

Cryptoassets and stablecoin consultation

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RE: HMT UK regulatory approach to cryptoassets and stablecoins: Consultation and call for evidence

We are pleased to respond to Her Majesty's Treasury's (HMT) Consultation and Call for Evidence on the UK regulatory approach to cryptoassets and stablecoins.

Given the increased interest in cryptoassets, it is essential to ensure the UK regulatory architecture is fit for purpose to prevent consumer harm as well as to allow innovation to develop safely and securely. Alongside these objectives, there is growing interest in investment cases for our members in some of these types of assets.

With any increase in regulatory responsibility, however, there are associated requirements for the protection mechanisms in place. We request greater clarity on impacts to the FSCS levy if the regulatory perimeter is extended to include stable tokens. We look forward to working with you to address this and ensure a positive outcome for savers and investors.

Yours faithfully



John Allan
Senior Operations Specialist



IA Response to Her Majesty's Treasury Consultation and Call for Evidence

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £8.5trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 43% of this is for overseas customers. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

Certain cryptoassets, particularly Bitcoin, have been high profile in recent times, sparking widespread interest in cryptoassets. In this context, we welcome HMT's forward-looking approach to ensure that there is a full consideration of the risks and opportunities of certain cryptoassets to determine the appropriate regulatory approach for the future. Having more clarity on the categorisation of asset types and the extent of the associated regulatory perimeter is key to mitigating consumer harm and will help support the safe development of cryptoassets, and related products, going forward. Establishing regulatory clarity is key to supporting safe innovation, as well as to enhance the UK's attractiveness as a place to locate and invest.

From an investment perspective our members have, broadly, excluded cryptoassets from the investible universe to date. This has been for a number of reasons but is rooted in their wariness at cryptoassets' early stage of development and uncertain longer-term regulatory position. Many types of cryptoasset have no intrinsic value, and are instead tools for short-term speculation rather than long-term volatility-averse capital growth. However, there are signs that investment cases are developing, particularly following high-profile cases of large returns on investment. We expect to see more firms gaining exposure to cryptoassets, in the short term largely through indirect investment proxies such as the futures market, and through direct investment in the longer term as the regulatory intentions evolve. Indirect investment will also naturally increase as mainstream investee companies become involved in cryptoassets and investors will obtain an interest in cryptoassets through their ownership of seemingly-unrelated stocks. To this point, the environmental concerns with some types of asset will remain a concern.

On the proposals to extend the perimeter, however, we would welcome early clarity on the impacts of including the new stable token regulated category on the FSCS levy for our sector. While having a robust compensation scheme of last resort provides retail consumers with a welcome safety net, the current scheme is no longer fulfilling its purpose. Cost-benefit analysis of any changes to the regulatory perimeter should include the impact on the FSCS levy. The FSCS recently announced a forecast compensation scheme levy of over a £1bn and by any measure this is disturbing. Customers should get appropriate products for their needs and risk appetite and we have called for a review of the scope of the levy both in terms of products and territoriality. The investment management industry has seen a rapid increase in its contribution



to the FSCS levy despite its risk profile remaining unchanged, and as such, we would argue that the FSCS levy is already not achieving the 'polluter pays' principle and its scope should not be extended further. The IA will continue to work with the FCA, FSCS and HMT to reduce the size of the levy, which is required regardless of any new regulatory scope. In any event, we would not expect to see an increase in the levy to our class for the increased regulatory scope outlined in your consultation.

We support a tech-neutral approach to regulation, which is applied proportionately and where the activity conducted is regulated according to its risk profile. We do not hold a strong view on whether stable tokens in particular should be included in the regulatory perimeter. However, their similarity to other asset types and their intrinsic value does lend itself to comparison with other regulated assets. Taking a phased approach towards determining the future of regulation for cryptoassets is welcome as it allows for due consideration of the risks and opportunities involved, as well as learning from past cases. However, given the rapidly evolving nature of forms of cryptoassets that have a tendency to change characteristics easily, it may be difficult to keep pace with the rate of change and regulate accordingly. Accordingly, the categorisation of cryptoassets and accompanying regulatory definitions need to be easily understood by all stakeholders including individual investors, and aligned to other jurisdictions.

