ICAEW
REPRESENTATION 37/23

HMT CONSULTATION AND CALL FOR EVIDENCE: FUTURE FINANCIAL SERVICES REGULATORY REGIME FOR CRYPTOASSETS

Issued 28 April 2023

ICAEW welcomes the opportunity to respond to *Future financial services regulatory regime for cryptoassets*, published by the HM Treasury on 1 February 2023.

For questions on this response please contact ICAEW Financial Services Faculty: fsf@icaew.com quoting REP 37/23.

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KEY POINTS

1. Overall, we support the government's ambition for the UK to be home for the most open, well-regulated and technologically advanced capital markets in the world. The government's consultation is a good first step in the process for the UK to establish a proportionate, clear regulatory framework which enables firms to innovate at pace, while maintaining financial stability and clear regulatory standards. We also support the design principles as a starting point.
2. We however would emphasise caution at this point in the regulatory journey. Where the technology is still immature and the private sector is likely to see both wins and fails in respect of use cases and investment propositions, there will always be enhanced risks. As the asset class and underlying technology are developing within financial services those risks can become consequential be that from a conduct, investor loss or market stability perspective.
3. For this reason, the design of the regulatory regime should set a high bar. Not such that it is overly prohibitive to innovation and investment but that it sets clear guardrails and expectations for actors in the sector. We believe focus should be given first to those protections afforded to consumers, who have been to date, the primary market for crypto related products and services. In particular, in the activities of retail investment and retail payments.
4. Regulation, while provides for greater oversight, rule setting and enforcement, also affords legitimacy to regulated firms and the products and services they offer and, to some extent, unearned trust with consumers. By expanding the perimeter and authorising firms for crypto related activities, consumers might be justified in concluding that the perceived risks that are known about cryptoassets have been to some extent addressed or managed. We know that this is not the case. Many of the propositions are yet to demonstrate a clear business case or economics that justify current asset valuations.
5. The consultation paper references the approach to use existing frameworks which is consistent with the "same risk same regulatory outcome" design principle. We agree with this approach. However, we should be careful not to conflate "same risk" with "same activity" i.e. the risks posed by cryptoassets are not to be assumed to be the same as associated with traditional assets for a given regulated activity. Regulators should be mindful that we do not fully understand the risks associated with cryptoassets and are unlikely to for some time given the ongoing pace of change.
6. Where we are likely to see clear departure from traditional financial assets is where cryptoassets can act as both a means of payment or cash substitute and investment asset. Ecosystems within financial services could enable seamless cross over between these activities.
7. In this context the protection of customer assets and money is paramount. We therefore support a CASS and safeguarding regime that is equally robust across both payments' services and custodian and investment intermediary activities. Both regimes should provide a coherent approach to addressing the differentiated risks. This also applies in terms of the prudential regimes that underpin each group of activities.
8. It is important that this consultation is capable of teasing out any gaps in the existing framework that do not deal with the specific, unique or differentiated risks associated with cryptoassets, for example (but not limited to):
    - Varying nature of products and scope of the perimeter of regulation.
    - Territorially distributed nature of firms
    - Lack of information regarding ownership of assets
    - Implementation timeline and censure for lack of implementation

9. Given the potential harm to retail customers, further consideration should be given to circumstances that might appropriately give rise to FSCS protections, in particular for retail

payment and investment activities. We are not proposing that all circumstances that give rise to losses are covered, for example poor investment decisions. However, in instances of fraud or wind down where customer funds have been misappropriated, or where retail consumers have been mis-sold complex and unsuitable products further consideration should be given to whether compensation is appropriate.

10. We also note that the government's consultation is the first stage in developing and implementing a regulatory regime. There will also be much detail for the FCA to develop and then implement and operationalise the regime. In this respect we welcome the FCA's statement in its 2023/24 business plan that it will be investing in additional skills, to ensure that it has the technical capability to do so.
11. Our detailed comments are provided below. We have chosen to respond to the key regulatory questions within the consultation that underpin regulation in the sector as these questions are pervasive across the marketplace and information regarding the outcome of these questions would benefit all participants.

