THE INVESTMENT ASSOCIATION

Response to consultation

HM TREASURY CONSULTATION AND CALL FOR EVIDENCE ON THE FUTURE FINANCIAL SERVICES REGULATORY REGIME FOR CRYPTOASSETS

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 £10 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 46% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Executive summary

Digital assets and their underlying technology have the potential to drive a profound transformation of established financial markets. Our engagement on cryptoassets specifically is from connected but distinct perspectives:

- As an established financial services sector, seeking to ensure there are no detrimental impacts on existing regulation or firms subject to it as a result of new sectors joining the regulatory regime;
- As innovators responsible for applying new technologies to existing activities, seeking to utilise digital tokens and DLT for efficiency or operational reasons;
- As investors and potential future investors in cryptoassets, seeking alternative ways to diversify investment portfolios; and
- As an industry with an important stake in the future international competitiveness of the UK financial services sector, and in the attractiveness of the UK as a place to do business.

An over-riding concern is to ensure that there is a level playing field established across mainstream investment and cryptoassets markets. Although we agree with the phased and risk-prioritised approach towards the implementation of a UK cryptoasset regulatory regime, we are also concerned with ensuring that cryptoasset providers are held to the same standards as mainstream market participants as soon as possible. This is a theme that arises throughout our response. Whether it is in the remit of financial advice and promotions, resilience or sustainability disclosure, there should be no lower set of requirements or cost of entry for cryptoassets providers than other financial services firms, especially where the activity performed is similar or identical to the mainstream.

In particular we seek to emphasise two points:

- **Scope and definitions**. Although we have received some assurances from you separately on the scope of the definition of 'cryptoasset', its currently broad nature is problematic and does require more focused language. Going beyond even the usage of DLT, the proposed wording would capture a range of cryptographically secured digital assets that are clearly not cryptoassets. While providing you with a broad range of areas for intervention this should be narrowed appropriately and our understanding is that you intend to do so.

- **Enabling digital funds**. An immediate priority is to establish tokenised funds in the UK, as many other jurisdictions have already done. Our members have found hurdles to being able to do so in the UK, in that additional cryptoasset requirements apply on top of existing fund regulation, making it an overall more complex undertaking. The principle of avoiding layered regulation is recognised in the consultation paper with respect to commodity-linked tokens, and so we recommend that this principle is extended to security tokens that represent investment funds.

In seeking to ensure the future international competitiveness of the UK as a place to do business, we are keen to see the willingness to apply adaptive and responsive regulations to this emerging sector applied also to established sectors of financial services. Utilising FSMA is a welcome approach in supervising similar activities in similar ways, but there is more to do on scoping and definitions, and in avoiding regulatory duplication for assets with both mainstream and cryptoasset characteristics.

General comments

While cryptoassets are still largely outside mainstream investment portfolios, the investment management industry has a range of interests in the accelerating regulatory debate.

Firstly, investment management is a well-established and significant sector of financial services and so is potentially impacted as a result of new sectors joining the existing FSMA regulatory regime. This impact could be seen in a number of ways: for example, from a competitiveness perspective if there is not a level playing field between firms and products undertaking broadly comparable activities; or potentially from a customer protection perspective if there is an impact on compensation scheme coverage and funding costs.

Second, as innovators we are keen to apply new technologies to existing activities, making the most of distributed ledger technology ("DLT") which can drive operational efficiencies as well as open up certain parts of the capital markets to wider audiences in a transparent and well-controlled way. This second perspective is currently less mature and so our comments are based upon only limited existing experience in an area that we anticipate will significantly evolve in the near term.

Third, as existing investors on a currently very limited basis, but potentially more significantly in future, we welcome the greater certainty and reassurance that a regulatory environment could provide for cryptoassets as an asset class.

Finally, we see this whole debate as increasingly important for the wider competitiveness position of UK financial services, including investment management. Ensuring the right regulatory regime is in place both for cryptoassets and wider parts of the digital asset and DLT ecosystem is an essential precondition for the UK industry to thrive.

