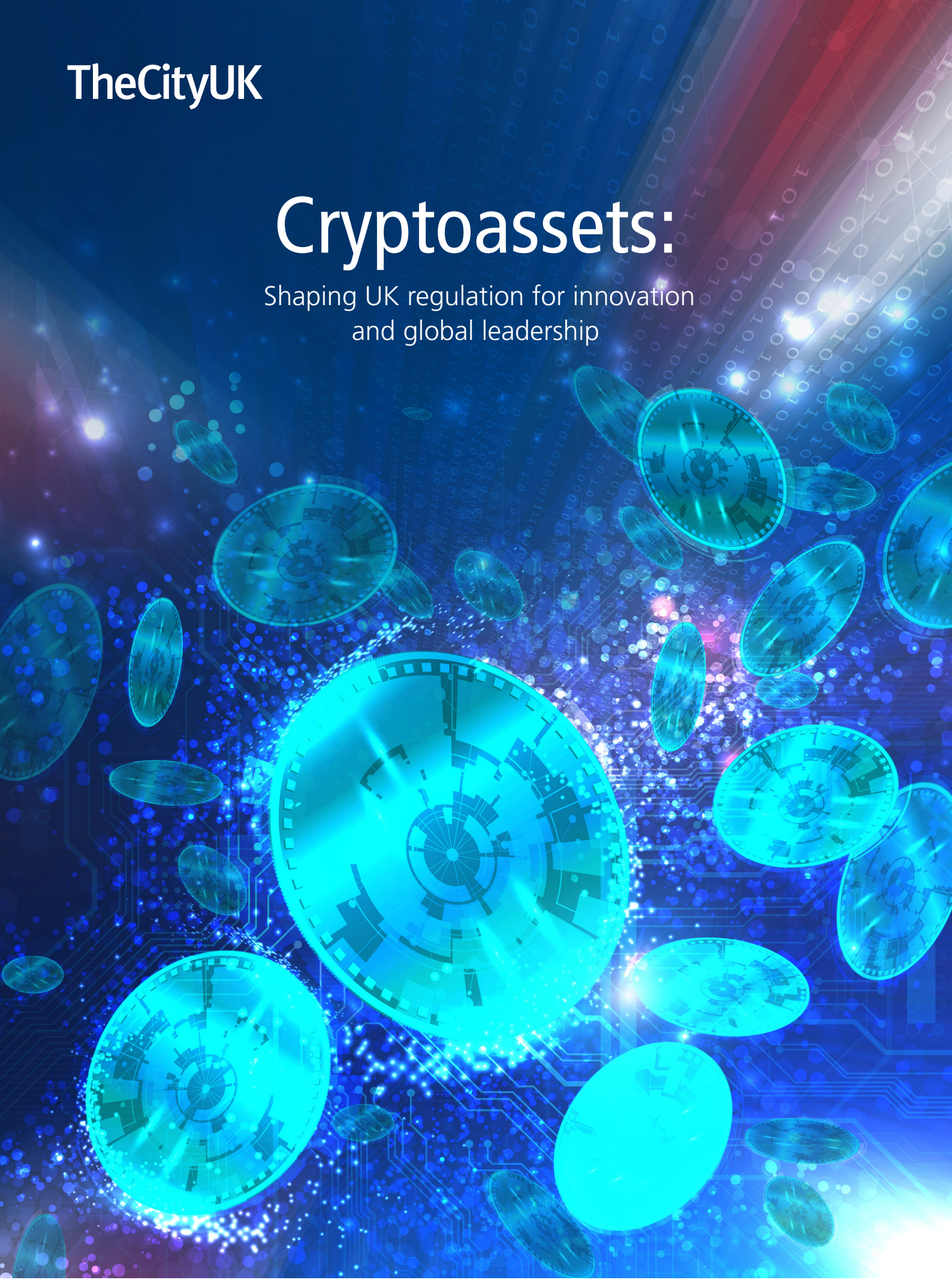
TheCityUK

Cryptoassets:

Shaping UK regulation for innovation and global leadership



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TheCityUK

TheCityUK is the industry-led body representing UK-based financial and related professional services. We champion and support the success of the ecosystem, and thereby our members, promoting policies in the UK, across Europe and internationally that drive competitiveness, support job creation and ensure long-term economic growth. The UK's financial and related professional services industry contributes over 10% of the UK's total economic output and employs more than 2.3 million people. It is the largest tax payer, the biggest exporting industry and generates a trade surplus exceeding that of all other net exporting industries combined. It also makes a real difference to people in their daily lives, helping them save for the future, buy a home, invest in a business and protect and manage risk.

