

Future of Financial Services Week



Pushing the Perimeter: Are cryptocurrencies going mainstream?

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Speaking with you today



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Introduction



← Tweet



only if @tesla accepts grimacecoin



Elon Musk @elonmusk · Jan 25
I will eat a happy meal on tv if @McDonalds accepts Dogecoin

11:14 PM · Jan 25, 2022 · Twitter for iPhone

6,947 Retweets 1,977 Quote Tweets 48.6K Likes

Top stories



Fake Grimacecoin Jumps 285,000% After McDonald's' Tesla Joke

6 hours ago



McDonald's Responds to Elon Musk, Causing 6000% Pump in Newly-Created GrimaceCoin

6 hours ago



Fake crypto Grimacecoin rockets 285,000% in HOURS after McDonald's Tesla joke on Twitter...

2 hours ago



More news

Introduction – Are cryptocurrencies going mainstream?

- **Private Investors:**

- 2.3m UK adults hold cryptoassets, most holding £300 or less...

But... 21m have Premium Bonds (£5,000 on average)

- **Institutional Investors:**

- Hedge funds have over \$4 billion in crypto AuM, Blackrock owns 15% of Microstrategy, Coinbase briefly tipped a \$100 billion valuation...

But... but that is a fraction of the total investment market and the fluctuations and uncertainty in the market is holding institutions back

- **State Reserves:**

- Republic of Bulgaria is the 2nd largest holder of BTC in the world 213,000 BTC (ca. \$9.5 Bn...
- El Salvador adopted BTC as a national currency alongside US\$...
- German Bundesbank is a strong supporter of CBDCs...

But... has no comprehensive regulatory framework for crypto-transactions (although they are subject to tax!)

But... it led to massive street protests

But... acknowledges the lack of anonymity and loss of control likely to impede uptake

...and now Russia is looking at banning cryptoassets and crypto-mining altogether.

Pushing the perimeter

"Ultimately, if you want mainstream users, the reality is that the average person wants the insurance policy of a regulated product."

- Jamie Burke, CEO Outlier Ventures

- Status of cryptocurrency regulation
- ASA oversight and rulings
- Future of crypto regulation
- CBDCs
- Pension scheme investment

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Cryptocurrency regulation



What do we mean by cryptocurrency?

"cryptographically secured digital representations of value or contractual rights that use some type of DLT and can be transferred, stored or traded electronically" – Cryptoassets Taskforce



