ICAEW
REPRESENTATION 15/24

DP 23/4: REGULATING CRYPTOASSETS PHASE 1: STABLECOINS

Issued 5 February 2024

ICAEW welcomes the opportunity to comment on the Financial Conduct Authority's consultation on regulating stablecoins, published on 6 November. A copy of which is available from this link: DP23/4: Regulating cryptoassets Phase 1: Stablecoins | FCA

If you have any questions or would like to follow-up on any matter raised in this consultation response, please contact the ICAEW's Financial Services Faculty: fsf@icaew.com

Our main points are that:

- there should be a clear understanding of the purpose for the regulated stablecoins to ensure the appropriate regime can be developed;
- the regulated stablecoin regime should seek to leverage existing FCA regimes to ensure the overall regulatory framework is coherent - consistent with the "same risk same regulation" philosophy. There are, however, new and unique risks with stablecoins that will require new bespoke regulatory approaches;
- the FCA and Bank of England regimes should provide for a coherent UK approach to stablecoins, with a clear understanding when the different regimes apply and how to transition between them;
- audit or assurance, as with the CASS regime, will be a key tool to assess firm compliance and promote trust in the use of regulated stablecoins. There are, however, a number of new challenges with auditing stablecoins and further discussions are needed between the FCA and the audit profession to establish how an audit can be conducted effectively and meet the FCA's needs; and
- there may be tax and financial reporting issues that need considering.

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KEY POINTS

DETAILED COMMENTS

1. We welcome the publication of the Financial Conduct Authority's (FCA's) Discussion Paper (DP23/4): *Regulating cryptoassets phase 1: Stablecoins*; and the opportunity to comment. It is important that the risks associated with the new cryptoassets are well understood and any regulatory regime deals appropriately with those risks to minimise harm to UK consumers and disruption to UK markets, while not unduly impeding innovation and the potential efficiencies and benefits that brings.
2. In this section of our response, we set out our key overarching themes. In the next section we provide detailed responses to selected questions. We have typically answered those questions that are of relevance to our members (eg, that relate to audit and assurance) or where we and our members have relevant experience and knowledge (eg, as Client Asset Sourcebook (CASS) auditors our members have extensive experience and knowledge of custodial and safeguarding arrangements).
3. Our response should also be considered alongside the response we have provided to the Bank of England (the Bank) and its related discussion paper on regulating systemic payment systems using stablecoins.

Purpose of regulating stablecoins

4. There should be clarity of use for regulated stablecoins. This would enable the appropriate regulatory protections to be determined and help to clarify the boundaries between regulated and unregulated stablecoins.
5. In its October 2023 update, the government stated, "*it is the government's intention to facilitate and regulate the use of fiat-backed stablecoins in UK payment chains*". The FCA's discussion paper, however, seems to consider payments as one possible use of a regulated stablecoin (eg, see definition of regulated stablecoin in the table within paragraph 1.6).
6. It is important that that there is clarity of purpose to ensure the relevant harms and benefits can be identified and the appropriate regulatory regime be developed. For example, payment is a core function of the financial system and might require more stringent measures than would be applied to stablecoins used for other purposes (eg, to provide collateral), to ensure there is no loss of confidence in UK payments.
7. Clarity of purpose also helps potential issuers of stablecoins and others in the stablecoin ecosystem better understand whether they need regulatory approval and the effects of regulation on different business models.
8. Consideration should, however, be given to making the regulations flexible so that they can adapt or be modified in time to accommodate different purposes.

Business model of stablecoin issuers

9. For a regulated stablecoin to be a success it needs to be commercially viable. At present there is a concern that the proposals of the two regulators do not provide for a viable commercial business model for stablecoins in the UK, and as such the implementation of regulated stablecoins may fail to happen.
10. For example, the FCA Discussion Paper (DP) assumes a single remuneration model for issuers, that is based on returns from backing assets. This is a different business model to the Bank's proposed regime for the use of stablecoins in systemic payment systems.
11. As the FCA's regime is developed, consideration should be given to ensuring the proposals are commercially viable, which might include considering whether alternative or different

service charging business models might emerge (eg, charging for transactions, where interest on backing assets is returned to the customer either in full or partially). Consideration should also be given to how the regime may be constructed to allow flexibility to accommodate future developments.

Development of FCA regulatory framework

A new Stablecoin regime and leveraging existing FCA regimes

12. We believe that the existing FCA regimes can provide a good foundation for a stablecoin regime or aspects of the regime (eg, CASS for the safeguarding and custodian elements of regulated stablecoins, or Senior Management Arrangements, Systems and Controls (SYSC) for the organisational requirements).
13. We would, however, caution that regulated stablecoins will introduce new risks, some of which may be significant, and that may not be dealt with adequately by the existing regimes. So, while it may be appropriate to leverage the existing regimes, it is likely they will need to be adapted or modified, potentially significantly so. For example, the regime will need to deal with:
    - the nature and challenges associated with the use of new technology such as: blockchain, including the adequacy of governance and controls; the operation of wallets, private keys and new custodial arrangements; the operation of on and off chain records; and the interoperability of blockchains;
    - ensuring there is clarity on the regulatory perimeter of what exactly is a custodian of a regulated stablecoin as opposed to software;
    - defining or clarifying what constitutes internal books and records in the context of distributed ledger technology, and how external reconciliations can be carried out; and
    - the implications of real time transactions and enhanced speed of processing on, for example, reconciliations, finality of settlement, and the accuracy of books and records (where under CASS the focus is end-of day).
14. We also believe that any regime needs to be ‘future proofed’ – that is, it will need to be capable of adapting to accommodate evolving and potentially innovative and rapidly moving changes in the stablecoin space; and potentially to deal with other cryptoasset or digital asset activities.

Inter-jurisdictional challenges

15. We note below the perceived issues with the interaction of the FCA and PRA’s regimes. We would also note there may be challenges for stablecoin firms operating in different jurisdictions and therefore dealing with multiple legal and regulatory frameworks. We appreciate the FCA’s approach needs to, rightly, manage risks to the UK, but would highlight that consideration of and coordination with other jurisdictional approaches may be helpful to promote interoperability, and develop a more efficient global approach.

Audit of regulated stablecoins

Audit requirements for stablecoin issuers

16. Paragraph 3.33 contemplates asking for an annual audit like that within the CASS regime. We would suggest that the FCA should include a separate annual audit requirement to promote trust in stablecoins. Arguments for an annual audit requirement include that:
    - An audit will provide greater confidence in the effective operation of controls or governance, or the appropriate valuation of assets.

- While not an equivalent measure to Financial Services Compensation Scheme (FSCS) coverage, to the extent that FSCS coverage is not available for aspects of the stablecoin regime, then more robust assessment of firm compliance with the rules may be required.
- The ability to draw upon the expertise of third-party assurance providers, that have existing experience in assuring cryptoassets.

17. We would also suggest drawing on the approach taken for money market funds when considering what regulatory audit requirements may be required for the backing assets.

