraud cases relating to digital art assets or NFTs);
- that the financial services regulation of cryptoassets will be within the regulatory framework established by the UK’s Financial Services and Markets Act 2000 (FSMA) to deliver a level playing field between crypto and traditional financial services firms conducting the same activity;
- that HMT intend to expand the list of “specified investments” in Part III of the RAO to include cryptoassets;
- that activities involving cryptoassets “by way of business” would be performing regulated activities and therefore require authorisation under Part 4A of FSMA;
- that the FCA will be given powers to write tailored rules, as opposed to the existing rules automatically applying to cryptoassets. The FCA will need to consider what is appropriate and consult accordingly;
- that the DAR regime in the FS&M Bill is designed to enable HMT to designate certain activities in order to make regulations relating to the performance of that activity, including prohibiting the activity in its entirety or setting direct requirements;
- not currently expanding the definition of “financial instrument” in Part 1 of Schedule 2 to the RAO to include presently unregulated cryptoassets; and
- in line with the principle of “same risk, same regulatory outcome”, HMT will seek to use other legislative and regulatory mechanisms to put in place equivalent or similar safeguards where cryptoassets present similar risks to financial instruments.
Q4. How can the administrative burdens of FSMA authorisation be mitigated for firms which are already MLR-registered and seeking to undertake regulated activities? Where is further clarity required, and what support should be available from UK authorities?

Authorisation is critical to ensure bad actors are kept out and those who subscribe to good conduct standards are allowed in. Authorisation also protects customers if things go wrong with authorised firms. Responsible cryptoasset companies should subscribe to the standards expected, and it is right that, where firms fail to meet the necessary standards, they are refused authorisation.

There is merit in bringing together the AML/CTF Regime with the FSMA regime under a single register so regulated cryptoasset activities adhere to the same financial crime standards and rules under FSMA that apply to equivalent or similar traditional financial services activities.

Additionally, it is important regulators have the necessary resources and skills to enable them to perform their functions efficiently to ensure the UK remains competitive fulfilling the UK’s ambition to become a technology and innovation hub, within which cryptoassets and blockchain adoption play a vital part.

Challenges with the Temporary Registration Regime (TRR) are well documented and have been discussed as part of Treasury Select Committee (TSC) hearings on Cryptoassets. Should an authorisation regime under FSMA materialise, it is critical that regulators urgently adopt a timely and proportionate authorisation process for complete and accurate applications, and endeavour to avoid duplicative information requests of businesses, taking into account the supervisory history of businesses during the authorisation process.

Q5: Is the delineation and interaction between the regime for fiat backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

In general, yes, delineation of fiat backed stablecoins for payments (phase 1) relative to the broader cryptoassets regime (phase 2) should be clear enough so that market participants know what is subject to regulation at that time and what is not.

However, as a consequence of the interaction between stablecoins, both fiat or otherwise, and the wider cryptoasset ecosystem, whether regulated or unregulated, the planning of the policy and legislative phases is critical and likely to present commercial and operational challenges for operators. Please also see Q6 for more detail.

It is important to ensure the two regimes interact appropriately. This would be especially relevant for the definition of redemption rights for stablecoin holders.
At present, most fiat-backed stablecoin arrangements operate in a tiered model, in which the majority of users do not have a direct relation with the issuer. Instead, they buy and sell the tokens on secondary exchanges, which have subjected them to KYC requirements.

Tiered arrangements ease the operational burden on issuers (e.g. the burden of onboarding of clients and processing redemptions) and mitigate risks by distributing them through a number of regulated intermediaries. Furthermore, consumers can choose from a range of intermediaries to effectively convert their stablecoins back to Fiat.

Holders should always be given the choice to enter into a direct relationship with the issuer and redeem directly from it at par, but the issuer should not be required to onboard each and every client unless and until they decide to exercise that right.

Q6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.

We understand the motivation behind this approach, but believe that the industry should be regulated by holistically considering the workstreams, rather than on an activity-by-activity basis.

The cryptoasset industry is part of a broad digital ecosystem, extending way beyond stablecoins and financial services categorisation. This includes digital innovation affecting other industries not within the financial services regulated perimeter, but which is still very relevant to UK growth and digital competitiveness.

The phased timelines should be shortened given their inherent dependencies. For example, stablecoins (phase 1) can be dependent on cryptoasset activities (phase 2). All of phase 1 and phase 2 are also dependent on future phases with no clear timelines. This regulatory uncertainty will risk making it more difficult for industry and customers to understand what is regulated. It will also be harder for the broader benefits of the underlying technology to be fully realised across different parts of the ecosystem if approached in phases. As with any ecosystem, it depends on healthy interaction with its constituent parts to grow, and the phased approach may inadvertently affect this.

