Crypto regulation in the United Kingdom

Last updated in July 2022

Introduction

The UK has long been a global leader in financial services, and has a long history in providing opportunities for innovative firms. For example, the UK launched the first regulatory sandbox, a scheme which has been replicated now in many jurisdictions.

However, the UK's response to the emergence of the cryptoasset industry has tended to be more cautious, with a particular focus on preventing consumer detriment. While the UK has implemented the majority of the Financial Action Task Force's recommendations regarding money laundering and terrorist financing risks in the crypto industry (with the remainder due to be implemented in the coming months), only the most risky products (like crypto derivatives) have been directly addressed through regulation. Other activities have only been regulated where they fit within the existing regulatory perimeter, for instance where a cryptoasset meets the definition of a specified investment.

In April 2022, there appeared to be a distinct change in the mood music when the UK government announced its intentions to make the UK a 'global hub for cryptoasset technology', with a 'world-leading regime' for cryptoasset businesses. In July 2022, the Financial Services and Markets Bill was proposed that would provide HM Treasury with broad powers in respect of certain cryptoasset activities involving stablecoins. For the first time, UK operators of stablecoin-based payment systems will be required to become authorised. The UK is also taking steps to integrate the use of distributed ledger technology in the regulation of financial market infrastructures, with a sandbox

due to be up and running in 2023. Separately, the Government intends to launch a consultation on its regulatory approach to a broader range of cryptoassets, including those primarily used as a means of investment (such as Bitcoin) later in 2022.

In what is an exciting time for UK-based cryptoasset businesses, we provide an overview of the complex regulatory environment, and how this is due to change.

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1. Are cryptoassets regulated in the UK?

The UK does not currently have a bespoke financial services regulatory regime which applies specifically to cryptoassets. However, some types of crypto-asset will have characteristics which bring them within the UK's existing regulatory perimeter, either under the Financial Services and Markets Act 2000 (FSMA), the Payment Services Regulations 2017 (PSRs) or the Electronic Money Regulations 2011 (EMRs).

Under FSMA, it is prohibited for a person to carry on a regulated activity in the UK, or purport to do so, unless authorised or exempt. This is known as the 'general prohibition'.

Regulated activities are activities of a specified kind which are carried on by way of business, and relate to a specified investment (for example, shares, debt securities, or units in collective investment schemes). Specified activities and investments (as well as exclusions) are set out in the FSMA (Regulated Activities) Order 2001 (**RAO**).

In July 2019, the FCA published its Guidance on cryptoassets in which it set out its view on tokens which fall within the existing perimeter (regulated tokens) and those which fall outside of the perimeter (unregulated tokens).

The FCA divides tokens into categories according to their characteristics: exchange tokens, utility tokens, and security tokens.

Unregulated tokens include exchange tokens, being 'those types of crypto-asset that are usually decentralised and primarily used as a means of exchange' and including crypto-currencies such as Bitcoin.

In some situations, an exchange token might be used to facilitate regulated payments, in which case the provider using the tokens in this way would need to consider whether the services fall within scope of the PSRs or EMRs.

However, this would not bring the token itself within the regulatory perimeter (it would remain an unregulated token, in the FCA's view). Utility tokens, which 'provide consumers with access to a current or prospective product or service and often grant rights similar to pre-payment vouchers', are also considered to be unregulated tokens unless they fall within the definition of e-money and thus are within scope of the EMRs.

Security tokens, which 'provide rights and obligations akin to specified investments as set out in the RAO, including those that are financial instruments under MiFID II' are within the regulatory perimeter.

Accordingly, firms which carry on specified activities involving security tokens will need to ensure that they are appropriately authorised under FSMA and are following the FCA's rules in relation to their activities. Therefore, tokens which have the characteristics of a share in a company, a debt security, or a unit in a collective investment scheme will be regulated under the FSMA regime.

January 2021
HM Treasury launched a Consultation and Call for evidence on the regulatory approach to cryptoassets and stablecoins and the use of distributed ledger technology (DLT) in financial markets (the regulatory approach consultation).