DETAILED COMMENTS

Chapter 2: Definition of cryptoassets and legislative approach

Question 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

12. There is a consensus that there should be a single definition of cryptoassets in use across all forms UK legislation and guidance. It is therefore important to ensure that there are appropriate mechanisms in place to ensure the definition within the Financial Services and Markets Bill (FSMB) can be updated or supplemented as appropriate to deal with issues identified by this consultation or other work.
13. An alternative to this would be to provide for the ability to amend subsequent regulation with a list of exclusions. We think this is important. The definition of cryptoassets as included in the proposals is broad and could lead to a scenario where any activity that is cryptographically secured falls into the perimeter. The presence of cryptography alone does not immediately translate into risk and so to take a binary approach would be in contradiction to the "same risk, same regulatory outcome" principle that underpins the proposals.
14. If the proposal is implemented, the expanded list of specified investment, that may presumably introduce a new kind of investment called 'specified cryptoassets', will need to clearly define the characteristics of cryptoassets that fall in that kind of investment and a clear indication of what is in scope and out of scope would need to be defined to enable firms to identify if they are within the perimeter of the regulations. To ensure compliance when the proposal is implemented, we suggest market participants be given sufficient clarity on different subsets of cryptoassets and to ensure they know that activities involving specified cryptoassets are regulated activities. Consequently, firms should also ensure they have the correct permissions when carrying on regulated activities. Therefore, we also suggest that the FCA's Guidance on Cryptoassets should be updated to include more than three categories of tokens.

Question 2. Do you agree with HM Treasury's proposal to leave cryptoassets outside of the definition of a "financial instrument"? If not, then please specify why.

15. Whilst HMT's proposal to expand the list of specified investments to include cryptoassets enables certain activities involving cryptoassets to be brought into the regulatory perimeter, it is important to ensure safeguards available in relation to similar activities are applied in the same manner. By leaving cryptoassets outside the definition of a financial instrument, HMT is delaying the imposition of safeguards in important areas such as market manipulation practices which are important given the nature in which such assets are already traded. If cryptoassets were to be included in the existing definition of financial instrument, such

safeguards which are already well established and understood could be applied to ensure the same regulatory outcome, with any limitations identified and excluded as necessary.

16. However, there are clear unintended consequences and limitations of transposing an existing regime onto a different asset class with distinct features and risks.

Chapter 3 Overview of the current regulatory landscape for cryptoassets

Question 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?

17. The proposal outlines a single point of registration for both MLR and FSMA which is a practical approach.
18. For those firms already MLR-registered, we consider that UK authorities should set out a clear and fair transitionary pathway for authorisation under the new FSMA-based regime. Given that FCA has previously approved and registered around only 15% of cryptoasset applications, there appears to be a need for a more comprehensive and practical explanation of the expectations of prospective applicants, many of whom will come from a largely unregulated background.
19. Developing good guidance and open lines of communication with applicants, for example, having a dedicated team to review and answer questions around applications may help facilitate the submission process, both in terms of efficiency and quality. Continued and timely general feedback on good and poor-quality applications as well as indicative guidance around areas that are consistently poorly answered would be beneficial to applicants.
20. In addition, efficiencies maybe gained by providing a “Sandbox” that sets out the ongoing reporting and control process requirements for firms seeking additional authorisation. Cryptoassets may have different data models to existing assets so a test platform may go some way to avoid a protracted submission process ensuring a high standard of submission from the outset.
21. Existing providers may need time to adapt to higher standards. HMT could also consider whether, similar to the registration route introduced for MLR purposes, there may be merit in a two-hurdle approach – introducing a lighter touch registration first, with restricted business, to give firms an opportunity to get ready and put in place required systems, controls and governance before full authorisation.
22. Furthermore, section 1E(2)(e) FSMA 2000 provides for the FCA to consider how far competition in the financial services sector is encouraging innovation. The current HMT policy objectives reinforce supporting innovative markets as a priority. However, recent suspected fraudulent activities formed part of the collapse of both Terra Luna and FTX. It is reasonable for cryptoassets to receive extra scrutiny as they are brought into the regulatory perimeter. Therefore, while the FCA has some existing data and risk understanding of MLR-registered firms, it is in our view sensible to ask this relatively small group of firms to provide the same information as all new applicants for authorisation, where it has not already been requested.
23. Finally, by way of extra support, MLR-registered firms could be prioritised and processed first. If this approach is taken, there may however be a need to review and stratify the population of potential applicants, to assess the appropriateness of prioritising certain applications. For example, giving priority to all MLR-registered firms might unfairly disadvantage potential new entrants that are not already MLR-registered but nonetheless may meet the requisite regulatory competencies and capabilities to better clear the hurdle for registration than another applicant that is MLR-registered.