With this in mind, and given the native crypto elements of the questions, we will be responding only to selected questions. Nevertheless, we would like to **emphasise the importance of considering future developments of *existing* markets** and where this may, perhaps inadvertently, fall within the scope of the regulatory regime you are seeking to apply.

Scope

The definition of 'cryptoassets' appears to be extremely broad, albeit we have subsequently received reassurance that this will be adjusted to suit supervisory objectives As proposed in this consultation, the definition of 'cryptoassets' is as follows:

> *'Any cryptographically secured digital representation of value or contractual rights that: (a) can be transferred, stored or traded electronically, and (b) that uses technology supporting the recording or storage of data (which may include distributed ledger technology)'*

Firstly, using the word ‘may’ could encompass cryptographically secured contractual rights that are not recorded on DLT. A liberal interpretation of this might conclude that many existing financial assets and records would fall within this definition, a position that a dispassionate observer would probably not recognise.

Secondly, the definition will inevitably include traditional assets such as already-regulated stocks and bonds or cash, where these have been tokenised and/or are recorded cryptographically. We recognise that over time the vast majority of financial assets will be represented as tokens, on-chain, and so it will be increasingly difficult to differentiate between native digital assets and traditional assets that are digitally represented, and this may give rise to unintended consequences.

We understand that this approach has been designed to ensure that policymakers have a maximum level of potential future scope but that in practice it will be narrowed to target specific assets. For this to be effective, as above, we urge regulators to avoid layered regulation by applying rules to natively digital assets only.

The decision to extend the existing FSMA regime, rather than creating a separate rulebook in the way that the EU Markets in Crypto Assets (“MiCA”) does, is sensible and ensures a level playing field between traditional and decentralised finance (“DeFi”), where we have previously been concerned that cryptoasset firms have been able to transact more easily with consumers due to them being outside of, for example, the marketing and promotions rules.

Policymakers appear to be aware of the ‘halo effect’ in regulation providing legitimacy to activities and/or firms currently outside of the regulatory perimeter, but care should be taken to continuously ensure that when applying the same regulatory regime that encompasses banks, insurance, and investment firms, cryptoasset firms are not able to take advantage of this in their positioning with consumers.

Approach

The phased timeline approach seems sensible in applying regulation more quickly to areas of greater consumer harm.

We would ask that the principle you suggest applying to commodity-linked tokens also apply to **security tokens representing interests in collective investment schemes. We agree that a bespoke regulatory regime is not required where such tokens meet the necessary definitions and they should continue to be regulated accordingly**, whether or not cryptography is utilised.

At present, firms are operating in an uncertain regulatory environment in respect of cryptoassets, and this is especially problematic for firms operating in multiple jurisdictions. We will continue to work closely with our member firms, UK government, the FCA and international regulators to coordinate and combine efforts to move forward to provide the very necessary clarity for our industry and establish an effective framework.

There are a range of views in our membership on the investibility of cryptocurrencies and the long-term outlook for the asset class. Some have responded to specific demands of clients and provide exposure to unbacked cryptoassets, others are monitoring the situation and may do so in future, while the remainder do not wish to involve themselves.

Practically, it should be acknowledged that the nature of crypto exchanges, and the post-trade infrastructure, does require different operational processes that are outside of the mainstream. While service providers, including mainstream brokers and custodians are moving in this direction, it may be some time before many of our firms have the level of client demand required to invest in the operational changes required at scale.

However, with time it may be appropriate for a regulated investment fund to allocate some capital to crypto as part of a well-diversified portfolio. This could provide a solution to the concerns of regulators in consumers being over-exposed to crypto.

At the core, we are keen to strike a balance between UK competitiveness and ensuring that people holding cryptocurrency are protected and can do so safely, rather than being directed to unregulated avenues as is the case now.

Consumer protections

We strongly support the notion for bold but responsible innovation. Irrespective of whether investor exposure to cryptoassets is regarded as prudent, it is fundamental that if people choose to hold assets such as crypto, they must be able to do so with awareness of the associated risks.