On 4 April 2022, in its response to the regulatory approach consultation, HM Treasury confirmed that stablecoins which reference fiat currencies (either a single currency or a 'basket' of currencies) will be specifically brought within the UK's payments regime through amendments to the PSRs and EMRs.

On 20 July 2022, the Financial Services and Markets Bill was published. The Bill sets out various proposed amendments to the UK's regulatory regime, and would give HM Treasury wide-ranging powers to set, and modify regulation regarding 'digital settlement assets', which would include stablecoins which reference fiat currencies. HM Treasury would also be empowered to modify the definition of digital settlement assets, which will allow it to amend regulation in line with technological advances.

The Bill will be debated in the House of Commons in the autumn of 2022.

Firms which carry out the following activities are likely to need to be authorised under the PSRs/EMRs:

- Issuing, creating, or destroying tokens.
- Value stabilisation and reserve management.
- Validation of transactions.
- Access.
- Transmission of funds.
- Providing custody services for a third party.
- Executing transaction in stablecoins.
- Exchanging tokens for fiat currency.

In its response, HM Treasury also confirmed that it plans to consult more widely on the regulatory approach to unregulated tokens (including crypto-currencies like Bitcoin).

The UK's anti-money laundering (**AML**) regime applies to providers of certain services relating to cryptoassets (see section two of this document). The sale, marketing and distribution of derivative products and exchange traded notes which reference unregulated transferable cryptoassets to retail customers has been prohibited in the UK since 6 January 2021.

2. AML requirements

Under the Money Laundering, Terrorist Financing and Transfer of Funds (Information on the Payer) Regulations 2017 (the MLRs) 'relevant persons' acting in the course of business carried on by them in the UK (including in-scope crypto-asset businesses) are required to adhere to AML requirements including:

- carrying out customer due diligence (CDD)
- conducting a risk assessment
- putting in place other measures such as policies and procedures, and appointing a nominated officer who has a number of responsibilities, including determining when a suspicious activity report is to be made registering with the FCA for the purposes of AML/CTF supervision.

Crypto-asset firms in scope of the MLRs

For the purposes of the MLRs, a crypto-asset is defined as: 'a cryptographically secured digital representation of value or contractual rights that uses a form of [DLT] and can be transferred, stored or traded electronically'.

The definition of a crypto-asset is broad, and will include most tokens (whether exchange, utility or security tokens).

It should be noted that there is no exclusion where a token is non-fungible. As a result, under certain circumstances a non-fungible token (**NFT**) will be considered a crypto-asset for the purposes of the MLRs.

Both crypto-asset exchange providers and custodian wallet providers are relevant persons for the purposes of the MLRs.

A custodian wallet provider is a 'firm or sole practitioner who by way of business provides services to safeguard, or to safeguard and administer - (a) cryptoassets on behalf of its customers, or (b) private cryptographic keys on behalf of its customers in order to hold, store and transfer cryptoassets'.

A crypto-asset exchange provider is defined as (our emphasis) 'a firm or sole practitioner who by way of business provides one or more of the following services, including where the firm or sole practitioner does so as creator or issuer of any of the cryptoassets involved, when providing such services - (a) exchanging, or arranging or making arrangements with a view to the exchange of, cryptoassets for money or money for cryptoassets, (b) exchanging, or arranging or making arrangements with a view to the exchange of, one crypto-asset for another, or (c) operating a machine which utilises automated processes to exchange cryptoassets for money or money for cryptoassets'.

Temporary registration regime (TRR)

The relevant sections of the MLRs bringing crypto-asset businesses in scope came into force on 10 January 2020, with a requirement for existing crypto-asset businesses to register with the FCA by 10 January 2021 (crypto-asset businesses beginning operations post-10 January 2020 needed to register prior to commencing operations in the UK).

The TRR was established so that existing crypto-asset businesses which applied to the FCA for registration before 16 December 2020 were allowed to continue operating past the 10 January 2021 deadline.