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Introduction

The UK has a strong track record of fostering a forward-looking digital economy within financial services and payments. An emerging area of technology that is transforming financial services involves cryptoassets and their underlying technology known as distributed ledger technology (DLT). There has been much debate around the potential for DLT to be used more widely, from revolutionising the way land registration works, to transforming supply chains. However, its potential in financial services has arguably received the most attention and it is already being used in this context.

Cryptoassets and stablecoins have been rapidly increasing in popularity in recent years. The FCA estimates ownership of cryptocurrencies is up to around 2.3 million, up from around 1.9 million in 2020 – and 78% of adults have now heard of cryptocurrencies[1]. The total market capitalisation of stablecoins has grown from $2.6 billion at the start of 2019, to $20 billion in September 2020 – with global trading volumes estimated at $198 billion in April 2021[2].

This market is served by a wide range of participants of all sizes. Established financial institutions have begun to explore opportunities involving cryptoassets and stablecoins, as well as large corporates, big tech, and a growing number of start-up and scale-up firms.

As a result of the growing popularity of cryptoassets and DLT, jurisdictions across the world, including the UK, are considering how to regulate this new and exciting area of technology.

The UK-based financial and related professional services industry enables the delivery of innovative financial and payments products in a dynamic market. Appropriate and proportionate regulation of cryptoassets that safeguards consumers and ensures the operation of a safe and effective market has the potential to empower billions of users and create a safer and more inclusive financial system.

This report aims to provide an overview of existing types of cryptoassets, how they are categorised in the UK, the key policy issues that should be considered when designing the regulatory perimeter, and a proposed policy approach for Government.

[1] FCA, 'Research Note: Cryptoasset consumer research 2021', (June 2021), available at: https://www.fca.org.uk/publications/research/research-note-cryptoasset-consumer-research-2021.
[2] Market Wrap: Stablecoin Market Cap 'Goes Parabolic' – CoinDesk and Top Stablecoins by Market Capitalization – CoinGecko

Key policy recommendations

The UK has a valuable opportunity to shape its approach to DLT and cryptoassets in a way that supports the competitiveness of the UK in FinTech and financial services globally.

Cryptoassets have many cross-border applications which in turn require alignment on core regulatory approaches with other leading jurisdictions to ensure cross-border interoperability, legal clarity, and certainty, while minimising risk.

Raising consumer awareness of the risks associated with cryptoassets will be an important part of ensuring consumer protection.

Failure to recognise differences across specific use cases and the risks and issues they raise may create legal uncertainty, disproportionate regulation, and the potential for regulatory arbitrage.

Therefore, our policy recommendations are:

The UK should act quickly to set high standards in cryptoasset and DLT regulation, while recognising that not all uses of DLT need to be regulated.

The specific features and risks associated with novel technologies and use cases should not be overlooked.

Industry engagement should be maintained, as it is crucial to achieve a proportionate and risk-based approach.

Legislators and regulators should recognise the transformative potential of stablecoins and Central Bank Digital Currencies (CBDCs).

A detailed analysis of these policy recommendations can be found in the chapter titled 'A suggested approach to policy development' on page 15.

Glossary

There are several terms that often appear when discussing DLT and cryptoassets. While there are no universally recognised definitions and the terms are often used in different ways, below are some general definitions which will be helpful when reading this report.

- **Distributed ledger technology (DLT):** a set of technologies used to maintain a common ledger on a distributed basis. Blockchain, for example, is a type of DLT.
- **Cryptoassets or tokens:** digital representations of rights and/or value that make use of cryptographic technology to identify ownership and control. These can be transferred, stored or traded electronically and typically use DLT.
- **Cryptocurrency:** a subset of cryptoassets. This often refers to cryptoassets that may be used as a means of payment. In its broadest sense, the term could incorporate everything from Bitcoin or Ether, to stablecoins and CBDCs. However, central banks typically seek to distinguish CBDCs from currencies not issued or administered by any central bank or authority.
- **Defi or 'decentralised finance':** decentralised finance refers to financial services provided through a distributed platform that typically uses smart contracts. DLT-based finance does not usually rely on financial intermediaries and traditional players to offer financial instruments.
- **Smart contracts:** computer programs often run on DLT that automatically execute actions. They may or may not amount to a legal contract.