Question 5. Is the delineation and interaction between the regime for fiat-backed stablecoins (phase 1) and the broader cryptoassets regime (phase 2) clear? If not, then please explain why.

24. In our view, if a phased approach to regulating cryptoassets is pursued, then this should be prioritised according to aspects of greatest potential risk of customer harm or damage to the stability and integrity of the financial system. We do not consider that areas of "greatest opportunity" as per para 1.14 should be given equivalent weighting.
25. Applying the noun stablecoin attracts the adjective “so-called” because established market risk parameters and financial services regulation conclude it is improper product labelling. From an investor protection viewpoint, the planned classification of a “fiat-backed stablecoin” can be judged to be potentially misleading. In our view, a better label congruent with established market practice and financial services regulation would be the term “fiat-collateralized cryptoassets”. For instance, in FCA-compliant financial promotions, all communications with potential investors would be required to label any so-called stablecoin backed by one or more fiat currencies as fiat-collateralized cryptoassets.

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

26. Whilst we are generally supportive of the phased approach due to the complexities presented, this will inevitably delay the implementation of an effective and complete regulatory regime. There are potential unintended consequences should this approach run contrary to achieving a level playing field in the short- to medium-term, and a risk of 'regulatory arbitrage' persisting in the interim.
27. In addition, the challenge is that the market will develop faster than the legislature which may give rise to unforeseen risks.

Chapter 4: Cryptoasset Activities

Question 7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.

28. We agree with the proposed territorial scope of the regime; it sensibly includes both those activities conducted by entities based in the UK as well as to UK ‘customers’ which limits the risk of regulatory avoidance and arbitrage. However, a clear understanding of the alignment to other jurisdictions and understanding the lack of such would need to be understood as enforcement where geographical presence may not be in the UK.
29. We would like to highlight some additional comments:
    - The basis by which the proposed territorial scope of regime appears to be broadly consistent with other comparable areas of financial services. HMT should also consider setting a clear definition of exemptions, like reverse solicitation, such that it prevents misuse and regulatory arbitrage.
    - Any of these regimes should be considered alongside other policy proposals and the impact this might have on the existing products and markets.
    - It is important for the UK to continue to work with regulators around the world to try to align international regulation where possible and limit fragmentation as competing regimes may affect the competitiveness of the UK as a place of business. This includes keeping proposals and frameworks under review as new international standards emerge.
    - In cases where HMT intends to pursue equivalence type agreement where firms in third countries can provide services in UK without needing a UK presence, HMT should set out the requirements for equivalent acceptable standards along with the documented standards for suitable cooperation mechanism.

30. In addition, there is a risk that the notion of "physical presence" (including what this represents and how it is determined) is a dated term and may not be fit for purpose for a digital and progressive regime.

Question 8. Do you agree with the list of economic activities the government is proposing to bring within the regulatory perimeter?

31. The list of economic activities provides a good illustration of the proposed scope of the regime.

32. However, some additional considerations have been highlighted below:

- Clarity on distinction between custodian/safeguarding providers versus digital wallets is a key point which needs further elaboration within the consultation. Digital wallets are an interface providing the details of your holding assets but might not be responsible for safeguarding the asset which is the custodian's responsibility.
- As digital assets can take multiple forms (for example, investment products, exchange tokens, lending products and securities), in our view HMT should provide a more detailed definition for each of the economic activities in association with different digital asset forms and define the involved actors (e.g., who is considered as a principal or an agent dealing in cryptoassets).
- We noted some other activities that should potentially be considered in terms of where the sit in regulatory perimeter as these activities are related to the retail customers and has an immediate risk of financial harms. There is an opportunity for HMT to consider the development and uptake of crypto advice and portfolio management – these activities are covered by markets in crypto regulation (MiCA) EU legislation:
  - Advising on cryptoassets
  - Portfolio management of cryptoassets
- In terms of presentation, the distinct nature of "custody" activities could be confusing if, for example, the safe custody of cryptoassets was to be also inherent in payment or investment activities.
- Our view is that there should be coherence when regulating the same asset class across different activity categories – there should not be marked differences in treatment for the same asset that is moving across activity categories. For example, if a fiat-backed stable coin can be held as both an investment asset and a means of payment then having two separate custody rule books may not work. Our view is that HMT should ensure commensurate levels of protection and arguably, at present, Safeguarding vs CASS rules do not provide for this.