Audit requirements for the custody of cryptoassets

18. Regulated stablecoins have some new, important and very different features when compared to existing financial products. The most significant difference is the custodial arrangement for a consumer's holding of stablecoins (eg, the operation of wallets and the holding of private keys to access wallets) as noted in paragraph 5.7. The technology associated with these custodial arrangements is new, and there is no precedent for auditing these arrangements within the existing FCA regimes.
19. We agree with the statement in 5.46 that further work will be required to determine how an audit of the custodial arrangements would work, as the existing audit approach within CASS may not be capable of a simple 'lift and drop'.
20. For new audit requirements to be effective the following points will require further consideration and / or development:
    - a clear scope for the audit. Unlike CASS, the audit may need to go beyond whether a firm maintains systems and controls to enable compliance in the period, and whether the firm was in compliance with the rules at period end;
    - a clear understanding of the nature of the audit opinion required;
    - a clear basis of preparation against which to audit (for example, how should the auditor assess whether the matter being audited meets the FCA's requisite standard); and
    - an audit framework and / or standard which governs the audit approach (similar to the FRC's Client Asset Assurance standard for CASS audits). This is needed to set clear expectations for the conduct and standard of the audit (eg, given the advanced technology involved, ensuring that auditors have the required competence and skillset, and determining what audit evidence is sufficient and appropriate in a virtual crypto-world), and to promote a consistent approach across audits.
21. In the absence of clarity around these points, we would draw a parallel with the Safeguarding regime, where a separate audit standard and detailed rules do not exist, and which affects the maturity and robustness of the audit regime.

Audit of backing assets

22. Paragraph 4.5 indicates stablecoin issuers might need to disclose and therefore obtain evidence that is '*the most recent independent audit of the composition and value and safeguarding arrangements …*". We would appreciate further clarity on what is proposed by this paragraph. However, consideration of the points in paragraph 20 would also be relevant to determining the nature of this audit requirement.

ICAEW audit support to the FCA

23. The audit of stablecoins (and cryptoassets more broadly) can be a complicated and challenging matter, in no small part due to the infancy and complexity of the technology.

24. We note that paragraph 5.46 refers to the FCA engaging in discussion with auditors. ICAEW, as a world leading body that supports auditors and promotes audit quality, is ready to engage when the FCA wishes to do so, and we would be happy to coordinate and facilitate any discussions between the FCA and our members to provide further help to establish a workable audit framework. Specifically, we have a working party that has legal and audit expertise in the area of custody that might provide a forum for discussions, and that already engages with the FCA on CASS audits.

Interaction with the Bank of England regulatory regime

25. The Bank is developing a regulatory regime for systemic payment systems using stablecoins. We believe the FCA and Bank regimes should be coherent and that there should not be an unduly significant difference (ie, significant step change or cliff edge effect) between the requirements for a systemic and non-systemic regulated stablecoin. There should also be clarity of the assessment process to determine a systemic payment system using stablecoins and the various steps that firms would need to undertake to move between the two regimes.
26. The existence of a significant step change between the two regimes, or a lack of clarity about the transition, could pose a significant barrier to firms moving between the two regimes, which may have detrimental competitive effects, deter innovation, or impose unnecessary costs.
27. The Bank's proposals are somewhat predicated on being able to identify what might be systemic at inception and that only Sterling stablecoins would be used in a systemic payment system. While these seem reasonable assumptions, we would caution that the stablecoin market is still very embryonic, and that the authorities should ensure flexibility in their proposals to cater for a range of eventualities. For example, while an FCA regulated stablecoin issuer might not intend to establish a systemic stablecoin, it is possible that changes in the market and end-users' actions (ie, outside of the control of the issuer), might result in a stablecoin becoming systemic.
28. At the moment there seems to be a significant step change for firms that provide Sterling based Stablecoins. An FCA regulated stablecoin that is subsequently determined to be part of a systemic payment system would need to replace all its backing assets with Bank of England reserves on which no interest is earned. This could radically affect a stablecoin issuer's business model, potentially making it unviable if the firm's primary income stream is the interest on the backing assets.
29. We have responded to the Bank's related discussion paper, and would also refer you to our comments therein, as there may be read across to the issues raised in this discussion paper.

Tax considerations

30. The tax implications of disposing of stablecoins are often overlooked or misunderstood. Under the current tax rules, as illustrated below, making payments using stablecoins will give rise to a taxable event.
31. Whilst it is for HMRC to determine the tax treatment of stablecoins, the FCA might need to consider whether the tax treatment has any implications on the creation of a regulated stablecoin regime. For example, whether the FCA should require the issuer to highlight in disclosures to holders that there may be tax implications when transacting in stablecoins. Specific consideration may be required as there is a likely expectation that they are treated as cash for tax purposes which might not be the case.
32. While currently there is no specific HMRC guidance, the FCA should consider consulting HMRC to better understand the tax treatment and implications, including if specific tax guidance on the use of stablecoins should be published in HMRC's cryptoassets manual.

Current tax treatment of stablecoins

33. HMRC's current position is that cryptoassets (including stablecoins) are not cash, money or currency. As stablecoins are not treated as "currency" for tax purposes, any exemptions for currency do not apply. For example, this would mean that disposals of stablecoins would be within the scope of (typically capital gains tax for UK resident individuals) reporting requirements and any gains would be chargeable and losses allowable. Note that "disposal" is a broad term which includes using stablecoins in exchange for goods and services. This means that reporting obligations could arise if stablecoins are used for day-to-day purposes. Despite the fact that a tax change could arise, it is likely that the general public would assume such transactions to be the same as using sterling cash, such that no tax obligations would arise. On the assumption that any sterling based stablecoins retain parity with pounds sterling the risk of a tax charge arising is small (though, as noted) reporting may still be required).
34. However, for non-sterling stablecoins, there is a significant risk that the use of these could give rise to a tax charge as it is common for foreign currency to fluctuate against sterling, giving rise to gains (or losses) due to exchange rate movements. Exemptions from tax that apply to foreign currency cannot apply, including the exemptions for foreign currency bank accounts and for foreign currency acquired for personal use abroad (but not in the UK).
35. The tax reporting position and potential for chargeable gains and allowable losses to arise could have significant impact on individuals. This includes any individual employees who are paid in stablecoins. Where this is the case, the value of stablecoins received as payment for services would be subject to income tax at the time of receipt. There will then be a further disposal (and consequent tax reporting obligations) arising on the disposal of any stablecoins, potentially leading to further tax being payable (particularly if non-sterling stablecoins are involved, due to currency fluctuations. For businesses, using non-sterling backed stablecoins may increase complexity if goods and services frequently need to be repriced due to foreign exchange movements.

Accounting and financial reporting for stablecoins

36. The stablecoin accounting requirements might need considering for entities in the regulated stablecoin ecosystem and that hold regulated stablecoins. The issue may be particularly relevant when considering the prudential requirements for regulated stablecoin issuers, and how to determine their appropriate capital and liquidity requirements, if the issuer's financial statements are the starting point for any assessment.
37. The relevant accounting standards and treatment may change with time, while the final contractual arrangements of the regulated stablecoin will also affect the accounting treatment, but stablecoins currently in existence are classified as either intangible assets or financial instruments under International Financial Reporting Standards and UK GAAP. This leads to differences in how they measured and how potential gains and losses are recognised in the financial statements (eg, intangible assets are carried at cost, while financial instruments are carried at fair value). In particular, it is unclear whether any existing stablecoins could meet the definition of cash or cash equivalents on the face of the balance sheet.
38. We have provided a fuller description of the accounting and financial reporting matters in our response to the Bank's related consultation.