Likewise, we are already seeing lots of international regulatory attention on cryptoassets and it will remain important to drive alignment to prevent unnecessary barriers across jurisdictions. Given the decentralised nature of these assets, the fact that they are not confined to one exchange and so are located globally and tradeable around the clock, harmonisation across jurisdictions is crucial. It would pose serious complications if both the categorisation and treatment of cryptoassets varied across jurisdictions, particularly as the investment supply chain is likely to include third parties in other jurisdictions such as the US. It would be helpful, given the global nature of these assets, that common definitions and terminology are set by regulators so that there is a common understanding.

We also take this opportunity to respond to your call for evidence on investment and wholesale uses. We have seen an increase in interest from members on tokenised investment funds, which have significant potential to become a reality within the UK market in the medium term. There are a number of potential benefits to their adoption and we are currently supporting members to look at how they can be used to provide a superior experience for investors. We advocate for a review of the OEIC Regulations and the FCA COLL rulebook to ensure the regulatory framework is appropriate for these types of investment fund.

Additionally, it is critical that international standards are utilised to aid interoperability and to provide transparency for market participants and authorities. ISO and the BSI have active workstreams in these areas and we hope that these will be encouraged to develop for wider benefit.



Response to Consultation

General comments

We will make some general comments on the proposals before turning attention to some specific questions of relevance to our sector.

In general, we are supportive of HMT's objective to ensure the UK's regulatory framework is fit for the future and is suitably equipped to harness the benefits of new technologies, supporting innovation and competition, while mitigating risks to consumers and market stability.

As we articulated in our response to HMT's consultation on the Future Regulatory Framework Review¹, we support the Government setting the regulatory framework and parameters to achieve its objectives, and the regulators being responsible for creating the rules that apply to firms in a proportionate manner.

We broadly agree with HMT's proposed objectives and are supportive of a risk-based, proportionate approach to regulation, as well as a commitment to working with other jurisdictions to build a harmonised regulatory environment. Having a principle led approach will help provide the guidelines by which providers and users can operate under without being unnecessarily prescriptive. Likewise, we support the principle of 'same risk, same regulatory outcome'.

From an investment perspective our members have, broadly, excluded cryptoassets from the investible universe to date. Part of this is because some cryptoassets are specifically excluded from the list of permitted investments for UCITS, and so their utility is reduced for firms mainly offering these products. There is also wariness at their early stage of development and sometimes unclear infrastructure or ownership behind them. More significant is the acknowledgement that many types of cryptoasset have no intrinsic value, and are instead tools for short-term speculation rather than long-term volatility-averse capital growth. High-profile failures and, indeed, scams have meant that client demand for mainstream products with exposure to cryptoassets has been limited, which is reflected in the FCA's research that there is widespread recognition by the UK public that these are unregulated and contain more than an element of risk².

More recently, driven in part by Bitcoin's continued high-profile valuation increase, there has been more interest in seeking exposure to some cryptoassets. Some custodian and other investment support functions have developed the capability for handling cryptoassets and so the practical and operational barriers for entry are being removed. Increased certainty on the regulatory intentions across the broad suite of cryptoasset categories will bring some additional confidence. A very small number of products or funds already provided by our members do have an investment interest in cryptoassets, although this tends to be via an exposure by proxy, such as futures or other derivatives, or investment in other investment products with an exposure, rather than a direct ownership. However, it is likely, particularly where investible companies' wider operations become involved in cryptoassets, such as Tesla and others, that some exposure to cryptoassets will become mainstream simply by owning a traditional company stock.