The TRR has now closed (apart from for a small number of firms, where the FCA says 'it is strictly necessary to continue to have temporary registration').

Registration of crypto-asset businesses

The FCA has a responsibility to determine whether a crypto-asset business, and any officer, manager, or beneficial owner of that business is 'fit and proper', ie whether it has adequate skills and experience, and may be expected to act with probity. The FCA will assess all elements of the (extensive) registration application and conduct interviews with directors and the nominated officer.

In this respect, the FCA acts as a gatekeeper, and any crypto-asset business which does not meet the relevant standards will be refused registration and so will not be able to undertake crypto-asset business in the UK. The proportion of firms succeeding in the registration process has been low, and this has resulted in many firms seeking to move their crypto-asset business offshore to other jurisdictions.

Once amendments to the MLRs take effect, which are expected in September 2022, the FCA will have the ability to publish its decisions not to register crypto-asset firms. The FCA can already publish cancellation and suspension notices.

Travel rule

In July 2019, the Financial Action Task Force (FATF) confirmed that cryptoassets are within scope of the 'travel rule', which requires that financial institutions send and record information on the originator and beneficiary of a transaction, allowing institutions to detect potential ML/TF activity, and ensuring that appropriate records of transactions are kept for law enforcement purposes.

HM Treasury decided to delay UK implementation of this requirement in respect of cryptoassets until such a time when compliance solutions were available to facilitate adherence.

In its July 2021 consultation, HM Treasury confirmed its intention to 'begin planning' for implementation of the travel rule through an amendment to the MLRs.

In its June 2022 response to the consultation on amendments to the MLRs, HM Treasury confirmed that custodian wallet providers and crypto-asset exchange providers (including those which intermediate transactions between other crypto-asset businesses) will need to adhere to the travel rule for transfers meeting a EUR1,000 threshold (not including any fiat transfer).

There will be a partial exemption for transfers which only involve UK-based crypto-asset businesses, under which full information is not required to be sent with a transfer but must be provided to a beneficiary on request.

For unhosted wallet transfers, which were to be subject to the travel rule under the initial consultation, businesses will only need to collect information for transactions which are identified as posing an 'elevated risk of illicit finance'. Crypto-asset businesses will have a 12-month grace period from the point at which the amendments to the MLRs take effect, to implement compliance solutions.

Change in control

As noted previously, when assessing applications for registration as a crypto-asset business, the FCA will make an assessment about whether the firm, its owners, and officers are 'fit and proper'.

The FCA also has the power to suspend or cancel the registration of a firm if it becomes aware that such persons are not fit and proper. This process can take up to 90 days.

The government has identified a risk that illicit actors could acquire a registered crypto-asset business and take advantage of this period within which the FCA's actions are limited.

When the MLRs are amended, a provision will be included such that potential acquirers of a registered crypto-asset business will have to notify the FCA ahead of the acquisition.

The FCA will conduct a fit and proper assessment, and will be able to object to the acquisition, or even cancel the registration of the crypto-asset business being acquired. Such decisions will be able to be published by the FCA.

3. Promoting cryptoassets in the UK

Under FSMA, a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity, unless the person is authorised, or the content of the communication is approved by an authorised person or an exemption applies. Communications made from outside of the UK will be caught if the communication can have an effect in the UK. This is known as the 'restriction on financial promotion'.

Engaging in investment activity for these purposes includes entering or offering to enter into an agreement which would result in a party to the agreement carrying out a controlled activity, or exercising any rights conferred by a controlled investment to acquire, dispose etc a controlled investment.

Controlled activities and investments (which largely correspond to specified activities and investments, as discussed in section 1), and relevant exemptions, are set out in the FSMA (Financial Promotion) Order 2005 (**FPO**).