Despite the volatility associated with unregulated assets such as exchange tokens, many UK consumers have direct exposure to cryptoassets, without first having built up sufficient deposit savings or investments via mainstream assets. Indeed, research undertaken by the FSCS has found that from a sample of 2,001 consumers familiar with the phrase "cryptocurrencies", 18% have direct experience investing in such to date and a further 27% are open to investing in it in the future[1].

Other investors have taken advantage of more indirect ways of obtaining exposure to the wider ecosystem, such as via investments in companies with a participatory role in the cryptoassets industry.

A number of proposals included in this consultation seek to enhance consumer protection. However, there are areas where further intervention may be necessary. For example, action may be needed to combat the operational risks inherent in decentralised operating models. To achieve this, we suggest that whilst regulators should maintain an outcomes-based approach to operational resilience requirements for all traditional and cryptoasset service providers, regulators may wish to simultaneously prioritise certain crypto firms for greater supervisory engagement to mitigate the various risks that are significantly amplified in these business models.

In time, there may be a need for making cryptoasset investment advice and portfolio management regulated activities. This would reduce regulatory arbitrage between crypto and traditional financial services firms as well as increase the likelihood that consumers are able to ascertain the viability of investing via trusted sources, rather than being directed to unregulated avenues as is the case now. However, we recognise that intervention in this area may not be an immediate priority due to the limited scale of current activity.

We agree with HMT's proposal to refrain from including cryptoasset firms within the scope of the FSCS. We have been advocating for reform to the FSCS to reduce the exposure of mainstream investment firms to other elements of the wider financial services industry. Investment managers already contribute a disproportionate amount of the levy. Including cryptoasset firms within the scope of FSCS would produce a significant new exposure to the scheme that firms in our sector should not be expected to cover.

Responses to selected questions

1: Do you agree with HM Treasury's proposal to expand the list of "specified investments" to include cryptoassets? If not, then please specify why.

The IA does agree with this proposal, however, would prefer that the proposed definition of cryptoassets be restricted exclusive to digitally native assets that also demonstrate specific risk profiles, in order for the supervisory authorities to uphold the principle of "same risk, same regulatory outcomes".

Although we have received some subsequent assurances over and above the text of this consultation, under the broad definition of regulated cryptoassets as proposed in this consultation paper ("CP"), it is possible that any asset or record that is cryptographically secured and represented electronically will fall under scope. As the adoption of tokenisation becomes more prevalent across the financial ecosystem, this

[1] FSCS Consumer Research: *Attitudes towards investing in cryptocurrencies* April 2023

will inevitably include traditional assets, such as stocks and bonds[2].

Traditional assets do not demonstrate the same risk profiles as digitally native alternative assets simply because they are tokenised and make use of DLT-based technology. Therefore, the principle of "same risk, same regulatory outcomes" could be compromised if existing specified investments also qualify as regulated cryptoassets. Instead, existing specified investments should be carved out of scope to avoid regulatory overlap and layering of different regulatory rules.

Regulators should provide exclusions to the definition of cryptoassets, including those that already qualify as another type of specified investment. In turn, this will ensure that traditional financial assets, which already qualify as specified investments, should not be treated differently just because they have been tokenised for efficiency reasons.

The paper recognises this principle already for commodity-linked tokens. We therefore recommend that this should be extended to security tokens representing interests in collective investment schemes. A bespoke regulatory regime is not required where such tokens meet the necessary existing definitions and they should continue to be regulated accordingly, whether or not cryptography is used in the underlying technology.

The IA recognises that over time the vast majority of financial assets will be represented on-chain and so it will be increasingly difficult to differentiate between the two types of markets. Accordingly, it may be preferable for HM Treasury to create new specified investments covering different types of cryptoassets. To achieve this, it is fundamental that regulators consider the differences between them and their corresponding risk profiles. To assess the risk profiles of different types of cryptoassets, HM Treasury may wish to consider whether the token is recorded on a public versus private blockchain, as well as whether the token is backed by a physical and/or traditional asset.