Tokens

- Proof of associated rights
- NFTs



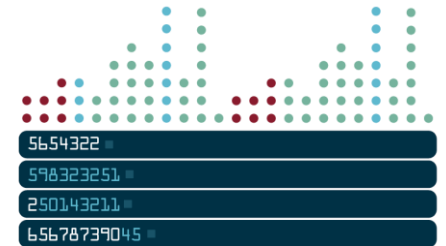
Stablecoins

- Digital cash deriving value from external asset



CBDC

- Central bank-issued digital coin

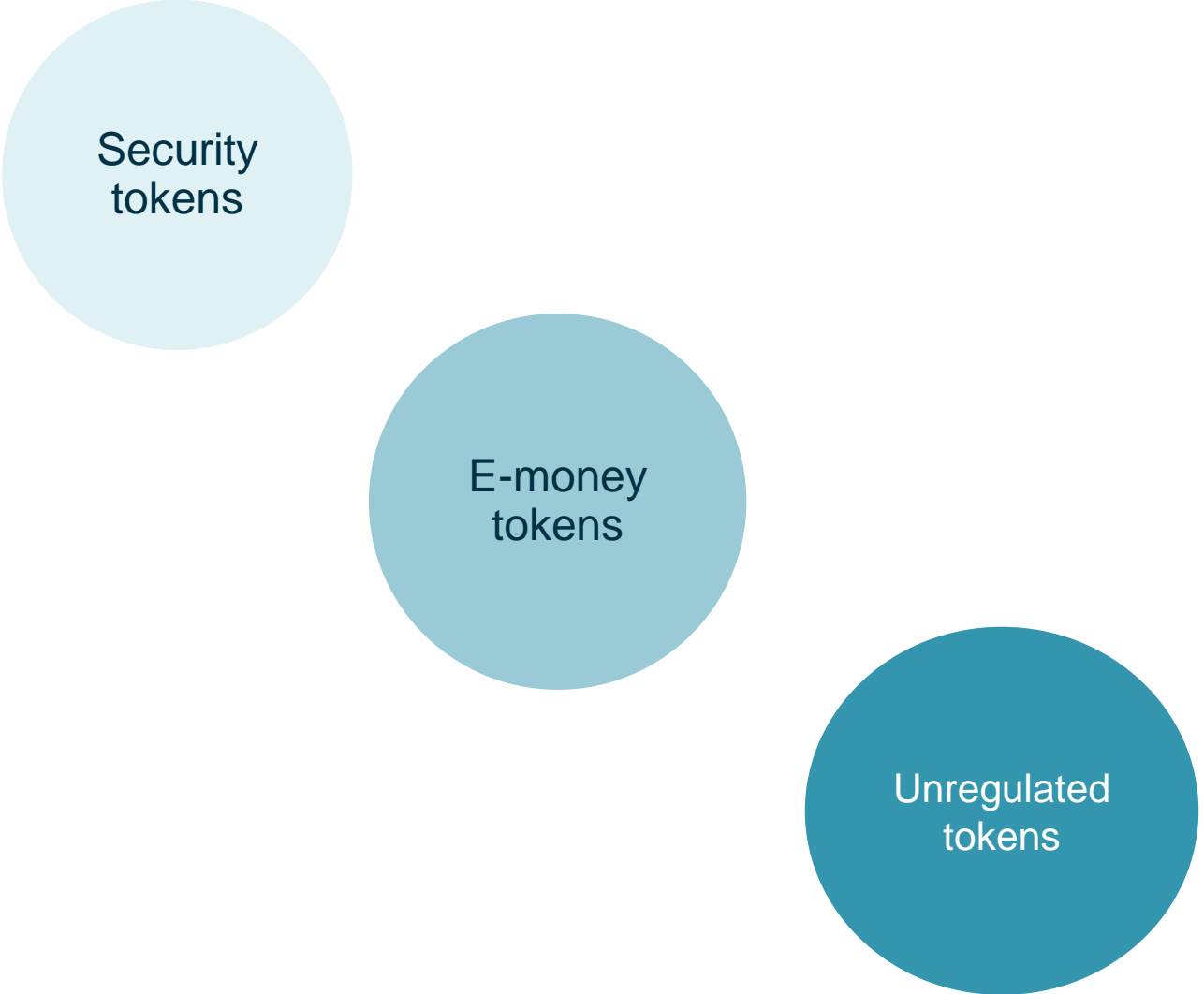


ICOs/STOs

- Fundraising mechanism
- Regulated

How are cryptoassets regulated in the UK?

- BTC, ETH and other virtual currencies and stablecoin (e.g. USDC) are generally **not** regarded as e-money and **not** within the scope of FCA regulation
- Only those cryptoassets that are 'security tokens' (e.g. ICOs) or e-money are regulated
- Whether a particular cryptoasset falls within the regulatory perimeter will be **fact specific** (relatively few in number)
- Futures, CFDs, etc. relating to cryptoassets are though "investments" and firms providing services related to this are likely to be caught
- FCA's financial promotion regime does not currently apply to cryptoassets (unless they are regulated)



Security
tokens

E-money
tokens

Unregulated
tokens

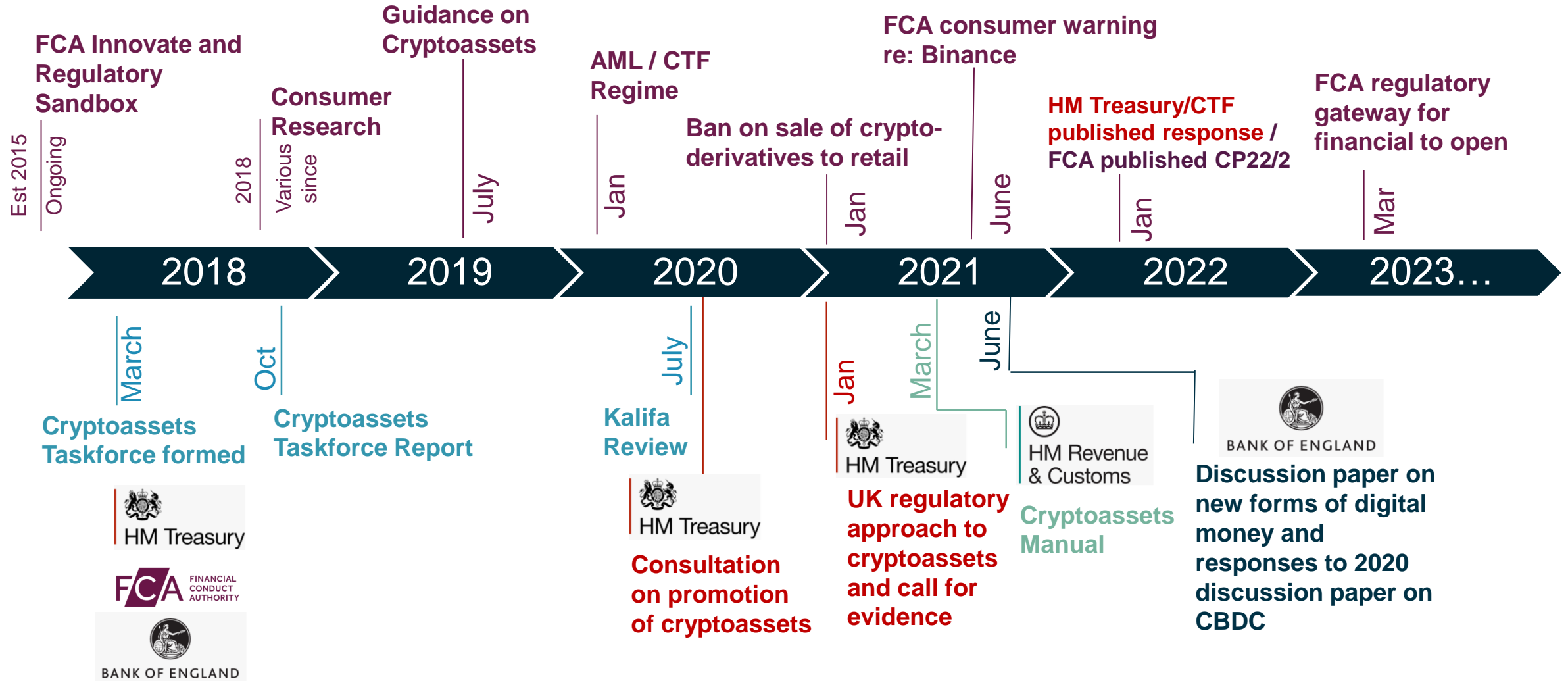
How do AML laws and regulations apply?