ANSWERS TO SPECIFIC QUESTIONS

Chapter 2: A new stablecoin regime

Q1: Should the proposed regime differentiate between issuers of regulated stablecoins used for wholesale purposes and those used for retail purposes? If so, please explain how.

39. In the round we think there is merit in exploring further whether the different purposes for stablecoins (eg, retail v wholesale uses; or as a means of payment, provision of collateral, or credit creation) or the different levels of sophistication of issuers, might warrant different approaches. This is to ensure a proportionate approach to the risks and benefits particular to the purpose of the issued stablecoins; but also to ensure the maximum benefits can be realised. With current regulation, retail customers typically require stronger protections due to informational asymmetries and their limited influence. The risk, however, is that those protections applied to a wholesale regime may discourage or distort the development of an effective wholesale stablecoin and so limit the benefits that might otherwise be obtained.
40. The flip side is that absent certainty of any growth in the usage of the different stablecoins, it may not be cost effective to develop different approaches (for example most current stablecoins are not sterling denominated).
41. The use of stablecoins as a means of payment goes to the core of the financial system which, when coupled with the risk of contagion between wholesale and retail stablecoins, suggests they should be both be subject to a high level of regulation. That does not, however, imply that the proposed regime should not differentiate between different issuers.
42. There might also be practical reasons to differentiate between different purposes. For example, it seems likely that wholesale volumes could be higher for both individual transactions and at the aggregate level of issued stablecoins. This may have implications for concentration in backing assets and/or the availability of backing assets if stablecoins issued for retail and wholesale purposes are subject to the same asset eligibility requirements and these requirements place a tight limit the type of eligible assets. If the market cannot accommodate the aggregate demand there is a constraint on the use and growth of the regulated stablecoins, which may also undermine confidence in their usage (though it might also be helpful in constraining any uncontrolled growth). In this situation, differentiating between retail and wholesale may provide some scope to remove market frictions.

Q2: Do you agree with our assessment of the type of costs (both direct and indirect) which may materialise as a result of our proposed regime? Are there other types of costs we should consider?

43. The analysis seems to be focused on the costs of the stablecoin firm. We wonder whether there are costs and benefits associated with the impact of stablecoin on other forms of money (eg, commercial bank money), that should also be considered. While for an individual FCA regulated issuer, this may be immaterial as by definition they are not systemic, they may be more significant as a result of the impact of the FCA regulated sector as a whole.

Q3: Do you agree with our assessment above, and throughout this DP, that benefits, including cheaper settlement of payment transactions, reduced consumer harm, reduced uncertainty, increased competition, could materialise from regulating fiat-backed stablecoins as a means of payment? Are there other benefits which we have not identified?

44. As the DP notes there are costs and benefits that could arise from the introduction of regulated fiat backed stablecoins, and it is important they are all teased out and understood. For example, stablecoins can enable instantaneous settlement of the “payment” leg. When coupled with a programmable feature in a smart contract with a tokenised asset it can ensure

both legs to a transaction either settle or fail, thereby reducing the credit risk faced by the participants to the transaction. On, the other hand, instant settlement increases the risk that fraudulent or erroneous payments cannot be stopped and retrieved.

45. Finally, we would also note a comment in our previous representation to HM Treasury on a regulatory regime for cryptoassets (ICAEW representation 37-23): that there is a risk that regulation affords legitimacy to firms and their products and services, and which may not have been earned. In this respect regulation needs to both provide the appropriate protections and be enforced.

Chapter 3: Backing assets and redemption

Q4: Do you agree with our proposed approach to regulating stablecoin backing assets? In particular do you agree with limiting acceptable backing assets to government treasury debt instruments (with maturities of one year or less) and short-term cash deposits? If not, why not? Do you envision significant costs from the proposal? If so, please explain.

Stablecoin backing assets

46. In the first instance this has the advantage of strong and simple (to steal a PRA term), while the use and experience of stablecoins evolves. As experience increases and there is further development in risk management capabilities, there may be an argument to relax the requirements in some situations and implement a multi-tier regime. Recognising this as a possible outcome may encourage greater take-up, as otherwise there is a risk that 'strong' also acts as a disincentive to invest and innovate.

47. There are, however, risks with the proposed approach which may require further consideration.

- The obvious risk is that the pool of eligible assets might be too concentrated. If all stablecoins are exposed to the same risks, the stablecoin market as a whole may not survive a single disruption. There may be some advantage therefore to exploring the risks and benefits from expanding the range of backing assets to instruments with a small increase in risk – for example non-UK short-term government debt (eg, US Treasuries – though they would introduce currency risk), longer-term UK government debt, Certificates of Deposit and liquid funds. The increased risk could be managed by limiting the holdings of any higher risk assets, higher prudential requirements, or it could be seen as a trade-off with reduced concentration risk. This may also enhance the yield available to the stablecoin issuer which may facilitate future capital investment for innovation and improve the attractiveness of the proposition.
- The DP recognises that the stablecoin need not be denominated in UK sterling. The DP does not seem to propose any restriction beyond the backing assets being short term government treasury debt and cash deposits. For some non-Sterling currencies, we think that there may still be a significant and unacceptable risk, including volatility in prices. We would suggest the FCA consider, at least in the first instance until further experience is gained, restricting non-UK stablecoins to currencies that exhibit the same characteristics as Sterling. The FCA could specify a set of acceptable fiat currencies or, as part of any application and ongoing monitoring, the stablecoin issuer could be required to demonstrate the appropriateness of the backing fiat currency's characteristics.
- Permitting short term cash deposits seems to allow for fixed one year term deposits, which may introduce a liquidity risk as term deposits are not necessarily tradable like government bonds.

- There might be no incentive to hold on-demand cash deposits on the presumption that the return is not sufficient to compensate the issuer. The regime may need to specifically set a requirement that cash-deposits or a proportion of cash-deposits are on demand.

48. We note that paragraph 3.5 refers to '*a reserve of backing assets equivalent in value to the circulating supply of the regulated stablecoin'.* We recognise that the detail of the proposals will need to be further developed but would highlight the need to ensure clarity around regulatory expectations or to use specific measures if possible. For example, we often see cases where the term "pegged at 1:1 ratio to US dollar" is used, or a 'circulating supply' might not be interpreted to include those stablecoins that the issuer holds. A '1:1 ratio' is also a metric that is used to assess how well a stablecoin is performing in the market, with some coins falling behind this ratio during periods of distress.

Costs from the proposal

49. There may be both direct and indirect costs associated with the proposal. Direct costs may include changes to business models, compliance, and training. Indirect costs could come in the form of reduced competition if smaller firms find the requirements too costly or lack the opportunity cost from utilizing a different asset class that they can earn revenue from.