There will also be a need for the regulators to consider the interaction of final rules based on the different phases and legislative timetable, as well as ensuring any transitional phases work in practice.
Q7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

We support HMT's active consideration of the:

- ‘By way of business’ test;
- FCA's existing framework for international firms, and whether firms carrying on cryptoasset activities would be required to have a physical presence in the UK and, if so, whether that should be a branch or subsidiary.
- Pursuit of equivalence-type arrangements as soon as practicably possible whereby firms authorised in third countries can provide services in the UK without needing a physical presence. It would be prudent during the assessment of equivalence to look on a service-by-service basis (or activity-by-activity basis). If a particular overseas regime does not capture a particular service or activity within scope of those being proposed for cryptoasset trading venues, then to avoid regulatory arbitrage, restriction should be placed on offering that service or activity to the UK. Therefore, equivalence decision making should not be based solely on like for like regime completeness.
- Permitting of cryptoasset activities provided from overseas companies if a UK customer accessed a particular cryptoasset service entirely at their own initiative and the firm does not solicit business from such customers.

Cryptoasset firms operating overseas should also be permitted to provide regulated activities into the UK through overseas exemptions that are considered “same risk”. For example, through authorised or exempt persons.

Q8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

In general, yes, as these are consistent with other regimes operating globally. The activity of “validation and governance activities,” will however, present operational challenges. Given mining, validating, staking and node infrastructure is integral to the operation of the technology infrastructure, including those connected interoperably but outside of financial services, it may be more appropriate to approach this on an outcomes basis.

In other words, given the proposed centralised nature of the regulatory framework for financial services cryptoasset activities, the centralised regulated entities should be the primary focus when it comes to consumer protection and market integrity. Subsequently, “validation and governance activities” should be excluded.

Further consideration is needed for the entire regulated framework and supervision approach, as DeFi starts to disintermediate traditional approaches to finance and digital commerce. Attempting to find a single solution to resolve issues for both centralised and
decentralised finance is unlikely to work well given their fundamental differences. Any regime must have the flexibility to recognise and accommodate this.

**Q9. Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?**

As per Q6, we are concerned the phased approach, rather than a parallel approach, may present difficulties. If the phased approach were to be adopted, then we would suggest our comments under Q8 relating to excluding “Validation and governance activities” are factored in.

**Q10. Do you agree with the assessment of the challenges and risks associated with vertically integrated business models? Should any additional challenges be considered?**

We agree that entities considered to be “vertically integrated” or “agglomerated” should be expected to follow rules covering all of these activities – not just those relevant to operating a cryptoasset trading venue. In particular, other business functions can effectively coexist with a regulated cryptoasset trading venue supported by robust governance, effective risk procedures and adequate internal control mechanisms. With adequate governance and oversight, products, services and activities can be appropriately segregated within the same group structure rather than limiting corporate groups to providing only specific ring-fenced services.

We agree “regulatory outcome” is the best approach, rather than prescriptive rules, as new technology changes the balance of risks in areas like clearing and settlement, auditability, transparency, and it is important that governance and regulation is able to take account of this.

In respect of opacity amongst operators and markets, clear unequivocal regulation combined with objective authorisation of operators will improve these industry perceptions and help regulators and governments meet their objectives. This includes the licensing assessments of new entrants at the gateway, the ongoing supervision of authorised entities and the subsequent data reporting requirements that regulators can expect to help support market abuse and systemic monitoring.

**Q11. Are there any commodity-linked tokens which you consider would not be in scope of existing regulatory frameworks?**

The consultation appears to suggest the UK regime will not have a regime that enables commodity-backed stablecoins to operate, and that the only version of stablecoins permitted via the proposed regulatory regimes will involve fiat-backed stablecoins. If interpreted correctly, this approach differs from other jurisdictions across the EU, Asia and Middle East and may warrant further consideration. If the proposed framework is to
be equivalent, it may be appropriate to allow well-designed and regulated commodity-backed stablecoins. This could be an additional category for these tokens catered for through the broader cryptoasset regime.

Q12. Do you agree that so-called algorithmic stablecoins and cryptobacked tokens should be regulated in the same way as unbacked cryptoassets?

Yes, we strongly agree with this proposal. Well designed and regulated fiat-backed stablecoins provide the highest level of confidence to users. To preserve that, they should be subject to robust regulation (i.e. equivalent to the rules applying to e-money) and be easily identifiable (e.g. through labelling) and distinguishable from other cryptoassets.