Proposed changes to the regulation of cryptoassets and stablecoins in the UK

In January 2021, HM Treasury published a consultation on its proposed regulatory approach to cryptoassets and stablecoins[3].

The consultation set out a gradual approach to the further regulation of cryptoassets in the UK, proposing initially to focus on extending the regulatory perimeter to stablecoins, with a specific new regime designed to be technology neutral. Such a regime would focus on asset-backed stablecoins, but would exclude algorithmic stablecoins from the regulatory perimeter.

In its response to the HM Treasury consultation, we identified some concerns with the current proposal, including:

- the need for clarification around the potential overlap, or underlap, of new rules with existing regulatory regimes
- the importance of proportionate and risk-based regulation to ensure that all possible stablecoin use cases are not hampered by regulation tailored to systemically important stablecoins designed for use in consumer payments
- that a staged approach to regulation, which does not propose including all stablecoins or cryptoassets within the scope of the regulatory perimeter, may lead to confusion and the potential for regulatory arbitrage.

We urged the government to take into consideration the following principles when designing the future regulatory framework:

- foster an innovation-friendly ecosystem by having a principles-based, outcome-focused approach to regulation, so that existing regulatory solutions and frameworks can be adapted quickly, if required and appropriate
- technology neutrality requires that rules apply irrespective of the technology underpinning the activity, however it is equally important to provide clear definitions and scope to ensure that no technology format is singled out, thereby enabling new risks to be identified and mitigated
- extension of the regulatory perimeter should be based on granular characteristics and taxonomies of relevant cryptoassets or 'tokens' and the identification of unregulated risks, which requires clear legal definitions.

[3] UK regulatory approach to cryptoassets and stablecoins: consultation and call for evidence – GOV.UK (www.gov.uk)

Token taxonomies

To understand how to regulate cryptoassets or tokens, consideration must be given to their characteristics and the general principles that underpin them.

General principles

Tokens are designed to do different things and work in different ways, including the rights they provide holders and their economic uses and impacts. As a result, they do not always fit neatly within the parameters of existing regulatory regimes.

In the UK, regulators have broadly split tokens into the following categories[4]:

Type of token	Description of token	Regulatory status
Exchange tokens	Often called 'cryptocurrencies', these are like traditional fiat currency in that they are intended to be used as a means of payment or exchange. However, they are not issued or backed by a central authority, and in more recent times have been a more speculative investment.	Unregulated under financial services regulation[5]
Utility tokens	Grant holders access to a service or product. The rights they confer are often like those held under pre-payment vouchers.	Unregulated under financial services regulation[6]
Security tokens	Have characteristics like those of traditional investments (e.g. shares or debt instruments) and bring with them similar rights and obligations.	Regulated under financial services regulation

While unregulated under financial services regulations, certain activities provided in respect of exchange and utilities tokens that qualify as cryptoassets under anti-money laundering (AML) regulations may trigger registration requirements and ongoing anti-money laundering obligations for registered cryptoasset service providers.

E-money tokens

An additional category of payment instrument, which may be considered a type of token where DLT is used, is e-money[7]. An e-money token is essentially a representation of a unit of fiat currency in digital format. It can be redeemed at par value, at any time, and gives holders a claim on the issuer who is required to safeguard the fiat currency it has received – i.e. if an issuer issues £1,000 worth of e-money, it must hold £1,000 in a segregated bank account. E-money is considered in more detail below.

[4] This is a practical breakdown consistent with regulatory analysis.
[5] Under the AML Regulations the FCA registers certain cryptoasset services providers which could include exchange and utility tokens. Please refer to https://www.fca.org.uk/firms/financial-crime/cryptoassets-aml-ctf-regime. Also see proposal to expand UK financial promotions framework.
[6] See previous footnote.
[7] E-money is a form of payment instrument regulated under the Electronic Money Regulations 2011.