This does, however, raise questions and potential concerns over the ethical and environmental impacts of investments in such assets. Whilst many cryptoassets offer the ability to lower costs

¹ IA: [Response to HMT Future Regulatory Framework Review](#) 2021

² FCA: [Cryptoasset consumer research 2020](#) 2020



and drive access to finance and other social advantages, there are many negative ESG factors. In most cases, the mining of some cryptocurrencies is extremely energy intensive and generates huge amounts of carbon emissions. For instance, the Digiconomist's Bitcoin Energy Consumption Index has revealed that the entire Bitcoin network's energy consumption exceeds that of a number of countries and that its mining facilities rely heavily on coal-based power³. Even the social advantages can be overstated if there is a heightened risk of fraud and criminal activity associated with the use of cryptoassets. The current focus of the investment industry in ESG matters, as responsible investors, may reduce the attractiveness of both direct and indirect investment in such assets.

We expect that, subject to regulatory oversight, there will be a case for direct investment in types of cryptoasset in the near future. As you have identified, there is a growing category of stable asset, which have a more compelling investment case given they are backed by, or in some cases are solely a basket of underlying traditional assets, in a not dissimilar way to an ETF. Your intention to introduce a new category of regulated tokens, stable tokens, is understandable.

However, we would like to gain clarity on the implications of an extension to the regulatory perimeter, at this and future stages. In particular, we would like to ensure that there is no intended increase in the FSCS levy for our sector to accommodate any potential failures caused by stable token providers. The FSCS levy has risen dramatically and so has the proportion that the investment management industry pays. The current system does not support the concept of 'polluter pays' and effectively makes our members responsible for covering the costs of businesses over which they have no control. The investment management industry has seen a rapid increase in the FSCS levy despite its risk profile remaining unchanged. An analysis of the data (pre-pandemic) shows that as a percentage of the overall levy our levy class' contribution has increased from 3.1% (2017/18) to an indicative 31.5% (2020/21) which is currently capped and therefore we are no longer contributing to the Intermediation class. While fully supporting the need for consumer protection, there are concerns that public confidence is impacted each time there is an occurrence of widely publicised mis-selling which results in the failure of firms and increased compensation. We would not expect to see an increase in the levy to our class for the increased regulatory scope outlined in the consultation.

Answers to selected questions

1. Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

It is certainly important to have a common taxonomy across UK authorities, as well as internationally, to avoid confusion or ambiguity that may prevent the effective translation of the rules into practice. Accordingly, continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed seems a sensible approach. We think that regulators should avoid taking too granular an approach when defining stable tokens, and other assets, given the evolving nature of the technology and its use cases. However, this should not detract from the fact that clarity of definitions remains important. Additionally, we would also urge international cohesion in this area to ensure consistent definitions. Given that these assets are not bound by native trading venues and overcome jurisdictional regulatory frameworks, it is important that common definitions and terminology are set by regulators so that there is a common understanding

³ Digiconomist: [Bitcoin Energy Consumption Index](#) 2021



internationally. We would advocate work with IOSCO at an international level, and with equivalent domestic regulators elsewhere, to ensure broad cohesion of understanding.

5. What are your views on the extent to which the UK's approach should align to those in other jurisdictions?

It remains important to align with other jurisdictions to prevent unnecessary barriers to healthy innovation, to ensure the similar standards around consumer protection and to encourage competition. As noted by the FSB in their report on Regulation, Supervision and Oversight of 'Global Stablecoin' Arrangements, stablecoins can pose additional challenges to effective regulation by the very ease with which these can be transferred across jurisdictions. However, such challenges can be overcome with attempts towards international alignment on this issue. There has been a wealth of international interest in creating a regulatory framework to support the safe development of cryptoassets and stablecoins, although with varied approaches. Notably, many of these approaches have been governed by a tech-neutral objective as in Switzerland and in Lichtenstein. We also welcome HMT's emphasis on monitoring the European Commission's proposed Regulation on Markets in Cryptoassets (MiCA).