Conversely, algorithmic stablecoins and cryptobacked tokens should be regulated like other cryptoassets. They should not be allowed to make a claim at stability and should be subject to clear disclosure rules to ensure investors are aware of the risks that come with them. Banning algorithmic stablecoins is likely to be unnecessary if appropriate safeguards are in place.

The same reasoning applies to crypto-backed tokens, which, at present, play a critical role in ensuring the interoperability of blockchains.

Q13. Is the proposed treatment of NFTs and utility tokens clear? If not please explain where further guidance would be helpful.

Yes, this is clear and in line with the focus on 'activities based' regulation rather than the technology or cryptoasset itself. We also agree with MiCA, Regulation 6(c) that the issuance of cryptoassets as non-fungible tokens in a large series or collection should be considered as an indicator of their fungibility. We would welcome confirmation on this point, which would also assist with any future equivalence discussions, and could help promote consistency internationally.

Q14. Do you agree with the proposed regulatory trigger points – admission (or seeking admission) of a cryptoasset to a UK cryptoasset trading venue or making a public offer of cryptoassets?

We agree with the proposed regulatory trigger points outlined, subject to the detailed policy and rules being consistent with the high level regulatory outcomes set out in the consultation document. In particular, we agree to an approach that:

- is tailored to the specific attributes of cryptoassets;
- does not intend to directly regulate the “creation” of unbacked cryptoassets under financial services regulation;
allows cryptoasset trading venues to be responsible for administration, including admission and disclosure requirements, as well as performing due diligence on the entity admitting the cryptoasset; and

allows exemptions to be available – for example for offers addressed only to wholesale investors or offers which fall below a certain value threshold.

Where there is no issuer (e.g. Bitcoin), we understand the trading venue would be required to take on responsibilities of the issuer if they wish to admit the asset to trading.

However, we query the extent to which the responsibilities of the issuer in a traditional sense can be achieved under such circumstances, and how that is taken into account in defining the liability of the trading venue (see Q16). In particular we would propose that the focus should be on the ‘scope of liability’, i.e. an exchange should take all reasonable steps to make sure the white paper is consistent with the regulations, but if the exchange has been misled or if there is a problem with the protocol, it would no longer be liable.

This would be consistent with the proper implementation of the high level regulatory outcomes outlined in paragraph 5.5. When combined with appropriate regulation and oversight of authorised entities and markets, this can achieve the same regulatory outcome for both consumers and markets.

Q15. Do you agree with the proposal for trading venues to be responsible for defining the detailed content requirements for admission and disclosure documents, as well as performing due diligence on the entity admitting the cryptoasset? If not, then what alternative would you suggest?

Yes, see Q14 for additional information.

Q16. Do you agree with the options HM Treasury is considering for liability of admission disclosure documents?

Yes. As the market in trading and listing cryptoassets matures, some form of liability regime modelled on existing legal precedent is helpful. Ultimately the courts will adjudicate on matters of liability. Our expectation is that we would expect this to be applied consistent with the high level regulatory outcomes outlined at paragraph 5.5 and specifically that “appropriate liability and compensation should be available for untrue or misleading statements made in disclosure / admission documents”. We suggest the application of such a rule is applied in a manner consistent with the FCA’s “fair, clear and not misleading” rule based on the nature of the client and of its business, if any, as per the guidance at COBS 4.2.2.
Q17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?

Yes. That said, we assume that the “necessary information” does not need to be restricted to only the “necessary information” stipulated, or the use of a specific template. Whitepaper providers operate globally and what is deemed necessary information for disclosures will vary by type of client and by jurisdiction.

Q18. Do you consider that the intended reform of the prospectus regime in the Public Offers and Admission to Trading Regime would be sufficient and capable of accommodating public offers of cryptoassets?

Yes, assuming the proposed requirements are consistent with the high level regulatory outcomes set out in the consultation paper, and so long as the requirements are tailored to the specific attributes of cryptoassets.

We agree some consistency in approach for various categories of cryptoassets is helpful in the prospectus regime, given the possibility cryptoassets may move between regulated or unregulated categories depending on the activity used for. We would also encourage flexibility in the DAR regime to consider taking listings of cryptoassets into account to accommodate future industry developments.

Q19. Do you agree with the proposal to use existing RAO activities covering the operation of trading venues (including the operation of an MTF) as a basis for the cryptoasset trading venue regime?

Yes, consistent with the high level regulatory outcomes described and our other comments in this consultation response, in particular to Q7.