The IA also urges HM Treasury to align the definitions of cryptoassets within the UK regulatory framework. Currently, the definitions for cryptoassets under the MLRs, the new proposed financial promotions regime, the new proposed stablecoin regime, and this regime broadly cover a similar class of assets but have slightly different scopes. This complexity and expense of compliance may result in potential criminal sanctions for any breach.

4: 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?

We support the supervisory authorities' ambitions to mitigate the administrative burdens of FSMA authorisation for cryptoasset service providers which are already MLR-registered and are seeking to undertake regulated activities.

In the same vein, it is paramount that the supervisory authorities prioritise not imposing additional burdens on mainstream investment management firms and participants in the financial services industry too. As per our response to question one, it is possible that cryptographically secured and electronically represented traditional assets, such as stocks and bonds, are captured under the broad definition of regulated cryptoassets as proposed in this CP.

Unless regulators include specific exclusions to the definition of cryptoassets or indeed create new specified investments depending on the different types of cryptoassets, firms undertaking traditional

[2] For example, Citi Group (2023) have forecast that between $4-5 trillion of traditional assets will be tokenised by 2030.

financial asset activities, including those that already qualify as another type of specified investment, will likely be disadvantaged by a layering of rules simply because the asset is recorded on a DLT and/or electronically represented as a token. This would unfairly burden highly regulated, traditional investment firms who are already AML/KYC compliant.

To overcome this, we once again ask that investment funds seeking to tokenise their fund units/shares are not subject to additional regulatory permissions, such as FCA AML registration[3]. It is fundamental that regulators are alert to preventing the duplication of regulatory procedures, as aside from the practical challenge of obtaining authorisation under a new regulated permission, further regulatory oversight for an existing activity could adversely impact the competitive of the UK financial services industry relative to other jurisdictions.

Therefore, while we agree with the intention to keep the administrative burdens of FSMA authorisation low for firms seeking to undertake regulated activities for cryptoassets, we equally encourage HMT to ensure that those firms already providing regulated activities are not subject to duplicative MLR processes simply because of the pursuit of tokenisation for efficiency gains.

To fully achieve the principle of "same risk, same regulatory outcomes", HMT may wish to reconsider the registration requirement under the MLRs with a view to removing it at the point the new comprehensive regulatory framework for cryptoassets comes into effect under FSMA. This would help to level the playing field in terms of compliance with AML/KYC rules between cryptoasset services providers and credit institutions, investment firms and other "relevant persons" as defined in the MLRs.

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

We agree in principle with the adoption of a phased approach and, in particular, the focus placed on applying regulation more quickly to areas of greater consumer harm. By adopting this approach, regulators can prioritise getting the foundations of the regulatory framework correct.

Despite the advantages to a phased approach, it must be noted that there are potential drawbacks that regulators will need to be alert to. In particular, a phased approach could create market uncertainty for cryptoassets service providers and, in turn, jeopardise the extent to which firms can commit to providing these services and limit their ability to plan and expand their business offerings. Furthermore, a phased approach may enable the development of a misaligned regulatory framework if further increments are adopted in an inconsistent manner.

It must also be noted that other jurisdictions are developing regulatory frameworks in parallel and/or in one iteration. From a global perspective, a UK phased approach may therefore increase the prevalence of regulatory arbitrage. To mitigate these risks, it is therefore important that UK regulators provide clarity on the intended longer-term regulatory framework as soon as possible. Irrespective of the speed at which a complete regulatory framework can be developed, the IA strongly advocates that regulators align its phased approach with the regulatory principles of other jurisdictions wherever possible so to ensure international cohesion.

[3] Investment firms issuing tokenised funds trigger requirements to register under the *Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017* (section 56), despite already being subject to mainstream AML/KYC regulations.

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

We do not believe that the CP provides a clear explanation of the proposed treatment of NFTs and utility tokens. Little detail is provided as to when an NFT will qualify as a specified investment, nor why there is an existing rationale for any to be excluded at present.