Stablecoins

Stablecoins (or stable tokens as defined by HM Treasury) are privately issued cryptoassets designed to have minimal price volatility. This is typically achieved by either linking their value to a stable underlying currency or asset (or basket thereof), or by using an algorithmic price stability mechanism.

Today, cryptocurrency traders typically use stablecoins as an alternative to basic fiat payment services. They are also a more stable store of value than volatile cryptocurrencies like Bitcoin and Ethereum. However, their features could lead to benefits in both wholesale and retail contexts. Many of the regulatory and policy concerns raised in relation to stablecoins relate to their potential to be adopted on a widespread basis, particularly by consumers. They could make cross-border payments faster, cheaper, and more inclusive than current arrangements.

Category	Centralised asset-backed stablecoin	Decentralised asset-backed stablecoin	Algorithmic stablecoin
Centralised or decentralised?	Centralised (central entity responsible for issuing and burning tokens)	Decentralised (no central entity for issuing or burning tokens)	Centralised or decentralised
Stabilisation mechanisms and asset backing	Value linked to assets (fiat currencies, commodities etc.) backing the stablecoins. Backing may not be 1:1	Value linked to assets (fiat currencies, cryptocurrencies, commodities etc.) backing the stablecoins. Given no central issuer, collateral may be tied up in smart contract	No asset-backed stability mechanism. Algorithm controls supply of tokens according to value rising or dropping above or below set thresholds (i.e. there is increase or decrease in stablecoin supply according to changes in demand, as with monetary policy)
Wholesale and retail users			
Regulated?	Currently not subject to financial services regulation but if a particular stablecoin meets the e-money definition, companies need to avoid triggering related activities under the e-money regime. Also subject to HM Treasury proposals for regulation of stablecoins	Currently not subject to financial services regulation but subject to HM Treasury proposals for regulation of stablecoins	Currently not subject to financial services regulation and outside of the existing scope of HM Treasury proposals for regulation of stablecoins

Stablecoins are not homogenous. They vary in structure, function, and regulatory treatment. While some stablecoins may currently be issued as e-money, others may have features like securities or might not currently be regulated under UK financial services regulation. Different types of stablecoins also present different benefits and risks depending on their structure and purpose. For example, a fiat currency-backed stablecoin used only by large financial institutions to improve the efficiency of cross-border payments has a very different risk profile than an algorithmically stabilised stablecoin that could be used by consumers to pay for goods and services.

The above taxonomy sets out one way in which different types of stablecoins may be categorised. However, this does not neatly correspond to the current regulatory treatment of stablecoins, and it remains a challenge for policymakers to develop a regime which fits the existing regulatory framework together with the different categories of stablecoins that emerge.

Use cases

The stablecoin market is at an early stage of development, with use cases still developing. It is likely we will see greater adoption of stablecoins for a wide range of wholesale and retail payments purposes in the coming years. To support this, it is important that policymakers strike an appropriate balance with regulation that reflects differing risk profiles across different use cases.

In this section, we explore two potential uses of stablecoins, to help illustrate the need for a flexible approach to regulating stablecoins.

Retail payments

Businesses accepting cryptocurrencies like Bitcoin as a medium of exchange take on significant volatility risk, which is one reason why we do not yet see cryptocurrencies widely used in a retail context outside certain activities. By maintaining a stable value, stablecoins may offer a solution for day-to-day payments between individuals and businesses, both domestically and internationally, where they could offer cheaper, easier, and faster payments for consumers and merchants.

Policymakers to date have particularly been focused on the Diem (formerly Libra) stablecoin proposal backed by Facebook and other brands. They have noted concerns around the potential for rapid scaling due to the large customer base of backers, existing links to retail platforms, and high volume of payments, posing potential risks to competition, financial stability, and monetary policy, among others. Examples of stablecoins used in this context are Terra and Tether.

Interbank settlement of payment obligations

In the wholesale market, fiat-denominated stablecoins seek to replace existing settlement processes for interbank and cross-border payments, cross-currency settlements, and security transactions. Financial institutions could use stablecoins to facilitate the instantaneous transfer of payments between institutional accounts, reducing the limitations of current wire payment systems by making interbank transactions faster, cheaper, and more readily and widely available.