Q5: Do you consider that a regulated issuer's backing assets should only be held in the same currency as the denomination of the underlying regulated stablecoin, or are there benefits to allowing partial backing in another currency? What risks may be presented in both business as usual or firm failure scenarios if multiple currencies are used?

50. In principle and as a starting point this seems reasonable. If the backing assets are denominated in a different currency, the stablecoin issuer will be subject to additional exchange rate risks (affecting the valuation of backing assets) and increased operational complexity (additional processes to manage multi-currencies), that it will need to manage. This increases the risk that the stablecoin peg breaks, so undermining confidence in the stablecoin. It is also possible that permitting a different currency may encourage trading in the backing assets based on price and exchange rate differentials, which would also introduce greater risk.
51. A key risk in a firm failure scenario might be the location of the non-sterling backing asset, and whether being located outside the UK could increase the time taken to redeem the asset or otherwise add friction to the redemption process.
52. However, it is also possible that part of the risk of using other currencies may be controlled and mitigated by placing restrictions around which foreign denominations can be used (so for example those that trade in a narrow band relative to Sterling), and as set out in the response to Q4 there may be some benefits to permitting some assets in other currencies.
53. Finally, we note paragraph 3.1 refers to '*maintain their value relative to their reference …currencies*'. We were unclear whether this indicated one type of stablecoin could also be measured against an index being a basket of currencies. If so, this introduces greater complexity.

Q6: Do you agree that regulated stablecoin issuers should be able to retain, for their own benefit, the revenue derived from interest and returns from the backing assets. If not, why not?

54. As the consultation paper notes, the retention of interest and returns is the current business model of stablecoin issuers. It seems this has the simplicity of avoiding the need to create a

charging mechanism for transactions in stablecoins, which would be another business model; and has the advantage of allowing a smoother transition into the scheme for existing issuers. The approach does however introduce a conflict of interest and whether the management of backing assets is to support a stable value for the stablecoin or is used to generate returns for the issuer (on the presumption that higher returns are typically achieved where there is greater volatility in asset values – ie, higher risk assets). Constraints around the nature of backing assets as proposed should however help manage this risk.

55. A further issue, however, is the purpose for which the regulated stablecoins are issued. Where the regulated stablecoins are held primarily as money as a means of making more efficient payments, then individuals are not necessarily holding stablecoins with the aim of making a return on the holding. In this case the returns are used to cover the costs of creating the stablecoins and to provide the issuer with a profit. There is a possible analogy to draw with the holding of, and payments from, interest free current accounts in the banking sector.

56. But there may be a need to consider whether alternate business models could evolve over time and how they might be brought within the regime. It is possible that certain business models may evolve where it would be fairer for the interest and returns to be paid to the holders - for example, charging for transactions might be fairer as it does not include a potential subsidy from low frequency to high frequency users.

57. There should also be consideration of how the FCA's regime aligns with the Bank's regime for a systemic payment system using stablecoins, and how firms may transition between the two regimes. At present, the Bank proposes backing assets are central bank reserves that do not pay interest – ie, its regime is predicated on a different business model to the FCA's regime. This immediately means there is potentially a significant step change between the two regimes and that may be a barrier to moving between them. Practically, this might mean that a systemic regulated stablecoin is not a viable proposition.

58. Under the Consumer Duty there may be a need for firms to advise consumers if they are maintaining significant stablecoin balances on which no interest is earned.

Q7: Do you agree with how the CASS regime could be applied and adapted for safeguarding regulated stablecoin backing assets? If not, why not?

Application of the CASS regime

59. We think that the CASS regime provides a good foundation for the regulated stablecoin regime, as firms holding client money and/or assets are subject to similar risks as firms safeguarding regulated stablecoin backing assets.

60. If the regulated stablecoin's backing assets are limited to short-term cash deposits and government debt, it should not be difficult for the existing CASS regime to be applied to them. These are existing traditional finance investments that are already within the remit of the CASS regime. Application of the CASS regime would also avoid any regulatory divergence that may require future adjustment or correction, as has happened with the Payment Services/E-Money Regulation.

61. We agree that the regulated stablecoin backing assets should be segregated and held in a statutory trust, with the stablecoin issuer's customers standing as beneficiaries.

62. An issuer should be required to keep records so that it can distinguish the total amount of backing assets it should be holding for each stablecoin class or type and, maintain records so that they are accurate at all times regarding the activity relating to the backing assets. This will facilitate a prompt distribution of backing assets if a firm fails.

63. We note that the discussion paper proposes a par redemption rate, and so requiring issuers to either add or deduct assets from the pool in line with the coin-asset value ratio appears reasonable.

64. In our view regulated stablecoin issuers should be required to appoint a CASS oversight officer to be responsible for supervising the assets and should be required to appoint an external auditor to carry out an annual audit of their compliance. Additionally, all regulated stablecoin issuers should be required to report information on their regulated stablecoin backing asset holdings to the FCA regularly.

Are there any additional controls that need to be considered?

65. The discussion paper has outlined controls on (a) daily valuation of backing assets, (b) internal/external reconciliations and (c) addressing shortfall/excess discrepancies. We would also suggest the following controls are considered:

- prudent segregation type controls, where a firm tops-up the backing assets pool if it is prudent to do so, to prevent a shortfall for specific anticipated risks to account for potential volatility in a stablecoin environment;
- internal and external reconciliations on at least a daily basis with a uniform cut-off time, to ensure that the value of assets and issued stablecoins correspond;
- the firm's data warehouse should backup ledger information on a per hour basis (eg, every 3 hours) to prevent significant data loss in case of platform crash, as well as at the end of day; and
- for reconciliation purposes, it is crucial that firms are clear as to their ledger valuation time – as stablecoins might be traded in different time zones. Firms could be required to value the backing assets on a daily basis, or more often if necessary to maintain equivalence, and that the amount held is adjusted accordingly each day to provide a more stable value for consumers; and
- generally, the controls required by FCA regimes to ensure operational continuity and resiliency of firms.

66. Paragraphs 3.24 and 3.25 discuss reconciling against the blockchain and requiring "*firms to have a means of validating whether the blockchain(s) or other distributed ledger accurately reflects the expected number of regulated stablecoins in issuance*". We think there needs to be further clarity or discussions on how firms would achieve this. Some particular and important issues are where there are multiple stablecoin issuances (by the same issuer) on different blockchains. In addition, firms will also need to consider the practical elements of reconciliations on a blockchain, such as ensuring that their internal systems can interact with the blockchain at an adequate level of detail. Overall, firms will need to have good blockchain governance and controls.

67. We think there will also need to be further discussions with auditors to clarify the FCA expectations for an audit of blockchain reconciliations, and what levels of assurance can reasonably be provided.

Backing regulated stablecoins that the firm mints and owns

68. Paragraphs 3.18 and 3.19 suggest that regulated stablecoin issuers should ensure any coins they mint and hold should also be backed.