Data reporting can raise numerous complexities and requires collaboration with industry to ensure that confidentiality, integrity and availability can be achieved on a consistent basis and in a format that is sustainable by industry and purposeful to regulators.

We would emphasise that any work on an insolvency or resolution regime should be consistent with other consultations on this subject. In particular, certain operators could offer multiple services and activities e.g. trading venues and systemic stablecoins.

Q20. Do you have views on the key elements of the proposed cryptoassets trading regime including prudential, conduct, operational resilience and reporting requirements?

We agree with the key elements of the proposed regime. But to enable a jurisdiction to become successful, requirements need to be proportionate to the nature, scale and complexity of the risks inherent in the business model and the activities of firms. It is
important to ensure focus on regulatory outcomes. Copying and using existing rules is likely to present operational challenges and risk harming the UK’s competitiveness as the benefits, risks and opportunities may differ due to the nature of the technology and the manner in which the activities and services inherent in the cryptoasset and digital ecosystem are provided.

Q21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

See Q20. Additionally, we would observe the nature and function of intermediaries is evolving in the cryptoasset industry and this will be relevant when designing regulatory solutions.

Q22. Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?

See Q20.

Q23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

Generally yes, where consistent with the high level regulatory outcomes and design features described and our other comments below.

The activities undertaken by cryptoasset custodians are a key cryptoasset activity and accordingly a cryptoasset regulatory regime should contain specific additional requirements applicable to cryptoasset custodians.

This includes requirements to ensure cryptoasset custodians properly protect and safeguard any client assets they are holding or controlling on behalf of their clients and insulate them in the event of insolvency.

Definitions of client money in existing legislation should be considered and expanded as appropriate to include money (e.g. fiat) of any currency which a regulated cryptoasset trading venue holds on behalf of a client or which a regulated cryptoasset trading venue treats as client money.

The different custodial arrangements in respect of cryptoassets should also be considered. For example:
Custodial Wallet: The regulated cryptoasset trading venue is wholly responsible for the custody of a client’s accepted cryptoassets and provides this service “in-house” through its own cryptoasset wallet solution.

Outsourced Custodial Wallet: The regulated cryptoasset trading venue is wholly responsible for the custody of a client’s accepted cryptoassets but operationally outsources this function to a third-party Virtual Asset custodian.

Non-Custodial / Self-Custody Wallet. The client is responsible for custody of their cryptoassets.

The inherent characteristics of cryptoasset trading venue businesses, and the underlying technology used, may require them to be regulated on a bespoke basis. For example, depending on the business or customers of the cryptoasset trading venues:

- it may not always be operationally feasible (and may in fact increase security risk) where a third party custodian is required to hold customers’ assets;
- the cryptoasset trading venue may list a wide range of tokens, some of which third party custodians may not be capable of holding,
- involving a third party custodian may require on-chain transfers which may compromise security, timeliness of transfer and increase cost to users.

Other considerations related to risk management controls for customer assets, private keys and storage include:

- That the proportion and mix of cryptoassets in hot and cold wallets is dependent on the cryptoasset trading venues business model and should be managed in line with, for example, its liquidity risk management policy and processes to ensure good operational resilience. This proportion and mix should be managed operationally and not mandated by the regulator. For example, mandating a small upper limit on the overall volume of cryptoassets that are able to be stored in a cryptoasset trading venues hot wallet (e.g. 10 percent) could (i) impact the speed at which customer withdrawals can take place; and (ii) compromise security systems of the cryptoasset trading venue as it will require more sweeping from the cold to the hot wallet.
- In addition to having risk management controls for the storage of private keys, having such controls for the key generation process is also critical to safeguard private keys. Private keys may be subjected to single points of failure, as well as internal or external threats. As such, we suggest the use of Multi Party Computation (MPC) in key generation, which is a mechanism to generate and split the private key into multiple pieces distributing them in multiple places and storing them securely so no one person will have full access to the private key. This methodology, in our view, has superior risk controls against the traditional method of creating private keys.

Custodian regulation should allow an independent corporate entity within the group structure of the cryptoasset trading venue, with appropriate insolvency ring fencing measures for wallets, to safeguard users’ assets. Regulation does not require a separate
regulation, Yes, responsibility Q28. speculative with Yes. that similar Q27. regulators regulatory the policy and Mous the abuse requirements? custody adequate those licensing in case custodian of the reserves in order to protect them in an insolvency of the issuer, as is the case in a common law jurisdiction such as the UK. Otherwise this requires double licensing of exchange and custodian and renders settlement between the wallets of those legal entities impracticable. The same outcome can be better achieved through adequate governance and oversight under appropriate regulation.