The restriction on financial promotion means that where an unauthorised person promotes a crypto-asset which is a security token that falls within the FSMA regime (ie is treated as a share, debt security or a unit in a collective investment scheme – see section 1) that person will need to, unless an exemption applies, have the promotion approved by a person who is authorised by the FCA.

The authorised person would need to confirm that the promotion complies with the FCA's requirements for financial promotions (including that such promotion is clear, fair and not misleading). In essence, the approver would take the regulatory risk for the promotion.

Where a token is unregulated, the financial promotion restriction does not currently apply. However, this is set to change following HM Treasury's decision to bring certain 'qualifying cryptoassets' within scope of the financial promotion restriction.

While the definition of qualifying cryptoassets has not been confirmed, the government's response suggests this will be broadly similar to the original consultation and will include any cryptographically secured digital representation of value or contractual rights which is fungible and transferable (excluding other controlled investments, e-money, and central bank money).

We note that:

- some cryptographically secured tokens such as those issued under loyalty schemes, which do not typically give rise to consumer protection risks, will be excluded through a 'transferability exclusion'
- fungibility will remain a component of the definition of a qualifying crypto-asset: however, the government does not rule out extending the regime further in the future to capture NFTs, should it be necessary to protect consumers
- the restriction will not specifically refer to cryptoassets 'that use distributed ledger technology' in order to 'future-proof' the definition against future technologies and be more technology agnostic.

There will also be a number of controlled activities which would trigger the financial promotion restriction. In some instances, decentralised finance (**DeFi**) may be in scope of the extended regime, but this will ultimately depend upon the activities being carried out and promoted.

This means that businesses which are communicating with UK recipients about qualifying cryptoassets (whether directly or indirectly) or making communications about such cryptoassets from the UK will need to consider whether their communication falls within the definition of a financial promotion (which in some cases is easier said than done, but in any case, will certainly include advertising material).

If a communication is a financial promotion, then it will need to meet the requirements set out by the FCA (on which the FCA has recently consulted), and be approved by a firm which is authorised by the FCA.

It is set to become more difficult for unauthorised businesses to make financial promotions, as the government intends, through the Financial Services and Markets Bill 2022, to make changes to the regulatory framework for the approval of financial promotions, by implementing a 'gateway'.

This will mean that new and existing authorised firms will be prohibited from approving the financial promotions of unauthorised persons, unless they have specifically and successfully applied to the FCA to be allowed to do so, and do so in accordance with strict rules (to be set by the FCA). This gateway is expected to make it harder for unauthorised firms to make financial promotions generally.

Advertising standards

Crypto-asset businesses should also note the Advertising Standards Agency's recent Enforcement Notice (published in March 2022) which provides guidance on the advertising of crypto-currencies and crypto exchanges which are aimed at UK investors, or made on behalf of UK-based advertisers. The notice sets out various requirements which should be adhered to for such advertisements; for example, advertisements must include a warning that crypto-currencies are unregulated in the UK.

4. Financial market infrastructure (FMI) using DLT

The UK Government has been investigating the potential uses of DLT in financial markets for some time, and this subject formed part of the regulatory approach consultation (described at section 1 previously).

Responses to that consultation identified several benefits which could arise out of the use of DLT in financial market infrastructures, including:

- improving operational efficiency
- reducing risk (for example, counterparty risk)
- improving transparency and traceability of transactions
- increasing resilience in financial market infrastructure services.

However, drawbacks, such as greater fragmentation, and implementation difficulties, were also identified.

In its response, HM Treasury noted that current financial services regulation and legislation were drafted without DLT in mind, and that the government intends to support industry in ensuring that legislation and regulation can accommodate 'tokenisation' (for example, of securities) and DLT in financial market infrastructures.

In April 2021, the Chancellor of the Exchequer announced the development of a Financial Market Infrastructure Sandbox, which will support firms wishing to test new technologies and structures. Provisions which would require implementation of the Sandbox form part of the Financial Services and Markets Bill 2022, and the Sandbox is intended to be up and running in 2023.