69. We believe that if the stablecoin issuer holds its own minted coins, its acquisition should follow the same issuance process as that with any other holder. We agree that any coins minted and held by the firm as their own should be backed in the same way as any other issued coins (ie, with equivalent backing assets, regardless of coin ownership) to

continuously preserve the stable value of the regulated stablecoin. We also do not think that it is necessary to maintain the backing assets in separate accounts (ie, one account for stablecoins held by the issuer and a separate account for other holders), to preserve the consistency of treatment.

70. The risk is greater when issuer-owned stablecoins are unbacked due to their fungible nature. The operational and legal challenges are greater when maintaining separate unbacked and backed regulated coins, risking cross-contamination and dilution in value of all stablecoins in circulation.

71. For the avoidance of doubt, however, we think that the separation of backing assets would be appropriate where they are backing different types of stablecoins.

Q8: We have outlined two models that we are aware of for how the backing assets of a regulated stablecoin are safeguarded. Please could you explain your thoughts on the following:

Should regulated stablecoin issuers be required to appoint an independent custodian to safeguard backing assets? And what are the benefits and risks of this model?

72. For the reasons set out in the DP, our view is that regulated stablecoin issuers should be required to appoint independent custodians to safeguard backing assets, which we think should also be an FCA regulated entity with appropriate permissions. This should help create a regulatory framework that provides credibility and trust for professional counterparties as well as retail clients.

73. We believe the main benefit of this model is an extra layer of protection for clients because of the independence of the custodian, provided that suitable due diligence has been carried out (both initially and on an annual basis), as is currently required by CASS 6.3.2AR, and the issuer has concluded it is a suitable institution to hold the backing assets, particularly with regards to credit risk.

74. We think this approach would be of particular benefit to smaller or newer firms that issue regulated stablecoins, as they may not have their own internal appropriate safeguarding measures.

75. Independent custodians can help mitigate the risks associated with fraud or misappropriation of assets and help ensure compliance with regulatory standards, which can enhance market confidence in the stability and reliability of the stablecoin, which is crucial for broader adoption and market stability. Custodians also have expertise in asset management and will be able to ensure that the backing assets are managed effectively and efficiently.

76. Applying CASS 6.3.4AR, the issuer would also be required to have an agreement in place with the third-party custodian or independent institution, setting out the terms and conditions and responsibilities of each party. The agreement would also need to make it clear that assets are being held in such a way. Specifically, it will be important to provide clarity on which party bears responsibility for ensuring the appropriate value of backing assets is always held, and to provide clarity on whether the issuer or the independent custodian will address discrepancies (removing excesses or topping-up shortfalls) noted during the reconciliation process.

77. Under the above, the independent custodian would be responsible for carrying out reconciliations of the assets. This could also have some benefit as they may have access to the wider market and may be able to carry out on chain reconciliations, which could lead to more accurate information and therefore more security to the underlying clients.

78. The risk is that the issuer does not continue to monitor the arrangements between themselves and the independent custodian. Therefore, the new regime should ensure that issuers are required to monitor the arrangements on an ongoing basis.

79. The final point to consider would be the respective costs of implementing the two regimes, and how those costs may affect the behaviour and appetite of issuers to enter the market, competition, and innovation.

Are there alternative ways outside of the two models that could create the same, or increased, levels of consumer protection?

80. An alternative approach to the two models set out in paragraphs 3.35 to 3.38 would be for the stablecoin issuer to hold an insurance policy to cover potential losses on the backing assets. The insurance method would be similar to the insurance or guarantee method permitted under the safeguarding rules for payment services and electronic money institutions. Insurance policies would be with an authorised insurer, or a comparable guarantee would be given by an authorised insurer or an authorised credit institution, and the policy or comparable guarantee would need to cover the value of the backing asset. Separately, the regulatory framework could require stablecoin issuers to maintain a certain level of liquidity and capital reserves.

Q9: Do you agree with our proposed approach towards the redemption of regulated stablecoins? In particular:

Do you foresee any operational challenges to providing redemption to any and all holders of regulated stablecoins by the end of the next UK business day? Can you give any examples of situations whether this might this be difficult to deliver?

81. We foresee operational challenges to redemption arising in circumstances such as in a market downturn situation, if the blockchain processing capacity gets overwhelmed, or there are technical issues or delays in the blockchain technology that complicate matters.

82. An operational challenge we have observed with existing stablecoins is that not all platforms can offer real-time crypto-to-fiat redemption. However, we've seen that stablecoin holders can have a subscription to platforms that do offer real-time crypto-to-fiat redemption. To facilitate a quick redemption, holders would transfer the digital assets they want to convert to fiat from one platform to the real-time platform and draw or convert it as and when.

Should a regulated issuer be able to outsource, or involve a third party in delivering, any aspect of redemption? If so, please elaborate.

83. We think it should be possible to outsource, or involve a third party in delivering, any aspect of redemption, because it can enable greater specialism and economies of scale which might lead to an overall more efficient and robust system. The outsourcing or use of third parties, however, should be subject to:

    - clear understanding, assessment of, and mitigation of the risks – for example that the third party has the necessary competence and capabilities; or that there is not undue concentration risk; and
    - clear oversight and understanding of roles and responsibilities under a Service Level Agreement when it comes to different redemption activities such as processing, administration, and pay out.

Are there any restrictions to redemption, beyond cost-reflective fees, that we should consider allowing? If so, please explain.

84. As under the current regimes, a firm should hold back redemption until the necessary Anti-Money Laundering (AML) and Know Your Customer requirements have been completed satisfactorily.

What costs associated with our proposed redemption policy do you anticipate?

85. The costs associated with the proposed redemption policy may include technological investments to upgrade and maintain the required infrastructure for efficient processing.

Other matters

86. Paragraph 3.42 refers to ensuring that the holder of a regulated stablecoin can convert into fiat at par value. We note that fiat money is physical cash and notes and central bank reserves. We believe it is also intended that conversion should include payment into a commercial bank account.

Q10: What proof of identity, and ownership, requirements should a regulated stablecoin issuer be gathering before executing a redemption request?

87. We think that it is sufficient that the requirements for customer due diligence procedures, including proof of identity and ownership for a regulated stablecoin issuer, follow the AML and Counter Terrorist Financing regulatory framework applicable in the UK.

Chapter 4: Other key expectations of stablecoin issuers

Q11: Do you agree with our approach to the Consumer Duty applying to regulated stablecoin issuers and custodians. Please explain why.

88. In principle we believe that the Consumer Duty should apply to regulated stablecoin issuers and custodians.

89. There may, however, be issues that need further investigation to determine whether there are practical challenges to applying the Consumer Duty, and whether in those cases it would be appropriate to do so – for example, there seems an inherent limitation in the ability of the issuer to apply the Consumer Duty to customers that acquire stablecoins on a secondary exchange, as the issuer won't know who the customer is at the point of sale.

Chapter 5: Custody requirements

Q13: Should individual client wallet structures be mandated for certain situations or activities (compared to omnibus wallet structures)? Please explain why.

90. We note the FCA's comments and agree that rules governing the registration and recording of safeguarding custody assets is key to developing a framework that protects the customer in the event of default. Whether these assets are registered in an omnibus account or in individual client wallets hinges on the trade-off between increased security at an increased cost.