Despite the definition in Table 4A, it remains unclear when an NFT is deemed to qualify as a specified investment. For example, it is not clear if an exchange trading NFTs would fall under the regulatory perimeter. To ensure regulatory compliance, it is therefore crucial that this distinction is clarified for the benefit of supervisory authorities and firms looking to undertake regulated activities.

Furthermore, and in the context of investment managers, we believe that the advent of tokenisation may provide a dual utility for NFTs: the creation of a new investible asset (such as a tokenised artwork) and the tokenisation of investment product structures themselves. At present, when an investor buys unit shares in a fund, they are buying a portion of the underlying assets held by the fund. These shares are fungible, which means that they are interchangeable with other unit shares in the same fund.

However, and as first set out in our recent report[4], we believe that the adoption of tokenisation may provide the opportunity for the hyper-customisation of investment portfolios, whereby the risk and return exposure is tailored by consumers at the individual stock and securities level. In turn, we envisage the possibility whereby investment management firms can replace the existing fund structure with an NFT, where each token represents the specific investment portfolio that has been customised specifically to the needs of an individual investor.

While the IA acknowledges that the likelihood that the emergence of NFTs as a suitable investment product structure for funds is unlikely to arise in the near-term, if investment product structures do indeed become more akin to NFTs then the issuance of such assets would not be subject to regulations proposed in the context of this CP. Without changes to proposed treatment of NFTs, this may render tokens to hyper-personalised investment portfolios outside of the regulatory perimeter simply because of the fact that they are non-fungible. Such an approach clearly compromises the principle of "same risk, same regulatory outcomes".

To prevent the potential exclusion of novel investment product structures from being regulated as a specified investment, the IA recommends that a technology-neutral approach should be taken in the regulation of NFTs. This means that NFTs should not be treated differently from other regulated cryptoassets purely because they are created as non-fungible objects within the blockchain in which they exist. Instead, they should be evaluated based on their characteristics and the type of rights conferred. NFTs used for financial purposes and traded on a secondary market as specified investments or regulated cryptoassets should clearly be included in the regulatory framework to ensure they comply with the regulatory requirements.

By taking a technology-neutral approach, regulators can ensure that the regulatory framework accommodates NFTs and other cryptoassets, both now and in the future, as the market continues to evolve, and the opportunities afforded by tokenisation become clearer.

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

By taking a technology-neutral approach, regulators can ensure that the regulatory framework accommodates NFTs and other cryptoassets, both now and in the future, as the market continues to

[4] The Investment Association: *Investing for the Future* July 2022

evolve, and the opportunities afforded by tokenisation become clearer.

The IA is broadly supportive of the key elements of the proposed cryptoassets trading regime. In particular, the IA agrees that the proposed prudential, conduct and reporting requirements are appropriate and sensible.

However, we do not believe that the operational resilience requirements are adequate to achieve the regulator's ambitions of creating a regulatory framework that enshrines the principle of "same risk, same regulatory outcomes" given the systematic importance of cryptoasset exchanges.

Whilst we agree with HMT's view that cryptoasset trading venues are at a relatively early stage of development when compared to traditional financial market infrastructures ("FMI"), this is not to say that their relative nascency reduces their criticality to the cryptoasset ecosystem.

In reality, these exchanges are of systemic importance to the cryptoasset industry specifically. Whilst it is entirely possible for cryptoassets to operate without exchanges, exchanges provide efficient on and off-ramps for cryptoassets and facilitate the clearing, settlement, and recording of financial transactions. Therefore, we strongly recommend that exchanges are treated as equivalent to traditional FMIs.

Accordingly, we therefore recommend that the operational resilience expectations placed on cryptoasset exchanges should be aligned with the PRA's and FCA's existing operational resilience rules for firms and FMIs, as set out in the FCA's Policy Statement PS21/3 and the Bank's Supervisory Statement SS9/21. Specifically, we recommend that cryptoasset exchanges:

- Identify their important business services that, if disrupted, could cause harm to consumers or market integrity, threaten the viability of firms or cause instability in the financial system
- Set impact tolerances for each important business service, which would quantify the maximum tolerable level of disruption they would tolerate.
- Identify and map the people, processes, technology, facilities and information that support their important business services (including those of their suppliers).
- Take actions to be able to remain within their impact tolerances through a range of severe but plausible disruption scenarios including developing a testing plan and carrying out scenario testing.
- Conduct lessons learnt exercises to identify, prioritise, and invest in their ability to respond and recover from disruptions as effectively as possible.
- Notify relevant authorities of significant disruptions and provide regular updates on their recovery progress.