International cohesion regarding the regulation of cryptoassets, as we have already stated, remains significant. Unlike traditional assets, cryptoassets are not bound to physical jurisdictions and operate with global supply chains. As such if jurisdictions have different regulations or even different definitions, this would have a serious impact on the trading of these types of digital assets.

7. Do you have views on the proposed initial scope of UK cryptoasset regulation as summarised above?

With regard to the proposed new regulated category of 'stable tokens', we broadly agree that the 'stable' nature of these tokens makes them similar to traditional assets, and as a proxy for exposure to these assets directly, there is an argument for them to be regulated. We are supportive of HMT's technology agnostic approach, where the focus is on regulating the activity rather than whether it relies on distributed ledger technology (DLT) or not. This is sensible given the technology's rapidly evolving nature and also the different forms stable tokens may take in the future. However, we would not expect to see an increase in the FSCS levy to our class for the increased regulatory scope outlined in the consultation.

9. Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

We are supportive of the approach to regulate the activities associated with processing and transacting with stable tokens that are similar to existing regulated financial activities, but are tailored to the specific requirements of stable tokens. The principle of same activity or risk, same regulatory approach and outcome is suitable here. Likewise, the list of activities to be considered in scope of regulation are largely consistent with those recommended by the FSB⁴, and we are supportive of international alignment in this area. We agree that the government should primarily use existing payments regulations as the basis of the requirements and adapt accordingly to accommodate a new stable token regime to reflect the activity risk profile.

⁴ FSB: [Regulation, Supervision and Oversight of "Global Stablecoin" Arrangements: Final Report and High-Level Recommendations](#) p30 2020



It will remain important to ensure appropriate risk management and AML/KYC requirements for stable tokens, utilising the electronic records available. This will help drive alignment across the supply chain given the efforts required to conduct due diligence and security assessment on third parties involved. It should be noted that for decentralised cryptoassets, it can be difficult to introduce effective AML/KYC given there can be unclear ownership.

Our response to *Call for evidence on investment and wholesale uses* follows on subsequent pages.



Call for evidence on investment and wholesale uses

Answers to selected questions

20. What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

DLT can be used as the underlying technology to support the trading and settlement of investment funds by tokenising them. Tokenised funds are investment funds where the share or unit is represented by a token, and the fund is bought, sold and maintained on a DLT network. Although there are no such funds currently, we foresee that they will develop in the medium term and we expect that these will fall within the scope of the existing 'security token' regulatory category. The IA has been helping support our members as interest grows in tokenised funds and particularly how they can be used to provide a superior experience for investors, for example through a shorter settlement cycle, or greater transparency or speedier dissemination of fund information. The efficiency gains are clear with the removal of duplicative reconciliations of a centralised register, and the automation of processes which in turn can result in faster, cheaper and frictionless transactions which are automated and driven by disintermediation.

DLT offers identical data sets to be shared across various parties in a transparent, immutable and real-time basis which both guarantees the integrity of data across participants and reduces the need for duplicative record-keeping and reconciliation across entities. The immutable nature of DLT records can help safeguard the protection of personal data.

By using a tokenised fund model there is potential for compliance, regulation and governance to be embedded into the token itself, or the underlying protocol to the asset. This has the benefit of streamlining typically lengthy and complex KYC and AML processes and aid fund managers and brokers in their compliance with their legal and regulatory obligations and ultimately improve the consumer experience. Additionally, these types of funds can benefit from the use of smart contracts, which could be programmed to automatically notify regulators when regulatory restrictions are breached.

The speed of settlement offers another potential advantage. Depending on the underlying assets contained within the fund, it is possible for a tokenised fund to facilitate T+0 settlement for both subscribing and redeeming investors. Current fund logistics are wedded to a, typically, T+3 settlement cycle. A tokenised fund with a suitable liquidity profile may be able to provide investors with near immediate market exposure on the way in and speedier access to their proceeds on the way out.