91. Whilst we think that custodians operating separate wallets for custody assets and firm assets protect against the risk of a claim against these assets in the event of insolvency, omnibus structures could be appropriate as long as the regulations and associated auditing

requirements capture the different types of wallet structure that could be available. There would need be controls to ensure that:

- records are maintained such that the individual assets of each customer can be determined at any time and without delay;
- trades are only executed where the customer has the necessary assets and there is no cross subsidisation of trades when processed (as this would present an elevated risk given both the volatility and liquidity in the market for crypto assets); and
- omnibus wallets are appropriately secured consistent with the rest of the requirements.

92. Our view is that individual client wallets should not be "mandated". Customers should be allowed a choice: either to i) allow their assets to be pooled in an omnibus account with all other customers' assets, which has the benefit of lower costs to maintain but perhaps at the cost of lower security in the event of default of the custodian; or, ii) that customers have the right to request their assets are held in an individual client wallet, not dissimilar to the 'designated client account' option available in traditional client money accounts.

93. At this time, the following matters should also be considered, though we would also note that new technology may also emerge which might make these matters redundant while introducing new issues to consider:

- whether to place a limit on the total value or nature of assets to be held in a single omnibus wallet to reduce the risk of a single point of failure where one hack could compromise all assets and the solvency of the custodian as a whole;
- the requirements around how the custodian holds keys (including omnibus keys) to ensure these are not held centrally in a single location; and
- mandating separate wallets for any assets held in lending or collateral arrangements (subject to these being permitted) such that there is no risk that assets held under these arrangements are commingled with those of the customers or the firm.

Q14: Are there additional protections, such as client disclosures, which should be put in place for firms that use omnibus wallet structures? Are different models of wallet structure more or less cost efficient in business-as-usual and firm failure scenarios? Please give details about the cost efficiency in each scenario.

94. ICAEW believes that disclosures should be put in place with the client agreement that detail the nature of the omnibus structure.

95. Omnibus wallets are generally more cost-effective in business-as-usual scenarios due to their operational efficiencies and economies of scale, as they reduce the need for multiple individual wallets and transactions, thereby lowering transaction fees and administrative overheads. However, whilst they entail higher operational costs, individual wallet structures offer greater security and ease in identifying and segregating client assets in a firm failure scenario.

Q15: Do you foresee clients' cryptoassets held under custody being used for other purposes? Do you consider that we should permit such uses? If so, please give examples of under what circumstances, and on what terms they should be permitted. For example, should we distinguish between entities, activities, or client types in permitting the use of clients' cryptoassets?

96. Left to itself, it seems entirely possible that the market would evolve and clients' cryptoassets be used in ways and for purposes not originally envisaged (eg, lending). It would however be expected that such developments would take place under certain conditions – for example,

there would be the need for either client consent to be obtained in advance, or for the cryptoassets to only be used for other purposes at a client's specific request. There would also need to be sufficient controls around disclosure, active consent, security, and record keeping, with acknowledgement that these functions are usually undertaken at the client's own risk on the basis the assets would usually transition to the custodian.

97. We would suggest, however, given the nature and volatility of cryptoassets, that custodians should not be allowed to use client assets outside of client directed activities as it undermines their safeguarding role.

Q16: Do you agree with our proposals on minimising the risk of loss or diminution of clients' cryptoassets? If not, please explain why not? What additional controls would you propose? Do you agree with our proposals on accurate books and records? If not, please explain why not.

Proposals on minimising the risk of loss or diminution of clients' cryptoassets

98. We agree with the FCA that, when designing a regulatory regime for stablecoins, having adequate organisational arrangements is a fundamental and over-riding principle in minimising the risk of loss or diminution of clients' cryptoassets, as this will promote credibility and trust from the outset as well as developing an appropriate mindset and expectations. From that founding principle there needs to be supporting controls and measures clearly setting out what that means in practice for firms involved, such that if a firm fails there is minimal delay when returning assets to the beneficial owner.

99. Firstly, we think that custodians holding clients' cryptoassets must establish key controls around their end-to-end systems and processes, especially when external or public distributed ledger technologies (DLT) are used, and that they must have robust internal IT governance controls. We also agree that custodians should have policies and procedures that are reviewed regularly.

100. Whilst DLT increases the reliability of data, it should be noted that cyber security is still a threat, with custodians facing higher vulnerability to hackers. However, for example, the application of DLT in tokenised funds could deliver efficiency through the removal of duplicative reconciliations as the process would create unique token codes. We suggest that multiple scheduled data backups be made daily for both on-chain and off-chain records to help manage the risk of potential significant data loss. We are aware that some firms, due to operational reasons, might be using cold wallets for their cryptocurrencies, which are not connected to the internet and are used for storing digital assets offline. The records from these wallets should be regularly backed up in a routine manner. Firms should assess and have a framework for monitoring and managing DLT-related operational risks.

101. Secondly, we agree that there should be explicit client disclosure requirements for safeguarding controls and liabilities, and that there should be a requirement to have terms outlining the assignment of liability where there are arrangements with sub-custodians, since it may not be reasonable to hold sub-custodians (or custodians) liable for activities outside of their control.

102. Additional points that we think should be considered are:

- that there needs to be clear legislation so that firms cannot avoid their responsibility for loss; and
- there should be a requirement for cryptoassets custodians to have insurance arrangements protecting them against the risk of loss (noting that this is currently being proposed in other jurisdictions' cryptoassets custody regime).

Proposals on accurate books and records

103. We agree with the requirement to maintain accurate books and records. Where on-chain records are used as internal records, finality of settlement is a key consideration. Controls will need to be put in place to identify the point where a cryptoassets transaction becomes immutable and is held in custody.
104. If firms are using only on-chain records, it is not clear how they would record ownership for clients. For example, would firms need to maintain an off-chain record in order to reconcile the assets held on-chain (where ownership of the asset is shown as belonging to the firm, as the firm holds the private keys) to the firm's books and records (which would reflect the client's ownership of the asset)?
105. We suggest that the CASS 6 Internal System Evaluation Method be used to allow firms to establish a process that evaluates the completeness and accuracy of a firm's internal records for cryptoassets custody. The evaluation process would need to address the risk of data flows and interactions between on-chain and off-chain systems from upstream to the ultimate internal downstream books and records system.

Q17: Do you agree with our proposals on reconciliation? If not, please explain why not? What technology, systems and controls are needed to ensure compliance with our proposed requirements?

106. Paragraph 5.35 states the FCA are considering requiring firms to reconcile client's cryptoassets on a real-time basis. Where off-chain records are used, and these off-chain records are held on traditional systems, firms would need to ensure that that their existing systems can interact with the blockchain on a real-time basis.
107. However, we agree that it is key to ensure reconciliations cover the full end to end process, including reconciling the various different wallets with the firm's internal and external records. We would also note, however, that technology may yet evolve that affects the reconciliations required and how they may be undertaken.
108. If allowing on-chain record keeping, a daily reconciliation of the day-on-day movement against transactions received from customers to detect errors in processing should be considered, as opposed to providers simply excluding certain reconciliation requirements.

Q18: Do you consider that firms providing crypto custody should be permitted to use third parties? If so, please explain what types of third parties should be permitted and any additional risks or opportunities that we should consider when third parties are used.