33. In addition, the need for cryptoasset exchanges to comply with the relevant rules for all regulated activities, as opposed to those specified for particular activities, is an important one to ensure a holistic approach is taken to roles within the entire ecosystem including reliance and support provided by the same and different actors. Consideration should be given as to whether caveats can be made for activities that can be ring-fenced.

34. HMT has highlighted the need for segregation in traditional financial institutions and proper governance but has not, in our view, gone far enough in requiring such controls for cryptoasset activities. Not stipulating regular reporting requirements from an early stage, may give rise to poor conduct and governance issues. Whilst we recognise the ability for authorities to revisit this at a later stage, by not requiring such information from the outset of being regulated this become less likely to be provided in a comprehensive manner later. At a minimum regulatory requirements should align to those required under statutory reporting purposes.

Question 9. Do you agree with the prioritisation of cryptoasset activities for regulation in phase 2 and future phases?

35. Generally, we agree with the list of economic activities the government is proposing to bring within the regulatory perimeter, particularly where this relates to custody activities and those in relation to governance and validation, although it is not quite clear why particular activities

have been placed for consideration in future phases and this would be helpful to understand further.

36. Particularly, the following three areas:

- Exchange activities (phase 2) standout as being a candidate for inclusion into phase 1 given this would be the most likely gateway for market participants to be involved and has, to date, been the area where the biggest failures have occurred.
- Lending, borrowing and leveraging activities (phase 2) will impact a large number of cryptoassets in the marketplace and not regulating this in phase 1 has the potential to cause significant harm to the customer / market.
- Safeguarding and /or administration (custody) activities of cryptoassets other than a fiat-backed stablecoin (phase 2) – not protecting these assets at the onset has the ability to significantly impact customers and knock confidence in the nascent market.

37. Understandably, the FCA is working with limited resources and will need to naturally prioritise different areas of focus, but we would recommend consideration of the above areas for inclusion in phase 1.

Question 12. Do you agree that so-called algorithmic stablecoins and crypto backed tokens should be regulated in the same way as unbacked cryptoassets?

38. While we overall agree with this, we have highlighted some additional considerations below.

- Where stablecoins bear close resemblance to e-money, application of the E-Money Regulations (currently outside of FSMA) would be appropriate. There is a risk that the term "stablecoin" falsely confers actual or perceived stability and investor protection.
- Having labelled fiat-collateralized cryptoassets as the relative lowest risk level of cryptoassets, clear labelling is then required for so-called algorithmic stablecoins. In our view, algorithmic stablecoins are more clearly labelled as “algorithmic cryptoassets” always accompanied by a definition that explains the applied algorithm seeks to provide some degree of price volatility control; furthermore, that the degree of price volatility control is not guaranteed. All the above may seem to some readers as pedantry. Yet it is essential to provide investors with clear and not misleading labelling of complex products.
- Digital assets such as algorithmic stablecoins and stablecoins are ambiguous and providing a clear classification between the two should be considered.
- Assuming algorithmic stablecoins do not guarantee their value by reference to reserve assets, consumers would broadly be exposed to similar risks as investors who invest in other unbacked cryptoassets like Bitcoin, where price swings can be volatile. On that basis algorithmic stablecoins should be regulated in the same way as unbacked cryptoassets.

39. It is important that this approach is kept under review as the market develops and new algorithmic techniques aimed at ensuring the coin can maintain a stable value, emerge.

Chapter 7 Regulatory Outcomes for Cryptoasset Intermediation Activities

Question 21. Do you agree with HM Treasury's proposed approach to use the MiFID derived rules applying to existing regulated activities as the basis of a regime for cryptoasset intermediation activities?

40. We agree with the HMT’s proposed approach to use MiFID derived rules as the basis of a regime for cryptoasset intermediation activities.

41. We consider however that there is need to ensure any operational resilience matters are fully considered in terms of appropriateness given the role of intermediaries in the cryptoasset ecosystem.