**Q24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?**

See Q20.

**Q25. Do you agree with the assessment of the challenges of applying a market abuse regime to cryptoassets? Should any additional challenges be considered?**

Yes, we are supportive of HMT’s effort to introduce standards to manage and mitigate the risk of market abuse specific to cryptoassets. We would highlight the need to revise MoUs and agree cooperation agreements with peers globally which can often take time and should be prioritised through supranational entities involved in global cryptoasset policy making, such as IOSCO.

**Q26. Do you agree that the scope of the market abuse regime should be cryptoassets that are requested to be admitted to trading on a cryptoasset trading venue (regardless of where the trading activity takes place)?**

Yes, although we recognise the practical challenges that this may pose for regulators in the short-term, including enforcement. As acknowledged in the consultation, it will require greater global coordination which should be achievable through greater regulatory clarity, the adoption of new technologies and better coordination amongst regulators and industry both domestically and internationally.

**Q27. Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?**

Yes. The introduction of formal regulatory admission practices at the gateway, coupled with greater market surveillance and regulation in general, will help to mitigate such speculative practices going forwards.

**Q28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?**

Yes, we anticipate that if the industry is increasingly subject to consistent and clear regulation, both domestically and globally, many of the concerns that relate to bad actors
and questionable trading practices should reduce. Greater industry involvement in addressing the challenges identified, including in relation to the admission of cryptoassets is welcome.

**Q29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?**

It will be important for the UK’s competitiveness going forward that the balance of resources focussed on RegTech, SupTech and the digitalisation of financial services in general reflects the reality that financial services are increasingly delivered by technology platforms. Regulators will have to continue to evolve to meet these demands and increasingly use RegTech and SupTech to meet their regulatory objectives efficiently.

RegTech is also in the pure technology space, not necessarily the regulated activity space. This means regulators globally must be willing to engage with RegTech firms even if they do not possess regulated permissions. Showing regulatory clarity is potentially one of the greatest levers to encourage the development of the RegTech sector, as it allows RegTech firms to better understand what problems they are trying to solve.

The current RegTech sector within the cryptoasset industry is vibrant and has been very proactive to date in finding RegTech solutions to help industry and regulators meet their objectives. There is ample scope for the cryptoasset and RegTech industries to also help regulators with SupTech solutions.

**Q30. Do you agree with the proposal to require all regulated firms undertaking cryptoasset activities to have obligations to manage inside information?**

We propose the main focus should be on the exchanges where the majority of trading and listing will likely take place. Where other activities are captured for ‘inside information’ purposes based on the “Proposed scope of cryptoasset activities to be regulated’ at Table 4.A, this may need to be more nuanced. In particular, regulation should be designed to:

- provide clarity and certainty for affected parties, recognising different groups may be affected differently;
- avoid duplication or conflict with other existing or proposed regulations.

As mining, validating, staking and node infrastructure is integral to the operation of the cryptoasset and digital technology ecosystem, including those sectors connected interoperably, but outside of financial services, we highlight our response at Q8 for these activities.
These proposals are intended to be consistent with the high-level regulatory outcomes set out in this consultation document. Where the policy solution is less clear the government should take a cautious and incremental approach to regulation as rules can always be adapted and amended in time.

**Q31. Do you agree with the assessment of the regulatory challenges posed by cryptoasset lending and borrowing activities? Are there any additional challenges HM Treasury should consider?**

In general, we agree there are challenges and opportunities cryptoasset lending and borrowing can present including around market volatility, borrower and lender rights, safekeeping and use of collateral, legal entitlement and enforcement of interests, and the treatment of cryptoassets for tax and property purposes. Staking and lending are distinct terms and should be subject to further consideration, as per comments at Q33, 34, 35, 45 and 46.

As with all financial decisions, consumers must take primary responsibility for those decisions. Given inherent information asymmetries across all financial products, regulators need to ensure that consumers have access to suitable and clear information. Decisions based on the transfer of value are not zero risk but blockchain technology, including trustless smart contract technology, can help. Regulators can also help to facilitate responsible innovation that protects consumers and markets, including in the borrowing and lending space.

**Q32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?**

Without getting into the specifics, it is evident that harms, including those relevant to consumers and markets, have occurred due to recent failures in the industry. The reasons for such incidents are subject to ongoing debate and litigation but some observations can be drawn that are helpful to this consultation. In particular:

- financial, operational, legal, governance, organisational and culture were significant contributors to the failures that occurred;
- the use of technology has not been considered as a contributing factor;
- regulation appropriate to the technology, activities and risks can help avoid future harm. This includes a need to purposely differentiate between centralised and decentralised platforms when developing regulatory solutions.