109. We believe that firms providing crypto custody should be permitted to use third parties, as there are clear advantages to using third parties. A separate third-party entity might be more specialised and capable of managing cryptoassets, which may bring increased benefits and reduce the risk of loss to clients. For example, it might help avoid any potential conflicts of interest that could arise between the issuer and custodian; while better processes, controls, and resources might provide for enhanced operational resilience. Scale and more efficient management might be achieved where a specialist is custodian to more than one issuer. A separate third-party provider may also facilitate more sole issuers entering the market with added competition benefits.
110. However, the regulatory expectations for the management and monitoring of third parties need to be clear (eg, through prescriptive rules), and there should be a clear agreement between the firm and the third party which sets out the responsibilities of each party and clarifies that the responsibility ultimately lies with the firm.

111. While appropriate due diligence should be carried out and evidenced before placing assets with a third party, due diligence and KPI reporting/meetings are not always sufficient. The onus should therefore be on the custodian being able to obtain sufficient evidence that the applicable parts of any governance requirements and controls expected of them as a regulated custodian are being adhered to by any third party, rather than the firm failing to take responsibility, because the assets are held externally. This will vary depending on the scope of services being provided, but they should be able to demonstrate that collectively the governance/controls at the custodian, plus the governance/controls they have monitored at the third party are sufficient to address the regulatory requirements. In addition to updating due diligence on an annual basis, we would also suggest mandating that the firm should ensure any controls at these third parties are tested and reported on at least an annual basis given they will be mandating a similar audit requirement on the custodian themselves. The firm will also need to ensure that the assets are separately identifiable from those of other clients and those of the third party.
112. It is also important that the regulatory requirements include operational resilience, especially for technology and systems underpinning processing. Some additional considerations to address blockchain specific risks that firms may need to make when using third parties may include:
    - the results of any third-party assurance reports on the controls at the third-party custodian, such as an ISAE3402 report, or a SOC1/SOC2 report;
    - the results of any third-party assurance reports on the controls at any service providers, such as an ISAE3402 report, or a SOC1/SOC2 report;
    - which security protocols any third parties are using (eg, multi-signature or multi-party computation);
    - compatibility of different blockchains at each third party; and
    - the policies and procedures in place at any third parties, including specifically around what will be paid back to clients in the event of a failure (ie, Crypto/fiat).
113. Finally, the liability obligations arising from these third-party arrangements and a requirement that either the custodian themselves is able to meet the liability or that they can get sufficient evidence that the third party would be able to meet any liability contractually passed on in the event of a failure should also be considered. This may be particularly relevant for technology companies that have limited assets but are involved in high-risk specialist functions such as delivering the underlying infrastructure within which crypto keys are held.
114. We would suggest that any third-party used should have appropriate safeguarding permissions and should be regulated by the FCA. As with the current CASS rules, it may be acceptable to use a third party based outside the UK, but any arrangement should provide for the appropriate safeguarding of customer assets.

Q19: Do you agree with our proposals on adequate governance and control? If not, please explain why not? What (if any) additional controls are needed to achieve our desired outcomes? What challenges arise and what mitigants would you propose?

115. We agree with the FCA that there should be a requirement to have an adequate system of governance and controls to underpin the protection of custody assets.
116. We anticipate, however, that there will be challenges, as it is likely that firms will need to invest in their governance and three lines of defence to develop the equivalent level of capability and maturity of existing financial services firms.

117. As a result, we think that there will be a significant need within any regulation or rules, to set very clear expectations on what is required for firms – for example what is expected: for 'adequate governance and control'; for 'clear and embedded three lines of defence'; for any assurance provided over the controls for custody assets; for documentation requirements; and for level and position of responsibility.

Client assets audit

118. There is an opportunity to be more prescriptive about the extent and nature of audit or assurance required, than with the audit requirements for payment services firms, where the lack of prescription has led to a range of practice. This is to avoid high level analysis being obtained in place of true assurance and which is not fit for purpose.
119. While we believe that it would be beneficial that a cryptoassets custodian be subject to an annual audit carried out by an independent external auditor, there is no current auditing standard that would provide a basis for the conduct of the audit. In the absence of an auditing standard there is a risk that any audit is not undertaken to a sufficient standard, and that audits are not undertaken consistently across auditors. The Financial Reporting Council's Client Asset Assurance Standard could provide a good starting point, but the standard would specifically need to address how the audit should deal with the new issues associated with stablecoins (eg, the use of blockchain technology).
120. A controls-based audit provides assurance over the operating effective of the controls over a specified period. However, as many controls may be new and/or may be hard to evidence, it will be important that there is a clear understanding of how an audit can be undertaken and that regulatory expectations are set accordingly.

Client disclosures and statements

121. In addition to the matters highlighted in paragraphs 5.42 and 5.43, further disclosures specific to the underlying blockchain technology may be required, such as:
    - the blockchain security protocols in place (eg, multi-party computation or multi-party signature); or
    - the omnibus structure in place.
122. The provision of periodic statements by custodians to each of their clients of the cryptoassets held for that client, and providing clients with a statement of account with information on their transactions would be helpful. Providing a proof of reserves as part of this would give clients comfort that the custodian will be able to honour withdrawals, and that their cryptoassets are safe because the firm has enough assets of its own to cover client deposits, ie, the firm is sufficiently liquid and solvent. As proof of reserves is, however, a point in time assessment, there would need to be clarity around how frequent the provision of a proof of reserves would be required. There would also need to be clarity around the audit methodology required to verify the reserves.

CASS oversight officer

123. In our view, cryptoassets custodians should be required to appoint a CASS oversight officer to be accountable for overseeing the custody arrangements.

Regulatory reporting

124. We would agree with the requirement for cryptoassets custodians to report information on their clients' cryptoassets holdings regularly.

Q20: Should cryptoasset custodians undertaking multiple services (eg, brokers, intermediaries) be required to separate custody and other functions into separate legal entities?

125. We believe that cryptoassets custodians undertaking multiple services should be required to separate custody into separate legal entities as this would reduce the risk of conflicts of interest, increase accountability of individual service offering, and therefore enhance processes and controls and enhance client asset protection. However, this should be weighed alongside the legal and operational costs of separating the services functions into legal entities.

Q21: Are there any practical issues posed by requiring cryptoasset exchanges to operate a separate legal entity for custody-like activities? Specifically, please could you explain your thoughts on the following:

Would these issues differ between institutional and retail clients?

126. A large institutional investor, such as a pension fund, requires high-security asset custody services for a substantial stablecoin portfolio. The investor prefers a separate custody entity due to the scale and sensitivity of their holdings. In contrast, a retail client with a smaller investment prefers a one-stop-shop service for convenience and lower costs.

What would be the operational and cost impact?

127. A separate custody entity would involve additional costs, as well as a regulatory cost for compliance. The additional cost associated would include both the initial costs of setting up a new legal entity (eg, legal, regulatory) and ongoing operating expenses of the entity (eg, compliance such as separate reporting).