42. The scope of the intermediation would need to be very clear as to what is in and out of scope of this area. Would for example a firm that uses stablecoin to facilitate cross-border trade or transfer of currency qualify as intermediation? These firms would not necessarily fall under the scope and this whole area appears to be missed in this chapter.
43. Furthermore, in our view, any additional rules required to manage the special characteristics of cryptoasset market intermediation, for example to address vertical integration risks, would beneficially seek to align with new MiFID rules covering crypto risk issues.

Question 22. Do you have views on the key elements of the proposed cryptoassets market intermediation regime, including prudential, conduct, operational resilience and reporting requirements?

44. We believe the key elements of the proposed cryptoassets market intermediation regime are appropriate.
45. We do however note the following:
    - There is lack of clarity within the consultation around the key risks in relation to AML and fraud and the impact this has on the customers, the market, and on the UK. We would encourage further consultation on the key regulatory requirements for cryptoasset firms to comply with regulation in this space such as the EU's 5th Anti-Money Laundering Directive (as an example).
    - There is no refence to Appointed Representatives (AR) or Introducer Appointed Representatives (IAR) and sales techniques, oversight of third parties in the distribution chain, and a requirement to understand the distribution chain in the intermediation market. All of this to ensure that customers are protected from a custody, sale, prudential, resilience (operational and financial) and governance. We would caution however that the risk and subsequent rigour applied to the assessment of these areas should not be underestimated given the potentially wide usage of such actors as the use of cryptoassets grows and becomes more mainstream, thereby increasing the potential risk of consumer detriment.

46. We would also note the following areas that the government should consider, or be aware of, as the regime develops:

47. Definition / regulatory trigger point
    - Given the proposed regulation leverages off FSMA, further clarification is required on whether staked tokens fall within scope (where a network facilitated the use of staked tokens and then rewards the staker in an effective "interest rate" in return of more tokens). Certain staking network operators could be potentially caught by Article 25 RAO of FSMA should the tokens an individual receive be deemed a security, contractually based investment, or an Article 86 or 89 investment.

48. Prudential requirements
    - Similarly, whilst prudential requirements are to be set by the FCA these will need to be clearly set out and tested to ensure appropriateness under the new regime.
    - There may be considerable volatility in the market prices of cryptoassets. The resultant asset values may therefore not be a good measure to use as a basis for setting minimum prudential requirements; or consideration will need to be given to how to factor the risk into calculating minimum standards (for example by using averages, or maximum values).
    - Certain forms of cryptoassets are more liquid than others and consideration should be made as to what capital or hedging requirements would be required to offset more or less liquid cryptoasset holdings.

- A sensible approach will have to be taken in respect of protecting client investments held on platforms and the extent to which a customer is subject to caveat emptor, and the interaction with any protection afforded by the FSCS.

49. Consumer protection and governance requirements

- The 'consumer governance and protection requirements' element indicates that trading arrangements should be transparent to clients. We would note that for trades conducted on DeFi or anonymous networks, it does not seem feasible to offer full transparency to clients regarding related parties. Furthermore, it might also be problematic where trades are carried out using stablecoins or layer 2 networks (such as lightning swaps in Bitcoin).
- Systems and controls to detect all potential forms of misconduct (market abuse, sanctions, ATF) are often weak in many cryptoasset service providers and may take some time to properly develop. Consideration will need to be given to how to transition these firms into the regime, on the presumption they can meet the requisite standard within a reasonable timeframe. For example, they could be allowed within the regime, but with restrictions on certain business until controls are sufficiently developed.
- Organisations brought into the proposed cryptoasset intermediation regime will need to comply with consumer duty requirements. This could impact every facet of crypto trading where generally such trading is seen as high risk, where individuals engaged in such trading are unlikely to have in-depth knowledge about the function of some cryptoassets, and there is an element of an allure of gambling style risk to some participants.

50. Operational Resilience requirements

- Larger intermediary firms based in the UK who have been part of the FCA's Project Innovate / Sandbox are likely to have gained some experience or understanding of the required people, processes, systems, and controls to mitigate operational resilience risks.
- As the size and complexity of potential intermediaries decreases there is an extra risk that firms will not have sufficient resources that can meet FCA requirements. This could be a barrier to competition and start-up formation. Consideration will need to be given to how to transition firms into the regime in a way that does not deter or stifle innovation while ensuring adequate protection for consumers.
- Adopting a traditionalist view of compliance monitoring and responsibility may not be appropriate when algorithmic oversight and on-chain validation of trades provides security of execution.