We support HMT’s initial approach, because:

- the high level regulatory outcomes are sensible and realistic;
- there is a strong case for developing a cryptoasset lending and borrowing regime as a priority;
the proposed approach does not pursue all of the same outcomes delivered by different traditional lending and borrowing regulations; disclosure requirements could help improve transparency associated with the use of collateral in cryptoassets financing activities; and the technology and resources of the industry are fully utilised when finding proportionate and targeted solutions.

Q33. Do you agree with the idea of drawing on requirements from different traditional lending regimes for regulating cryptoasset lending? If so, then which regimes do you think would be most appropriate and, if not, then which alternative approach would you prefer to see?

Focussing on the high-level regulatory outcomes assists in managing and mitigating the consumer and market harms. The regulatory obligations applied to lending should be consistent with “same risk, same regulatory outcome” as in traditional financial services markets. Not all forms of cryptoasset lending or borrowing will have the same risks, and some forms may not have features akin to traditional securities or necessitate detailed financial regulation e.g. peer-to-peer and consumer credit.

The creation of clear regulation, including clear policies and rules appropriate to wider risks e.g. financial and operational, will also provide broader support to the potential risks of borrowing or lending cryptoassets.

Q34. Do you agree with the option we are considering for providing more transparency on risk present in collateralised lending transactions?

Yes, particularly as regulated cryptoassets activities may result in borrowing and lending being collateralised with real-world assets, or act as a digital representation of underlying real-world assets.

Q35. Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?

Yes, as the risks may differ, including how they are treated for the purposes of insolvency. However, any regulatory treatment applied should not be done in isolation, but should be considered as part of a package of reforms being introduced to manage and mitigate risks to consumers and markets.

Q36. Do you agree with the assessment of the challenges of regulating DeFi? Are there any additional challenges HM Treasury should consider?

Yes, we agree with the assessment overall and believe HMT has grasped the concept well. In particular that DeFi:
transactions occur without centralised decision making or use of intermediaries;
- presents complex and unique challenges for policy makers and regulators;
- organisations are especially globalised and borderless in nature, with participants operating across many jurisdictions;
- has a long list of actors involved in product chains;
- could use the innovative nature of programmable transactions to increase efficiency and competition in the financial services industry;
- the way regulation is achieved may well differ and take longer to clarify.

We would emphasise the need to carefully consider the salient parts of DeFi i.e. “decentralised” and “finance”, when designing policy and hence addressing key challenges regarding clear categorisation and visibility of the DeFi ecosystem and the lack of intermediaries. This makes it very difficult for authorities to enforce existing consumer protection, market integrity, and financial crime rules.

Centralised business models which market themselves as DeFi, in order to circumvent regulatory obligations are not DeFi and should be subject to the same treatment as centralised organisations. Likewise, in situations where persons who maintain significant control or influence over apparent DeFi arrangements or protocols that provide regulated cryptoasset services and activities. At the same time, it is important to recognise that DeFi exists in a spectrum and that decentralisation will be iterative over time.

The integration of CeFi and DeFi (CeDeFi), with appropriate regulatory guardrails, could lower many of the observed risks (e.g. money laundering, bad actors, unsuitable products, conflicts and the safeguarding and administration of assets (custody risks)) whilst enabling DeFi to develop in a controlled and considered way.

Q37. How can the size of the “UK market” for DeFi be evaluated? How many UK-based individuals engage in DeFi protocols? What is the approximate total value locked from UK-based individuals?

Due to the current absence of a regulatory framework providing consistent categorisation of DeFi activities, as well as access to accurate data, assessing the UK market is difficult. Currently the DeFi market is small globally and it may be the case that in the interim, data and policy for DeFi can be developed by working with industry, including centralised actors and companies specialising in blockchain analytics.

Q38. Do you agree with HM Treasury’s overall approach in seeking the same regulatory outcomes across comparable ”DeFi” and ”CeFi” activities, but likely through a different set of regulatory tools, and different timelines?

Yes, but only where they fall within the regulatory perimeter and genuinely meet the combined test of “Decentralised” and “Financial”.
Q39. What indicators should be used to measure and verify “decentralisation” (e.g. the degree of decentralisation of the underlying technology or governance of a DeFi protocol)?

As per Q36 and Q38, it is important that regulated DeFi meets certain thresholds triggering the justification for it being regulated. This could include assessments of centralised ownership and control weighed against the use of technology and self-automation. Where ownership and control can be clearly attributed to a small group of network participants and not truly dispersed or self-automated, this is unlikely to be DeFi, as these centralised actors can be held to account as a constellation of interests. In this scenario policymakers may wish to consider what rules should apply and create guardrails to manage the risks appropriately.