Tokenisation also allows for fractional ownership and the funding of relatively illiquid assets. Secondary markets may develop in such funds which can provide greater liquidity, perhaps in funds that invest in fairly illiquid underlying assets such as Long-Term Asset Funds. Additionally, DLT may enable larger investors with the technical capability to invest with less friction and cost, and over time this may develop further making investment smoother and more accessible. Beyond this, market trading for such assets, once tokenised, is vital for liquidity while it also assists in price discovery and promotes further capital formation. The potential indirect benefit of improved liquidity in asset classes could be an increased flow of investment into previously inaccessible funds.

As such, there is great potential for tokenised funds to drive benefits for both firms and the end-investor through greater efficiency and enhanced trust.



21. What are the potential drawbacks of DLT for wholesale markets and FMIs?

Whilst DLT has the potential to bring many benefits, particularly by facilitating tokenised funds, certain challenges remain. Tokenisation is often linked to a high risk of fraud and fraudulent transactions, limited traceability of transactions, and inconsistency of AML and KYC procedures. However, such issues can be averted by integrating compliance with AML and KYC into each token from the design stage. Likewise, cross-border regulatory issues also remain; given the global nature of DLT there may be competing regulatory directives to consider in various jurisdictions. The use of decentralised DLT raised additional questions surrounding liability and accountability of those in the chain.

Operational and cyber resilience of course remains a key consideration in the development of a secure technological landscape. Cyber risks prevail with the use of DLT and as such appropriate technology governance arrangements and an understanding of the potential vulnerabilities such as from inadequate key management will remain important. As with other technologies the risk of cyber hacks and data security breaches should be considered and ensuring the security of investor's private keys will need to be a critical focus.

To realise the benefits of DLT will require a mindset change amongst financial institutions and this may also encourage new fund managers to emerge and disrupt. It should also be noted, that whilst tokenised funds may encourage greater accessibility, this may also result in investors making decisions without seeking expert advice and lead to sub-optimal investment outcomes.

22. Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation be optimised for DLT?

At present, there is a lack of regulatory certainty regarding DLT-based products in financial markets or specific legislation or regulation which addresses tokens and smart contracts. Whilst the UK Jurisdiction Taskforce recognises cryptoassets as property and smart contracts as enforceable under English and Welsh law⁵, issues relating to the validity of smart contracts and how they are to be interpreted by courts still persist. It is also uncertain as to whether DLT records of cryptoassets can amount to a 'register' for evidencing, consulting or transferring title to certain types of securities under private law.

The immutable nature of DLT records can help safeguard the protection of personal data. However, uncertainty remains over the compatibility of DLT with existing data protection legislation. As noted by the EU Blockchain Observatory and Forum, whilst data on a blockchain may be encrypted, it can be considered personal data too so long as it relates back to a natural person⁶. The European Parliament's study on this subject⁷ also examined the tension between blockchain and the GDPR. They noted that it can be difficult to establish a data controller and so determine who is accountable but also that these DLT systems can ensure data integrity. Whilst many will implement privacy-by-design systems which should aid compliance with the GDPR, a grey area remains that would benefit from regulatory clarity.

⁵ UK Jurisdiction Taskforce: [Legal statement on cryptoassets and smart contracts](#) 2019

⁶ EU Blockchain Observatory and Forum: [Opposites attract: Reconciling GDPR and blockchain](#) 2018

⁷ European Parliament Research Service: [Blockchain and the General Data Protection Regulation: Can distributed ledgers be squared with European data protection law?](#), 2019



To assist in realising the benefits of tokenised funds, it would be helpful if a taskforce-style group could be created to review and amend the OEIC Regulations and FCA COLL rules given they were written without these different operating models in mind. The decentralised nature of the shareholder register changes the dynamic of the authorised fund manager (AFM)-investor relationship. While at the moment the AFM is in control of the centralised register, a distributed ledger provides community ownership and responsibility; for example, an investor can update their own contact/static data. These changes can occur at network-level and so an investor's accounts with multiple different firms may be affected. The regulations may need to change to reflect this altered relationship.