A challenge for financial institutions to date in developing and adopting such products has been working within the limitations and uncertainty of existing regulatory frameworks. Interoperability and differing regulatory standards internationally are also key challenges. Examples of stablecoins used in this context are the JPM Coin and Fnality.

Jurisdictional issues

The cross-border nature of cryptoassets, including stablecoins, raises several questions about jurisdiction and location, such as whether regulations should apply to cross-border activity and how to determine the relevant governing law and jurisdiction. A key consideration for UK policymakers is whether and how market participants who deal with UK customers but are based outside the UK should be regulated by the UK regulators (if at all).

To address this without introducing stringent regulatory requirements, which would likely stifle business and competition in the UK and create barriers for UK consumers' access to innovative products, an approach analogous to the existing overseas persons exclusion[8] could be introduced. This regime enables the sale of specified investments to sophisticated investors, and to other investors if the transaction is intermediated by a locally licensed firm. As these concepts already exist and work successfully, a similar, adapted provision could be a good starting point for the regulation of stablecoins where certain relevant participants are located outside the UK.

[8] Article 72 of the Financial Services and Markets Act (Regulated Activities) Order 2001

Case study on stablecoins[9]

A stable token is valued by reference to a fiat currency, for example, the pound sterling. It is widely used by customers in the UK and all relevant market participants are based in the UK.

What issues arise when elements of this scenario are varied?

Token linked to a volatile currency/asset instead of the pound sterling	Market participant (e.g. issuer) is based outside the UK	Token is used both as a means of payment and as a speculative investment	Stablecoin issuer previously issued e-money, but decided that it would prefer to be an issuer of stablecoins	Unregulated exchange token is used far more widely as a means of payment than the stablecoin	Stablecoin is not used widely as a means of payment, but is used for a small number of payments
Will all tokens referencing an asset be within the regulatory perimeter, even if they reference a volatile asset? Will any exemptions or thresholds apply, how will one-off events be dealt with and how will this be monitored?	Regulating participants who are based outside of the UK raises a number of challenges for UK regulators. How should overseas activity be categorised? How do you balance competing objectives (consumer protection/ financial stability vs competition)?	If a stable token has characteristics of both exchange (unregulated) tokens and (regulated) stablecoins, such that the stablecoin is also able to be used for speculative investments will the token be regulated?	It is possible that issuers will no longer want to issue e-money (given the safeguarding / segregation requirements that apply to e-money). This could mean that e-money is phased out.	It is possible in this fast moving market that unregulated exchange tokens are the tokens that are used widely as a means of payment, rather than stablecoins. Given the scope of the proposals, how would this issue be addressed?	Will thresholds be introduced so that smaller, or more limited, stablecoins are not within scope of the regulatory regime? Capturing all stablecoins may stifle competition and could lead to a situation in which an unregulated exchange token is used far more widely than a small stablecoin.

A possible solution to this could be modelled after the existing overseas person regime under Regulated Activities Order (RAO); see page 10.

[9] Please note with reference to 'unregulated exchange token' within this table, whilst unregulated from a financial services perspective, they may qualify as cryptoassets under the AML regime. Please refer to footnote 5 on page 7.

CBDCs

A CBDC is a digital form of money representing a direct claim on the central bank, denominated in a single fiat currency. Central banks globally, including the Bank of England, are studying CBDCs, either as a complement or substitute to existing forms of central bank money, e.g., physical cash or central bank reserve/settlement accounts held by large banks. In some markets (for example, China and Sweden) pilots are underway.

CBDCs will likely feature many different designs. Choices will be up to specific jurisdictions and will reflect local policy drivers, which include innovation, inclusion, or an alternative to private cryptocurrencies. For instance, CBDCs could be issued for retail or wholesale purposes, and may or may not pay interest. The underlying digital architecture may, but will not necessarily be based on cryptographic technology and DLT, enabling innovative channels for distribution and use.

Regulators will need to consider several issues, including the regulatory treatment of domestic and foreign CBDCs, interoperability with other forms of public and private money, and crucially, the potential impact that the issuance of new digital central bank liabilities will have on the existing banking system.