What are the benefits to clients of cryptoasset exchanges prefunding trades? Can these be achieved if there is legal separation of entities?

128. We agree with paragraph 5.52, and do not support prefunding of trades by cryptoasset exchanges. We would also agree that cryptoasset exchange's architecture should be consistent with traditional financial markets.

Would separating custody and exchange functions impact the way clients' accounts are managed and structured (in omnibus and individual client wallets)?

129. We do not think that separating custody and exchange functions will have any effect on the way in which clients' accounts are managed and structured (except for the matters highlighted in our response to Q14).

Do you agree that the conflicts of interest we have identified exist? Are there other conflicts of interest we should consider?

130. We agree that conflicts of interest exist, and do not think that there are any other potential conflicts in addition to those identified in paragraph 5.50.

Are there alternative ways to ensure the same level of consumer protection?

131. We have not identified other alternative ways.

Q22: What role do you consider that custodians should have in safeguarding client money and redemption? What specific safeguards should be considered?

132. We consider that the custodians should have at least two roles:

- Administrative role: receive and register requests from clients for redemptions, pass on these requests to the issuer to process the payments to clients, and actively monitor the completion of these requests.
- Safeguarding of the stablecoins: custodians will safeguard the stablecoins on behalf of the clients until custodians receive confirmation that the issuer has made the redemption payments to the client.

133. Specific safeguards should be considered when the custodians hold the stablecoins that are subject to the redemption process. These stablecoins should be kept segregated until the redemption process has been completed and payments are received by the clients.

Chapter 6: Organisational requirements

134. In general, and for the purpose of promoting consistency and ensuring firms can deliver their obligations under the Consumer Duty, we believe the appropriate starting point for a regulated stablecoin regime is to leverage the existing FCA organisational requirements – so for example within SYSC (including SMCR), operational resilience, financial crime, or COBS.
135. The standing of the UK as a good place to undertake business is dependent upon good quality regulation that provides individuals with the protections they desire. The FCA should ensure its policy and regulations create a stablecoin regime under which people can trust the digital assets that they transact with.

Chapter 7: Conduct of business and consumer redress

Q30: Do you agree that the FCA should not be proposing to extend FSCS cover to the regulated activities of issuing and custody of fiat-backed stablecoins? If you do not agree, please explain the circumstances in which you believe FSCS protection should be available.

Issuing regulated stablecoin

136. As a matter of principle, the protections available to different forms of money should provide the same level of safety to the users. If the level of safety were different, it would seem that this would undermine the ‘weaker’ money, and if there were disruption might contribute to instability through a flight to safety. This does not, however, mean to say the protections are the same. For example, a distinction can be made between commercial bank money (bank deposits) and regulated stablecoins backed by fiat currency. While the former has the benefit of FSCS protection and bank capital requirements, it does not have the protection afforded by segregated accounts that the latter has. We do recognise that determining the comparability of the safety afforded by different protections is not easy.
137. We do, however, agree with the proposal that FSCS should not be extended to the regulated activity of issuing, at this time. Part of the reasoning is that, in the early stages of the regime, there may not be sufficient firms to support reimbursement of an FSCS payout in the event of a stablecoin issuer failure.

Chapter 8: Prudential requirements

Q31: Do you agree with our proposed prudential requirements for regulated stablecoin issuers and custodians? In particular, do you agree with our proposals on any of the

following areas: i. Capital requirements and quality of capital; ii. Liquidity requirements and eligible liquid assets; iii. Group risk; iv. Concentration risk; and v. Internal risk management

138. The DP sets out a high-level framework for the prudential requirements applicable to issuers and custodians. This is a necessary first step in developing a prudential regime.

139. We would agree that the proposed high-level framework is broadly appropriate, although we have some observations for considerations as set out below.

140. We note that this is a high-level framework. Much of the detail of the regime remains to be developed (eg, the calibration of the different capital requirements) and it is this detail that will be critical in determining whether the regime works, in terms of providing the necessary protections as set out in paragraph 8.4 but also to ensure the regime is proportionate and there are no inappropriate barriers to entry or to innovation.

141. Our observations on the framework are:

- While FCA regulated stablecoins are not used in systemic payment systems, they are still providing a means of payment, where 'payments' is a core function of the financial system, and where there may be the risk of contagion (ie, could the failure of an FCA regulated stablecoin undermine confidence in the stablecoins used in a systemic payment system). When calibrating the requirements of a future regime the purpose and risks of stablecoins will need to be considered. In this regard, while existing regimes (such as IFPR) might provide a useful benchmark, it will also be necessary to consider the different purposes and risks of the regime.
- An FCA regulated stablecoin is not systemic but presumably has the potential to be used in a systemic payment system and so be regulated by the Bank. In this regard the regimes of the FCA and Bank need a degree of alignment to ensure there can be a smooth transition between the two regimes if required.
- Under paragraph 8.49, we think it is appropriate that firms are required to undertake an independent assessment of the financial resources they will need. Firms should be responsible for their financial and operational resilience: regulation does not absolve them from this responsibility.
- Paragraph 8.25 (K-CII) only references operational risks facing the issuer for which capital might be required. The issuer is also required to adjust the backing assets to maintain a stable peg. As a result, there may also be price or valuation adjustments associated with the backing assets that should be considered as part of the capital requirement. There may be other similar market or credit risks that also need to be addressed.
- Within paragraph 8.23, it is proposed there be lagging to enable a smoother management of capital requirements. Notwithstanding that the lagging period is to be determined, we would note that lagging introduces a potential risk of delaying necessary capital changes (eg, where there is a significant and permanent change). We appreciate and agree with the reason for lagging but would suggest there should also be a process to reflect whether the lagging is appropriate – perhaps, there is guidance that this risk is considered as part of any ICARA assessment.

142. We would also note that the accounting treatment for regulated stablecoins will likely be a relevant matter to consider when developing the prudential regime, if the financial statements are to form the basis for any capital or liquidity requirements.

143. The relevant accounting standards may change and the final shape of the FCA's regime will also affect the appropriate accounting treatment, but stablecoins currently in existence are classified as either intangible assets or financial instruments on the balance sheet, which then affects how they measured (ie, amortised cost or at fair value). The accounting

treatment may therefore affect how the prudential rules need to be drafted to achieve the FCA's intended outcome.

Chapter 9: Managing stablecoin firm failure

144. We presume the FCA has considered what lessons may learned from the CASS regime and the failure or near failure of any firms subject to CASS, and the implications of those lessons for a regulated stablecoin regime. Similarly, there may be lessons from the operation of funds that might prove helpful – for example, when a fund manager can step in and take over a fund might be analogous to a stablecoin issuer taking over the stablecoin and backing assets of another issuer.

Chapter 10: Regulating payments using stablecoins

145. Not commented.

Chapter 11: Overseas stablecoins used for payment in the UK

Q39: What are the potential risks and benefits of the Treasury's proposal to allow overseas stablecoins to be used for payments in the UK? What are the costs for payment arrangers and is the business model viable?

146. The challenge will be how to regulate these overseas stablecoins and that they should not be allowed in the UK without a UK nexus, as otherwise there will be limited action that the FCA can take to protect UK customers.