If regulators opt against this recommended approach, regulatory arbitrage will exist between traditional FMIs and cryptoasset exchanges simply because of the type of assets that may exist on exchanges, rather than the activity being undertaken. This would be inconsistent with the regulatory objective of establishing a regulatory framework that delivers a level playing field between crypto and traditional financial services firms conducting the same activity.

In the near-term, we also recommend it may be prudent for regulators to make certain exceptions to their technological neutrality. Specifically, regulators may wish to take additional steps to mitigate the single points of failure and cyber risks that can be amplified in cryptoasset exchanges specifically. While we agree that it is important that regulators consistently apply an outcomes-based approach to operational resilience requirements for all traditional and cryptoasset service providers, it may be prudent for regulators to undertake greater supervisory engagement activities, at least in the near term, to mitigate against the operational risks inherent to cryptoasset exchanges.

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

The IA is broadly supportive of the key elements of the proposed cryptoassets custody regime. In particular, we strongly agree that the established custody regulatory framework for traditional finance which is primarily set through Article 40 of the RAO and the FCA’s Client Assets Sourcebook (CASS) should serve as the basis for the proposed cryptoassets custody regime.

Despite our broad support that CASS should serve as the basis for the proposed cryptoassets custody regime, we do recognise that these rules were designed to be imposed upon operating models and technologies that are vastly different to those that will likely be utilised by cryptoasset custodians. Accordingly, we encourage regulators to ensure that any custody regime is sufficiently nuanced to accommodate the idiosyncratic models of cryptoasset custodians, so to enshrine the principle of “same risk, same regulatory outcome” without stifling innovation.

Furthermore, and as in keeping with our response to Question 20 of this CP, we do not believe that the operational resilience requirements are adequate to achieve the regulators ambitions to create a regulatory framework that enshrines the principle of "same risk, same regulatory outcomes". To overcome this, we recommend that the operational resilience expectations placed on cryptoasset custodians should be aligned with the PRA’s and FCA’s existing operational resilience rules, as set out in the FCA’s Policy Statement PS21/3 and the Bank’s Supervisory Statement SS9/21.

We would also like to take this opportunity to restate our proposals for reform to the FCA COLL Handbook where changes may be necessary to implement tokenised funds. These mainly centre around the ability of a fund, or its management arm, to unilaterally make changes to the register of holders, in some cases via compulsory transactions. Under the DLT consensus mechanism, transactions are generally validated by both parties (the fund and the investor) before they are finalised, something that was not envisaged when the rules were written.

Looking ahead, secondary markets enable fund tokens to be traded by investors between themselves outside of the involvement of the fund acting as agent. Although there may be a technological solution for these items, there is a need for both firms and the regulator to assess the implication of funds not being as in control of the register as they are today.

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

We broadly agree with HMT’s assessment of the challenges of regulating DeFi, which intends to fundamentally disrupt the existing framework of financial services delivery. Whilst it is true that much of DeFi looks to replicate the services provided in traditional financial via different operating models, we recognise that regulating these models will be challenging in both the near- and long-term, particularly as they evolve with time. Indeed, the process of regulation itself may need to evolve as innovation accelerates and supervisory authorities must therefore maintain regulatory agility.

Despite these challenges, the investment management industry recognises that any potential exclusion of "decentralised activities" until HMT has defined a set of DeFi-specific activities as regulated under the RAO or DAR could risk creating a bifurcated market for certain cryptoasset services and traditional finance. In turn, this could lead to an even greater portion of certain activities being driven towards unregulated decentralised equivalents.