Q40. Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?

As DeFi is inherently digital technology that is accessible 24/7, cross-border, built on a global network that is open source and accessible through the internet, it requires a somewhat different approach from policymakers and regulators. This includes fully understanding the network effects of the ecosystem.

DeFi is also more than just protocols. It includes other areas which will be important for policymakers and regulators to understand and engage with e.g. validators, miners, AMMs (automated market makers / exchanges), DAOs (Decentralised Autonomous Organisations) and Oracles.

If DeFi develops in the way many expect, it will be working with consumer interfaces, such as traditional centralised entities, and collaborating with the DeFi ecosystem that will mark out regulators and governments for success. This approach is consistent with the FATF’s Updated Guidance for a Risk-Based Approach for Virtual Assets and Virtual Asset Service Providers¹, where the FATF suggested that ‘a mitigation option was to affirmatively require that a regulated cryptoasset trading platform be involved in any DeFi arrangement. This will allow regulators and policymakers to leverage off the technological infrastructure and practical know-how of market intermediaries such as virtual asset exchanges’.

Q41. What other approaches could be used to establish a regulatory framework for DeFi, beyond those referenced in this paper?

Clear principles based regulation focussed on the same risk, same regulatory outcome can enable regulators and industry to agree on rules that realise the benefits of DeFi

innovation without undermining the objectives of the regulators. It is not realistic to wait until DeFi is mature to decide on the regulatory approach and prohibition is unlikely to work.

Q42. What other best practices exist today within DeFi organisations and infrastructures that should be formalised into industry standards or regulatory obligations?

It is too early to say what precisely best practices will look like. Features that are necessary to enable the successful development of DeFi in a way that is safe and secure should be encouraged, for example:

- incentives that allow responsible DeFi participants to benefit from “good outcomes”;
- consideration of regulatory safe harbours, waivers, and modifications from traditional rules and regulations to support responsible innovation;
- self-regulatory models that encourage coordination, transparency and accountability;
- voluntary registers of responsible DeFi projects or a formal “opt in” option;
- industry standards, codes of practice and/or regulatory guidance for the responsible development of the technology and industry;
- regulator engagement and support to help shape and influence the industry and community in a similar way to how progressive regulators provide support for FinTech, RegTech and SupTech innovation and DLT/FMI sandboxes; and
- recognition that many of the current or perceived problems present in DeFi exist in traditional finance.

Q43. Is there a case for or against making cryptoasset investment advice and cryptoasset portfolio management regulated activities? Please explain why.

Yes, where the activities are caught under those categories within the RAO then the “same risk, same regulatory outcome” should apply. It is important that the individuals involved in the provision of those regulated activities, whether from TradFi or crypto, are competent and their experience and qualifications appropriate.

Q44. Is there merit in regulating mining and validation activities in the UK? What would be the main regulatory outcomes beyond sustainability objectives?

As per Q8, the proposed regulated activity of “validation and governance activities” is disproportionate to the policy outcome of focusing on cryptoasset regulated activities that are analogous to traditional financial services activities. A better approach is to maintain the focus on principles based regulation and the high level regulatory outcomes for regulated activities set out in this consultation.
Q45. Should staking (excluding “layer 1 staking”) be considered alongside cryptoasset lending as an activity to be regulated in phase 2?

Staking should be considered in future policy consultation work to provide greater regulatory clarity. Staking is the process of supporting a blockchain network and participating in transaction validation by committing cryptoassets to that network on-chain. It is used by blockchain networks which use the proof of stake consensus mechanism and is integral to the functioning of the blockchain network. Prohibition of staking, or heavy handed regulation, will not only prevent the proper functioning of the cryptoasset ecosystem in the regulated financial services space, but will also hinder the development and functioning of the broader UK digital ecosystem overall.

Through appropriate regulation, including the use of disclosure and customer consent, it is feasible that simple, lower risk, saving and lending activities can be made available to consumers safely. Importantly, this should include staking products that support the blockchain network.

Additionally, it may be helpful to consider the different aspects of the crypto ecosystem to ensure that services and activities can be made available to consumers in a way which is proportionate to the overall benefits and risks the industry presents. For example, activities such as yield farming, staking and saving have different characteristics, risk profiles, and utility within the cryptoasset ecosystem and should be considered separately. The levels of risk and reward, complexity and impermanent loss also differs across the activities with saving and staking simpler than higher-risk yield farming.