Non-fungible tokens

A non-fungible token (NFT) is a unique cryptoasset that represents rights to an underlying 'tokenised', typically digital asset which is created and transferred using DLT giving security of ownership. This contrasts with many existing cryptoassets, including cryptocurrencies like Bitcoin, which are fungible or interchangeable.

NFTs are not new, but they have had significant press attention recently, with some high-profile artwork sales raising millions of dollars. To date, they have mostly been used in the arts, sport, and gaming sectors, including digital art, music albums, moments of sporting history and recently a tweet was sold as an NFT. The technology has a broad application, and we are likely to see growth across different sectors, as it enables the commercialisation of assets that are otherwise difficult to sell.

NFTs may reduce the need for intermediaries between issuers and purchasers compared to traditional investment products, whether that is an investment broker, a platform provider, or a bank. As the market develops, it is likely that firms will begin to offer specialist intermediary services which will necessitate consideration of potential regulatory risks.

While NFTs are not specifically regulated in the UK, certain existing regulations may apply to a particular NFT depending on its structure, features and how it is marketed.

Regulatory approach

There is a broad consensus that cryptoassets have the potential to enable positive social and economic change by offering a new store of value, an alternative method of payment, and another way to access or deliver capital and financial services. The advent of cryptoassets has already led to the creation of new global, decentralised networks that are supporting billions of dollars of value in transfers. This in turn is enabling the emergence of whole ecosystems that are responding to increasing consumer demand for new products and services linked to cryptoassets.

Kalifa Review

As highlighted in the recently published Kalifa Review[10], the UK has the potential to build on organic developments to date and be a leading global centre for the issuance, clearing, settlement, trading and exchange of crypto and digital assets. An ambitious, innovation-driven approach to regulating cryptoassets that protects customers and creates a safe ecosystem can contribute to and help achieve this goal.

We welcome the Government's response to the Kalifa Review, which includes plans for a broader public-private engagement on CBDCs, and a new financial market infrastructure sandbox for firms. These initiatives are also supported by the Bank of England's recent announcement that it will introduce 'omnibus accounts' enabling a wider range of payment systems, including those utilising DLT, to interface with its real-time gross settlement (RTGS) system. Together they show real evidence of a genuine commitment to action.

The UK has already taken important steps towards the regulation of cryptoassets. Since January 2020, businesses carrying out cryptoasset activity in the UK need to be compliant with the Money Laundering, Terrorist Financing and Transfer of Funds Regulations 2017, including the requirement to be registered with the Financial Conduct Authority (FCA). HM Treasury has recently consulted on bringing a broader subset of cryptoassets within the FCA's financial promotions regime and as outlined above, concluded a second public engagement on the UK's regulatory approach to cryptoassets and stablecoins.

International regulatory frameworks

Regulators around the globe are similarly in the process of adopting or assessing how to regulate cryptoassets. Some jurisdictions are developing new regulatory frameworks, for example the broad cryptoassets legislative package ('MiCA') being negotiated in the EU, while others are focusing on clarifying how existing frameworks can apply to cryptoassets, particularly where these qualify as financial instruments. There is a need for structured international dialogue and co-ordination, particularly around (i) a common taxonomy for the categorisation of cryptoassets and associated activities; and (ii) a consolidation of efforts globally. The Final Report of the Cryptoassets Taskforce recommends that UK authorities continue to engage internationally through the G20, G7, Financial Task Action Force (FATF), Financial Stability Board (FSB), International Organisation of Securities Commissions (IOSCO), Basel Committee of Banking Standards (BCBS), EU, Organisation for Economic Co-Operation and Development (OECD) and bilaterally. This will be helpful to achieve both coordinated approaches to supervising cross-border activity and alignment on core regulatory principles.

[10] The Kalifa Review of UK FinTech - GOV.UK (www.gov.uk)

UK approach – global opportunities

Starting with its G7 presidency this year, the UK has a unique opportunity to build consensus around what needs to be done to avoid fragmentation of approaches when integrating international guidance, such as the standards being developed by the Financial Stability Board (FSB), into domestic policy and rulemaking activity.

The UK can use its new trade policy as a vehicle for more robust coordination and dialogue on digital initiatives with like-minded jurisdictions. For example, the Swiss legislative approach to fully enable ledger-based securities.