The nature of the distributed ledger also makes historical changes to records challenging. At the moment, a client can exercise their cancellation rights and have their investment deleted within a cooling-off period as though it did not take place. Similarly if an administrative error occurred with a transaction, it can be amended to show what should have originally happened. Neither of these scenarios will be possible in a distributed ledger and all changes or corrections will have to take effect as at the date of the change. There may be some changes to regulation required in these areas.

Whilst we advocate that it is not the DLT itself that should be regulated, but rather any activities that may happen to use that technology, it is nonetheless useful to understand the capabilities and differences in operating models that make happen with DLT. The IA is willing to convene discussions in this area with the supervisory authorities to ensure that proportionate rules are in place that reflect an evolving technology climate.

23. What are the wider industry incentives or obstacles to the adoption of DLT in wholesale markets and FMIs in the UK?

As we explore above, there are lots of opportunities but also risks to consider. However, removing the uncertainty about the regulatory and/or legal status of cryptoassets and stablecoins going forward will help drive innovation in a secure manner.

25. Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

We believe the use of international standards for the unique and unambiguous identification of digital assets, supported by a normalised set of reference data attributes would both aid interoperability and provide transparency for both market participants and the authorities alike. We would draw attention to work that is currently being undertaken by the International Organisation for Standardisation to establish an ISO standard for digital token identification (DTI), which we anticipate may be published as an international standard later this year. ISO 24165 will be formed of two parts: Part 1⁸ will address the method for registration and assignment, while Part 2⁹ will determine the data elements that will be required for registration.

Moreover, we would suggest that fragmentation of the approaches used to develop distributed ledgers for different markets or specific assets, which in turn would require market participants to connect into each in different ways, will hinder adoption. In this regard, we would draw

⁸ [ISO 24165-1: Digital token identifier \(DTI\) - Registration, assignment and structure - Part 1: Method for registration and assignment](#)

⁹ [ISO 24165-2: Digital token identifier \(DTI\) - Registration, assignment and structure - Part 2: Data elements for registration](#)



attention to the work of ISO Technical Committee 307 (TC307¹⁰), the scope of which is the standardisation of blockchain and distributed ledger technologies. The work of TC307 at international level is being mirrored by BSI in the UK through its committee DLT/1¹¹.

27. Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

It is evident that there are high levels of retail interest in digital assets. A survey¹² of 2,000 UK savers recently showed that whilst there is still much scepticism of cryptocurrencies there is also increasing interest. If the upwards trend in retail interest in digital assets and tokens continues, policy makers will need to stay abreast of these developments.

It will remain important to review the investment landscape frequently to prevent consumer harm, particularly as the cryptoasset landscape is evolving so quickly. For example, were a Central Bank Digital Currency to come into existence, as expected, this would provide the clear impression to the public that cryptoassets are legitimate for retail consumer use, and blur the lines with other assets undermining the research outcomes outlined in your paper. There may need to be an emphasis on increasing consumer education on cryptoassets and their uses, both legitimate and safe, and unregulated and risky. The previous FCA consumer warnings about cryptoasset scams are a good example of the useful interventions that can be made. By equipping consumers with knowledge of the inherently risky and speculative nature of many of these assets and an understanding of what they are investing in, it may help to reduce consumer harm as well as their vulnerability to scams. Moreover, without an understanding of the risk profile of regulated cryptoassets, there is a concern that consumers may be lured into a false sense of security if more volatile cryptoassets were brought within the regulatory perimeter.

Further information

For further information, please contact: [John Allan](#).

¹⁰ [ISO/TC307 - Blockchain and distributed ledger technologies](#)

¹¹ [BSI DLT/1 - Blockchain and Distributed Ledger Technology](#)

¹² Parliament Street: [The Great Cryptocurrency Report](#) March 2021