51. Data Reporting Requirements (MiFID 2 Related)

- Trade reporting data would potentially have to be made available to the FCA, whose trading data harvesting mechanism may not be compatible with crypto trading data or may not be able to cope with the scale of data received in terms of volume, complexity, or analysis.
- Compliance with MiFID 2 technical reporting standards may not be possible given the datasets and information available from transactions made on different networks or blockchains.
- Current FCA policy under The Data Reporting Services Regulations 2017 governing the requirements of data reporting by MiFID firms may require adaption to the data and methods of collection available to intermediaries themselves or Approved Reporting Mechanisms (ARMs) required to act for them.

- Other reporting requirements outside of MiFID 2 (e.g. PRA reporting depending on market participant size and possible SIF status) would also have to be considered given the volatility and novel nature of some cryptoasset entities.

Chapter 8 Regulatory outcomes for cryptoasset custody

Question 23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?

52. We would agree with the proposal to apply and 'adapt' existing frameworks. It is our view it would be unusual to look at custody activities for crypoassets differently.
53. We believe that many of the high-level principles and objectives of the CASS/Safeguarding requirements would be applicable to cryptoasset custody activities.
54. HMT should establish however whether there are any differentiators to cryptoassets to those financial products that have gone before, to establish if crypoassets naturally fit into Article 40 of the RAO, and importantly to determine what the appropriate adaptations to the existing frameworks might be.
55. Some classes of cryptoassets may be by nature generally more speculative and volatile. In contrast, CASS is a long-standing (pre-digital era) set of requirements that may not be fit for purpose for cryptoassets (e.g. daily reconciliations).
56. Certain stablecoins will fall under the EMR 2011 and therefore presumably under the safeguarding requirements, rather than the CASS requirements. It will be important there is effective delineation of the different cryptocurrencies by their risks, to ensure they are subject to the appropriate safeguarding or CASS requirements.

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

57. We agree that the highlighted elements are appropriate to the proposed regime.
58. There is however no indication of AML, financial crime, or ITGC within the elements of the regime. These are important issues that will need to be considered somewhere within the regime.
59. For the custody principle to work (based on other financial assets that are safe custodied in the UK), amendments to insolvency law are needed to enable the recovery of and/or the safeguarding of cryptoassets to return in full, or part, to the owner of these assets. We understand that this legal challenge remains unresolved and should be a priority to then enable prudential, conduct and operational resilience regulatory elements to work in practice.
60. Robust and proportionate regulatory standards must be in place to enable such assets to be returned in the event of an insolvency, to demonstrate the principle of custody works and affords the customer's protection.
61. There is also an argument that the regulation of cryptoassets needs to be better integrated than the regulation of traditional financial services. For traditional financial services trading, clearing, settlement and custody are carried out by different providers with distinct business models. This is not the case with cryptoassets. Cryptoexchanges frequently operate also as custodian combining trading, settlement, and custody under one roof. This may need to be reflected in the regulation. Focusing on trading, settlement and custody in isolation may lead to over as well as under regulation.
62. There should be further caution about writing forward traditional custody arrangements. These evolved against the background of physical paper documents that were stored in national depositaries. Cross-border arrangements are, for example, made through outsourcing. This led to the emergence of custody chains and requirements for the reconciliation across these chains. Custody chains can make it difficult for investors to exercise rights against issuers.

63. We would also note the following issues of relevance for the government or the FCA to consider or be aware of as the regime is developed further.