In traditional staking, it should also be noted that users retain ownership and control of their staked cryptoassets. This may differ to staking-as-a-service where a platform may act as an intermediary for a fee based on agreed terms and conditions.

Q46. What do you think the most appropriate regulatory hooks for layer 1 staking activity would be (e.g. the staking pools or the validators themselves)?

Given the relative complexity of regulating this area, and it's heavy dependency on open source cross-border technology that can be utilised in any cryptoasset ecosystem, including centralised and decentralised systems, it may be more appropriate to approach this on an outcomes basis e.g. centralised regulated entities should be the primary focus when it comes to consumer protection and market integrity. Attempting to identify and regulate individual staking pools or node validators, many of which will be outside of the UK, will be very difficult.

Q47. When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?
A relative comparison with other industries’ global environmental impact such as traditional financial services, fast fashion, tourism and the effects of deforestation. This may help provide additional real world context, drive positive behaviours overall, and help place the debate and decision making into greater context. It would also support the UK’s objective of becoming a global centre of green finance innovation and adoption. It will also be important to ensure this is measured consistently relative to other industries whether done globally or domestically. Recent research by the Cambridge Centre for Alternative Finance into the electricity usage of Ethereum is a good example.

The energy consumption of a blockchain protocol should not be confused with its environmental footprint. Many use cases related to blockchain technologies and crypto-assets tend to improve the environmental footprint of these decentralised networks, in particular by using surplus decarbonised energy in certain geographical areas where the need for electricity is lower than the level of production.

Q48. What reliable indicators are useful and/or available to estimate the environmental impact of cryptoassets or the consensus mechanism which they rely on (e.g. energy usage and/or associated emission metrics, or other disclosures)?

Good data and information that helps users understand the environmental footprint and context that the blockchain, cryptoasset, or sector, is producing. This could include:

- differentiation between cryptoassets using Proof of Stake and Proof of Work consensus mechanisms;
- individual cryptoasset market values as a percentage of the overall market capitalisation of the industry;
- the amount of energy used by the individual cryptoasset based on the protocol used;
- trend analysis of the individual cryptoassets, the sector and renewable energy types used relative to other industries for real world context e.g. Q47;
- whether the cryptoasset is dominant in the decentralised or centralised sector;
- whether the cryptoasset is used mainly or wholly in a private or public or blockchains;
- whether the blockchain hosting the cryptoasset is permissionless or permissioned.

Q49. What methodologies could be used to calculate these indicators (on a unit-by-unit or holdings basis)? Are any reliable proxies available?

Whatever process and methodologies are used, the data sources should meet the principles of good data quality to maintain credibility. As blockchain technology and infrastructures have an international dimension, it is important to ensure that harmonised

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2 https://ccaf.io/cbnsi/ethereum/comparisons
and standardised methodologies are used across the globe. In this context, the European Union, through MiCA regulation, will soon publish its technical standard on the matter for EU Crypto Assets Service Providers (CASPs).

When calculating these indicators, it is important to consider the various types of consensus mechanisms used to validate crypto-asset transactions, their incentive structures and the use of energy, renewable energy and natural resources, the production of waste, and greenhouse gas emission. The required indicators should not require information that would be irrelevant for UK equivalents of CASPs to provide in comparison to the traditional financial sector.

**Q50. How interoperable would such indicators be with other recognised sustainability disclosure standards?**

This data is intended to estimate the environmental impact of cryptoassets, or the consensus mechanism upon which they rely. The data sources and solutions developed should reflect this and should guide the required level of interoperability and interconnectedness.

**Q51. At what point in the investor journey and in what form, would environmental impact and / or energy intensity disclosures be most useful for investors?**

Disclosure likely has most relevance at the point of purchasing the regulated cryptoasset financial services product or service. The type and manner of disclosure will also be influenced by the customer classification e.g. retail or professional.

MiCA imposes two different informational obligations for CASPs: (1) A crypto-asset white paper shall contain information on principal adverse environmental and climate related impact of the consensus mechanism used to issue the crypto-asset; and (2) Crypto-asset service providers shall make publicly available, in a prominent place on their website, information related to principal adverse environmental and climate-related impact of the consensus mechanism used to issue each crypto-asset in relation to which they provide services. This information may be taken from the crypto-asset white papers.

**Q52. Will the proposals for a financial services regulatory regime for cryptoassets have a differential impact on those groups with a protected characteristic under the Equality Act 2010?**

The proposals will not have a material impact on groups with protected characteristics any differently to other regulatory requirements applicable to technology or fintech products and services.