The UK can also continue to use its leadership role of the Global Financial Innovation Network (GFIN) to encourage the testing of innovative DLT-based products, services, or business models across different jurisdictions. Beyond specific regulatory considerations, there are also good opportunities for international collaboration linked to the innovation aspect of cryptoassets and DLT-based initiatives.

One of the most promising use cases for cryptoassets as a means for payment is their potential for solving cross-border constrictions. It is imperative that the UK continues to engage in wider discussions around areas such as conflicts of laws points for DLT being considered by UNCITRAL and The Hague Convention, as well as the consideration of practical applications within the regulatory community taking place in the Bank for International Settlements' Innovation Hubs.

Key regulatory issues

Some of the key issues to consider when regulating cryptoassets are set out below.

Consumer protection

Some, but not all, cryptoassets are both available to consumers and are potentially volatile in nature, and therefore are more likely to expose consumers to possible financial losses. It is appropriate that firms marketing cryptoassets to consumers are authorised and accountable, which HM Treasury has rightly proposed through an expanded UK financial promotions framework.

Transparency on the part of issuers and other service providers is critical to protect consumers, including transparency around cryptoasset holders' legal rights and recourse, the risks they face, and any fees or conditions associated with their activity. It is important to note that not all cryptoassets are intended for consumers, and sophisticated market participants should be regarded as able to manage risks related to cryptocurrencies (as they do traditional assets).

Legal and regulatory certainty

Regulatory developments impacting cryptoassets are in progress globally, and a clear and focused regulatory approach will help to position the UK in a globally competitive position. Clarity on the regulation of cryptoassets and related services such as issuance, trading and safekeeping will determine firms' appetites to use the UK to launch innovative products and services. The proposals set out in HM Treasury's consultation paper to regulate stablecoins will provide some clarity for a subset of products, but there will remain a level of uncertainty given many cryptoassets are not in scope of either the proposals or existing UK regulation, and it is not clear whether other forms of cryptoassets will be brought into scope of some or all regulation in the future.

Use and regulation of new technology

The use of DLT and cryptographic technology alone does not generally determine whether a cryptoasset is regulated or the risk it presents. Some cryptoassets share the legal and economic characteristics of traditional assets such as securities or electronic money and are therefore in scope of existing regulations, despite their use of novel technology, including DLT. Other cryptoassets may raise risks that require new or enhanced regulation, such as the consumer and financial stability risks posed by global stablecoins.

Competition and choice

Some cryptoassets may improve the consumer experience for core financial services, including payments. Both incumbent financial service firms and new entrants are looking to provide innovative services and unlock efficiencies using cryptoassets.

A regulatory framework that treats all firms undertaking the same activities the same way will ensure consumers have access to safe and transparent products and services, no matter the provider. It is important that this framework is proportionate, including the use of exemptions and thresholds where appropriate to ensure that innovation is not stifled. The specific risks related to large-scale stablecoins for consumer payments can be dealt with through supplementary provisions and regulatory enhancements, as HM Treasury has proposed in its consultation.

Cross-border alignment

To support UK competitiveness, a regulatory environment that supports innovation at both a domestic and cross-border level is absolutely key, as many promising cryptoassets use cases are cross-border in nature.

A basic level of regulatory alignment across markets is needed so that firms can meet high regulatory standards without facing conflicts of law, or uncertainty regarding the legal treatment of their assets.

Alignment on policy goals and outcomes also minimises opportunities for regulatory arbitrage, which helps to protect consumers and maintain financial stability.

A suggested approach to policy development

The UK has a valuable opportunity to respond to the emergence of DLT and cryptoassets in a way that supports its competitiveness, and places it at the forefront of the next generation of technological developments that will be applied to finance.

Below, are five key considerations for policymakers.

1. The UK must act quickly to set a gold standard in crypto assets and DLT regulation

Many jurisdictions have recognised the opportunities presented by cryptoassets and related technologies, such as DLT. Several (notably in Asia and Europe) are seeking to take a leading role in regulating the industry with a view to attracting global investment and influencing international approaches. There are some market perceptions that the UK is beginning to trail by comparison.