64. Custody / safeguarding / client assets (CASS)

- We presume the intent is to implement CASS/Safeguarding equivalent rules for the custody of cryptoassets. New and existing custodians will need sufficient time to adapt their risk and governance frameworks, processes, and controls to meet the higher bar of custody requirements under either the Safeguarding or CASS regime in the UK. Establishing an effective transition approach to firms wishing to enter the regime will therefore be necessary. The consultation (first sub-bullet-point) refers to "restricting" the commingling of investors' and the firm's own assets. We believe this should refer to "preventing" or "prohibiting" commingling due to the risks of a lack of delineation. The final regime may also benefit from bespoke requirements around collateralisation, similar to the CASS treatment of client money requirements.
- The existing custody regime includes record-keeping and reconciliation requirements that may not easily transpose for certain classes of cryptoassets, including across decentralised structures. The notion of 'legal title' may also be practically difficult to implement and enforce. Safeguarding and CASS should enable the return of assets promptly and as whole as possible. Consideration will need to be given whether and how to adapt the current regimes where cryptoassets ownership is not known due to the nature of the cryptoasset or underlying design of the product; and how to safeguard safeguarding investor rights, if the investor is not known. This point is also a matter directly linked to the challenges in KYC – take on AML and financial crime risk.
- The collapse of FTX has arguably shown that the terms associated with wallets are not necessarily well understood by services users. The rights of an investor depend on the extent to which they have access to the private key associated with their assets. If the private key is held by the wallet provider and the investor has no right to access it, then the arrangement arguably is contractual rather than custodial. Any regulatory framework needs to consider that there is a substantial variation amongst wallet terms.
- Traditional custody arrangements operate around paper documents and central databases. Cryptoassets are accessed through private keys, which can be duplicated. The ‘custody’ of such keys requires different safeguards than the custody of traditional assets. These will need to be developed by reference to the characteristics of cryptoassets rather than carried over from the traditional financial space.
- With regulated products, the risk to UK market stability and the loss of customers’ assets, we would expect there to be assurance provided by regulated firms and custodians, to the UK regulators for and on behalf of the customers. We see such third-party independent assurance for both CASS and Safeguarding in the UK. To provide confidence in the market is there an expectation that firms would undertake an annual audit or assurance requirement? If this assurance is given, will a specific assurance standard be introduced, or existing standards modified to accommodate these new requirements for the varying nature of crypto market?
- The current CASS rules classify firms by size of custody assets (see CASS 1A.2 - Small (less than £10m), Medium (an amount equal to or greater than £10m and less than or equal to £100 billion) or Large (more than £100 billion). Payment services firms are also classified based upon number of transactions. Consideration will need to be given to similarly categorising firms by reference to size or risk, for the purpose of implementing rules in a proportionate manner.
- Linked to the firm size are the reporting requirements to the FCA under SUP 16, in particular SUP 16.14 (Client money and asset return). We assume cryptoasset custodians will report to the FCA to enable the regulator to monitor the risks being run and that these are being managed affectively; and think that the current SUP rules would be a relevant basis for cryptoasset firms to adopt once authorised. The reporting framework should also include change in control, change in operating model, change in approach to protection of assets, material breach. Given the magnitude of cryptoassets

traded and held in the market, and how these may grow and evolve, consideration will need to be given to the appropriate frequency of reporting.

65. Consumer protection and governance arrangements

- Other regulated firms have seen the implementation of the Senior Manager and Certification Regime. Consideration will need to be given to the appropriate allocation of responsibility and accountability for the custody and safeguarding of cryptoassets.

66. Operational resilience requirements

- Custody arrangements can be delegated to other firms either via outsourced arrangements or Model B arrangements in the market. Within the custody asset space, taking PSR and Electronic Money Institution as an example, there are examples where the flow of funds and custody requirements are outsourced. We can expect this will also be the case with custody arrangements for cryptoassets.
- SYSC 8 provides requirements for the regulated firm to retain the responsibility for compliance with custody arrangements even where those arrangements have been outsourced. Consideration should be given to whether and how SYSC 8 and other associated regulations could be factored into the cryptoasset regulations. In particular, where they might help determine the operating model arrangements and provide certainty as to where regulatory responsibilities lie.

67. Resolution and insolvency

- There are existing resolution principles and capabilities detailed within the FCA's CASS 10 (CASS resolution pack) rules where firms that custody customer assets demonstrate the governance, oversight and monitoring of the custody arrangements to assist with the orderly wind down and timely return of assets. Consideration will however need to be given to whether the TR22/1 and Wind down planning guide is used in the interim prior to full regulation.

68. Location requirements

- We recognise that cryptoasset arrangements can be international in nature. While custody arrangements and UK regulations may be recognisable under one set of regulations in the UK (e.g. CASS/Safeguarding) how does the government plan determine the international protection of assets where other jurisdictions have different regulatory rules and arrangements?