We are therefore of the view that it is critical that DeFi is brought into regulation in whatever capacity is possible, in order to ensure the creation of an effective, robust and sustainable cryptoassets regulatory framework that enshrines the principle of “same risk, same regulatory outcomes”.

Noting the ever-evolving nature of DeFi, we firmly recognise that if harnessed appropriately, DeFi has the potential to deliver substantial efficiencies that stand to benefit customers, both retail and institutional, as well as enhance the competitiveness of the UK financial ecosystem.

Going forward, we therefore recommend that regulators consistently approach DeFi reforms in an open-minded way, recognising that that existing industry functional divides may not be relevant if tech provides more efficient ways of achieving the same outcomes. In other words, while remaining technology-neutral, we urge regulators to refrain trying to fit new ways of doing things into existing frameworks where these are too rigid or have pre-existing views on the number of entities required to fulfil a function, or indeed prescribe their function.

Likewise, we acknowledge that it is paramount that the level of knowledge and experience within both firms and policy-making bodies must keep pace with current and future innovation, if the UK is to develop a financial ecosystem that is positioned to take advantage of potential opportunities presented by DeFi, whilst also maintaining consumer protection. There is an urgent need to adequately resource and develop technical expertise to address these transformative changes, as well as demonstrate the UK’s ability to lead and shape global regulatory standards where suitable.

To help support this approach, one key recommendation that we would like to propose is for HMT, in partnership with industry, to establish a DeFi taskforce to continuously assess suitability of the financial services regulatory framework to new innovations in DeFi, so that the regulatory authorities are readily positioned to adapt legislation and enhance the overall competitiveness of the UK financial ecosystem.

Furthermore, we would also like to reiterate that traditional financial activities and DeFi are not mutually exclusive. As paragraph 17.1 correctly acknowledges, “there is a spectrum of decentralisation amongst current DeFi offerings”. Accordingly, regulators should be mindful of assuming that there is a binary distinction between both financial models.

As has been a common theme throughout our response, we foresee that the tokenisation of traditional assets will become increasingly prevalent across the financial ecosystem. We strongly support the emergence of tokenised assets in opening new markets and increasing efficiencies. The likely adoption of permissioned and/or permissionless blockchain networks to enable the tokenisation of traditional assets, as well as the inevitable introduction and use of smart contracts, will represent an evolution away from the highly centralised, traditional financial models that are common today, to an increasingly decentralised one.

Moreover, we recognise that there are already a number of investment funds available in the market that currently offers exposure to cryptoassets, which may only increase over time if and/or where the allocation of some capital to cryptoassets becomes part of a well-diversified portfolio.

The potential widespread adoption of tokenisation and DLT technology across traditional firms, coupled with the exposure that some investment firms already have to cryptoassets, means that the divide between traditional finance and DeFi may become even less clear. Therefore, we suggest that regulators continue to reflect on potential areas of overlap between traditional finance and DeFI, both now and in the future, where grey areas may persist and clearly establish how such can and will be regulated from day one of implementation.

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

We agree with HMT's conclusion that the speculative nature of cryptoassets may render it difficult for an investment advisor to meet the existing criteria as set out in Article 37 and 53 of the RAO. However, if regulators are to fulfil their objective of establishing a regulatory framework that delivers a level playing field between crypto and traditional financial services firms conducting the same activity, we do recommend that investment advice and portfolio management for cryptoassets should be classed as regulated activities, at the appropriate time.

Whilst paragraph 12.1 of this CP correctly notes that "at present cryptoasset investment advice and discretionary portfolio management services are relatively limited and geared towards institutional investors" there is **no** guarantee that this will not be extended to retail consumers over time.

Indeed, according to research undertaken by the FSCS[5], many retail consumers in the UK already directly hold cryptoassets despite not having built up sufficient savings or mainstream investments to fall back on. Some also do so on a leveraged basis, which may potentially expose them to risks that are many multiples of their original stake. Other consumers have unfortunately fallen victim to scams, influencer or peer pressure or had their positions stolen. Despite these potential risks, research undertaken by the FSCS has found that from a sample of 2,001 consumers familiar with the phrase "cryptocurrencies", 18% have direct experience investing in such to date and a further 27% are open to investing in it in the future[6].