There are, of course, risks in acting too quickly. There are many complex issues with which to grapple and some proposals in other jurisdictions have been criticised as overreaching, heavy-handed, conflicting, incomplete and/or unclear. While the UK should be considered in its response, it should act as quickly as possible if it is to remain at the forefront of innovation while also providing certainty and addressing any new, unregulated risks.

Rather than merely following the same approach as other jurisdictions, the UK should seek to set a gold standard. This could be done in collaboration with like-minded jurisdictions, ideally with a view to achieving some degree of mutual recognition of regulatory standards to enable cross-border interoperability.

2. Specific features of novel technologies and use cases should not be overlooked

It is important to address the specific features of novel technologies and identified use cases in order to provide clarity as to what is and is not regulated and to also set the perimeter and related definitions appropriately, as innovation will be stifled if the regulatory perimeter is unclear. This is relevant in relation to clarifying the application of existing regulation as well as in developing new regimes. When faced with regulating a rapidly evolving industry, it is important for policymakers to allow flexibility to accommodate new developments as they evolve and to ensure regulatory standards remain technology neutral.

Policymakers should also appreciate the inherently cross-border nature of cryptoassets and related business models. As a practical matter, much of the value in DLT arises precisely because the networks are cross-border. While it will be important to protect UK consumers, the UK should not seek to regulate overseas firms or cross-border/global business models in a way that may be difficult to enforce or that is overly burdensome in practice.

3. Not all uses of DLT need to be regulated

It is important that policymakers appreciate the range of ways in which novel technologies such as DLT can be deployed in financial services, together with the benefits and applicable risks in each case. Notably, whereas some deployments can give rise to new forms of financial products and services which may be suitable for regulation, others may provide an alternative delivery mechanism for existing financial products and services or act as a record-keeping system without posing any new risks, and therefore do not warrant any changes in regulatory treatment. Policymakers should seek to recognise these distinctions and provide clarity as to what falls outside the regulatory perimeter and/or is adequately covered by existing frameworks.

4. Industry engagement crucial to achieving a risk-based approach

The UK should seek to develop regulatory frameworks that are genuinely risk-based in order to make them appealing for crypto-related activities to be established in the UK. To achieve this, UK regulators should draw on previous experience in creating world-leading, innovation-friendly regulation and regulatory support structures (such as regulatory sandboxes) while continuing to engage substantively with industry.

This is particularly important in such an innovative and highly complex market. For example, whereas some functionalities share many similarities with traditional arrangements and are capable of being regulated under existing (or similar) regulatory frameworks, others such as novel decentralised finance arrangements may not sit neatly within those frameworks and require a new, tailored approach. Similarly, unlike conventional financial products and services, some cryptoassets and DLT functionalities may be used for a variety of purposes – including both payment and investment purposes – and will require appropriate regulatory solutions that address novel risks without being heavy handed.

5. Transformative potential of stablecoins and CBDCs

Stablecoins and CBDCs are increasingly perceived by many market participants and policymakers as presenting valuable opportunities. Notably, cryptoassets that are structured to provide holders with legally enforceable claims, particularly in relation to state-backed currencies, have the potential to act as a platform for wide-scale payments innovation and broader digital transformations. The UK should seek to capitalise on these opportunities and remain at the forefront of international discussions and collaborations on these topics, given their cross-border nature. Authorities will also need to remain attuned to the challenges and risks associated with any significant reconfiguring of existing currency, payments and banking architectures, including any move to new forms of money and its distribution.

Conclusion

The surge in the use of cryptoassets has highlighted the need for the UK to implement a world-leading risk-based regulatory framework, as well as wider education for consumers and policymakers.

Industry engagement is a critical part of this process, as is consultation. As underlined by the Kalifa Review, the UK must act quickly in order to leverage the valuable potential of this new and exciting technology.

Cryptoassets all have unique characteristics, features and use cases. The optimum regulatory framework will take this into account, being adaptable, flexible, tailored to specific emerging risks, and clearly defined to serve both consumers and industry.

The challenge in devising a regulatory approach to new technologies is finding the appropriate balance between encouraging innovation and providing regulatory clarity, and ensuring that legislation mitigates possible risks raised by the relevant activities.

The UK is at a critical juncture in developing its regulatory approach for cryptoassets. The correct approach will be a huge support in positioning the UK at the forefront of innovation globally.

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