5. Prudential treatment of cryptoassets

In the UK, the Prudential Regulation Authority (PRA) is responsible for the prudential regulation of banks, insurers and designated investment firms. Such firms are 'dual-regulated', as they are regulated by the FCA for conduct purposes.

On 24 March 2022, the Deputy Governor of the PRA sent a 'Dear CEO' letter to the CEOs of dual-regulated firms, setting out the PRA's expectations of firms which have existing exposures to cryptoassets, or plan exposure to cryptoassets.

The letter notes an increased interest from banks and designated investment firms in taking exposures to cryptoassets: whether as agent or principal, through exposures to cryptoassets directly or through interests in crypto firms or providing custody arrangements.

Firms were reminded of their responsibilities which, for the moment, are set out under the existing framework (especially with regard to risk management), and the PRA also noted that the long-term prudential treatment of cryptoassets is likely to change (due to current work being carried out by the Basel Committee on Banking Supervision (**BCBS**) and other international bodies).

The Financial Policy Committee released a report on the same day, which highlighted that the Bank of England is engaging closely with the BCBS to 'ensure that as banks' involvement in cryptoassets and associated markets grows, it is met with capital and liquidity requirements that are appropriate given the level of risk being taken'.

6. Other legal considerations

There is now a growing body of case law relating to cryptoassets, and the English legal system has proven flexible enough to deal with questions such as whether cryptoassets, including NFTs, are treated as property (for example, *AA v Persons Unknown [2019] EWHC 3556*, and *Lavinia Deborah Osbourne v (1) Persons Unknown (2) Ozone Networks Inc. trading as Open sea (to be reported, 2022))*, whether a crypto-asset may be held on trust (for example, *Wang v Derby [2021] EWHC 3054 (Comm)),* and whether blockchain developers owe a duty of care to users *(Tulip Trading Ltd v Bitcoin Association for BSV and others [2022] EWHC 667 (Ch)).*

In addition, the Law Commission of England and Wales has been engaged to report on several significant questions of law, including projects on:

conflicting laws and emerging technology

which will examine issues around the jurisdiction and law to be applied to a dispute relating to digital assets, especially where a digital asset is recorded on a decentralised ledger

whether a digital asset is 'possessable'

in the legal sense, a concept which is currently limited to physical items. The Commission will make recommendations for legal reform to provide legal certainty for the development and adoption of digital assets, and is expected to publish a consultation in 2022

the facilitation of smart contracts

which concluded in November 2021 that the current legal framework in England and Wales is able to support the use of smart contracts. See our series on the subject of smart contracts under English law.

7. Conclusion

While there is some uncertainty as to the applicability of existing financial services regulation to cryptoasset activity in the UK, the government is already making legislative moves to allow the development and implementation of a regulatory regime which is agile enough to support innovation, whilst providing sufficient protection to consumers.

The development of the regulatory regime will be 'staged and proportionate', starting with the cryptoassets which have been identified as posing the highest risk: stablecoins which reference fiat currencies, and are used as a means of payment. However, we are also expecting further consultation on broader regulation (including on exchange tokens like Bitcoin and Ether).

Cryptoasset firms' main concerns currently are likely to be the extension of the restriction on financial promotions to qualifying cryptoassets, and compliance with the MLRs (and extending that compliance to cover the soon to be implemented travel rule).

The restriction on financial promotions in particular is likely to impact cryptoasset businesses' day-to-day operations in the UK, and drive more and more businesses toward the FCA authorisation process. It is certainly an exciting time, as the UK attempts to position itself as a 'crypto-hub'.

Whether businesses are located in the UK or not, English law looks set to dominate as a governing law of choice for the commercial dealings of cryptoasset firms, as well as for smart contracts themselves, given the willingness of the English courts to develop law in this area, and the work of the Law Commission. Moreover, the English courts appear to be leading the way in considering more and more complex cases concerning cryptoassets, and how they may be used, seized, and recovered. This means that England may well become a jurisdiction of choice for the hearing of crypto-based claims, and arbitrations.

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