With the knowledge that a substantial number of retail consumers are already exposed to cryptoasset investments, and given that we recognise it may be appropriate for a small allocation to the crypto market to be appropriate in a regulated investment fund as part of a well-diversified portfolio for both institutional and retail consumers in the future, we therefore recommend that making cryptoasset investment advice and cryptoasset portfolio management will be essential to ensure consumer protection.

Fundamentally, if people choose to hold crypto, they must be able to do so with awareness of the associated risks. By making both actions regulated activities, this will prevent regulatory arbitrage between crypto and traditional financial services firms and increase the likelihood that investors are adequately positioned to ascertain the viability of investing via trusted sources, rather than being directed to unregulated avenues as is the case now.

Furthermore, we also note that under MiCA, cryptoasset service providers will be regulated for the provision of providing investment advice within the EU. The exclusion of investment advice and cryptoasset portfolio management as a regulated activity in the UK would therefore undermine the regulators ambitions to achieve international regulatory alignment and minimise cross-border regulatory arbitrage wherever possible, which is something we agree is critical for the success of any final regulatory framework.

Moreover, and as per our response to question one, it is possible that cryptographically secured and electronically represented traditional assets, such as stocks and bonds, are captured under the proposed definition of regulated cryptoassets as proposed in this CP. Unless regulators intend to include for specific exclusions to the definition of cryptoassets or indeed create new specified investments depending on the different types of cryptoassets, firms undertaking traditional financial asset activities may face divergent regulatory expectations for the same activity, depending on whether the underlying asset is recorded on a DLT and/or electronically represented as a token or not.

[5] FSCS Consumer Research: *Attitudes towards investing in cryptocurrencies* April 2023
[6] Ibid.

47: When making investment decisions in cryptoassets, what information regarding environmental impact and / or energy intensity would investors find most useful for their decisions?

We are committed to bringing clarity, transparency and consistency to the way industry describes and delivers sustainable and responsible investment products across all asset classes, including cryptoassets. The investment management industry approaches this question from three perspectives:

- As **investors in cryptoassets;**
- As **providers of products that may contain cryptoassets** and therefore require disclosures to investors; and
- As **providers of products that may themselves be considered as being cryptoassets** under these proposals.

As has been the overarching message throughout our response to this CP, regulators must prioritise ensuring a level playing field as their guiding principle. Taking each of these perspectives in isolation, we have outlined below how the supervisory authorities can achieve this principle.

While there are differing views within the investment management industry on the investment case, a number of non-UK investment funds are already available in the market that offer an exposure to cryptoassets. Indeed, we recognise that permitting multiasset and well-diversified authorised funds to allocate a small exposure (for example <5%) to cryptoassets might become standard practice to ensure a well-diversified portfolio in the future and may provide a solution for the FCA's concentrated consumer protection concerns. In this case, the cryptoasset class is already treated the same as any other type of investment and the fund will be required to report against any and all sustainability-related commitments and standards, including net zero commitments.

Similarly for the first and third perspectives, ensuring that cryptoasset providers are required to report on their carbon emission and other ESG characteristics would enable a consistent approach across investible assets, and provide a familiar and proportionate regime for tokenised portfolios and/or funds to comply with in future.

Therefore, we recommend that it makes sense that these frameworks be used consistently across the investible universe, rather than creating a separate regime for cryptoassets specifically. This will ensure that there is consistency across ESG disclosure standards irrespective of the type of asset that is invested in.

Finally, we want to recognise the importance of globally consistent and comparable standards for client outcomes. While the global standards on sustainability reporting and disclosure are still being established, many of our member firms conduct business on a cross-border basis. We strongly advocate that regulators align their approach with the regulatory principles of other jurisdictions wherever possible, so as to ensure international cohesion across different jurisdictions.

[Ends]