- UK businesses providing **cryptoasset exchange and custody services** do have to register as a 'cryptoasset firm' with the FCA under the UK's MLRs, which implemented the EU's Fifth Anti-Money Laundering Directive (MLD5), in turn implementing FATF
- Original deadline of **10 January 2021**, extended to **31 March 2022**, with existing firms subject to a 'transitional registration regime' pending full review by FCA
- This regime catches:
 - **cryptocurrency exchanges** providing exchange services between fiat and cryptocurrencies and between cryptocurrencies
 - **custodian wallet providers**



MLD5 means that cryptocurrency exchanges and custodians will be:

- (1) 'obliged entities' under MLD4;
- (2) required to register with (in the UK) FCA; and
- (3) subject to all the same obligations as other firms (such as banks, e-money and payment institutions) to implement preventative measures relating to customer DD, including KYC procedures, and reporting of suspicious activity to domestic FIUs.

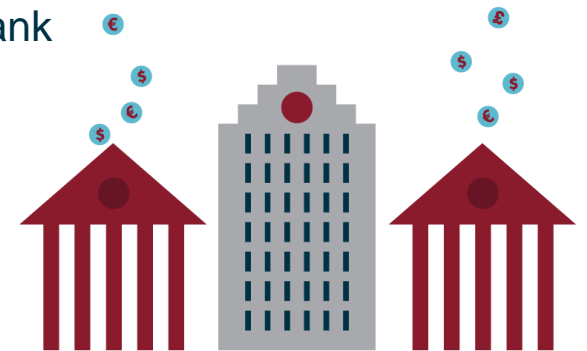


3 Regulatory approach



UK regulatory approach towards regulating cryptoassets

- 'Wait and see' approach to date, though this is changing...
- So far:
 - Largely fitting within the existing financial services regulatory regime
 - Implementing MLD5 and registration regime for cryptoasset firms (cryptocurrency exchanges and custody services)
 - Leaving the ASA to regulate advertising
- Now moving to strengthen regulation of cryptoasset promotions by bringing them into the financial promotions regime
- Further ahead, the FCA has signalled its intention to extend its regulatory perimeter
- The Bank of England and HM Treasury are looking into a possible UK CBDC (central bank digital coin):
 - Raises concerns around financial stability, privacy, impact on bank deposits
 - A lot of work required to reach a workable solution
 - A solution in search of a problem?



Advertising & Consumer: How are cryptoassets regulated in the UK?

Advertising Standards Authority (ASA) - Numerous rulings on cryptocurrency ads in December 2021 – Key takeaways:

Beef up your disclaimers – ensure you provide appropriate risk warnings.

Don't trivialise the risk of investing in cryptocurrency (e.g. *"It's easy as 1-2-3 to invest in crypto!"*).

1. Don't take advantage of consumers' inexperience or incredulity, for example by enticing consumers to invest with promotions/deals (*"Get \$100 cashback free!"*) when investing in crypto should be a considered and informed decision.



Make it clear that consumers may not benefit from government compensation and/or regulatory schemes.

Be responsible with your advertising and don't create a sense of urgency to invest (e.g. *"If you don't invest now, you'll miss the boat!"*).

Include information about any significant fees, particularly if the ad emphasises low requirements for investing (e.g. *"Invest for as low as £1"*).

Ensure the disclaimers are clearly readable and visible by the intended audience.

Explain that any gains may be subject to capital gains tax.

Even if you don't promote their tokens as investment products, they could still be caught by the cryptocurrency advertising rules if the FCA still categorises them as cryptoassets.



HM Treasury consultation response: promotion of cryptoassets

- Published on 18 January 2022:
 - "inaccurate promotions [are] a key risk to consumers"*
 - "risk-based, incremental approach"*
- FinProm regime will apply to qualifying cryptoassets: *"any cryptographically secured digital representation of value or contractual rights which is fungible and transferable"*
 - Excludes otherwise regulated tokens, non-fungible tokens (NFTs) and central bank digital coin (CBDC), as well as tokens which are used *"only to [transfer to] one or more vendors or merchants in payment for goods or services"*
 - Definition not tied to DLT (i.e. technology agnostic)
- No timeline for new legislation – 6 month transition period
- Heavy reliance on the FCA's market research



FCA CP22/2: Strengthening financial promotions rules for high risk investments



- Published on 18 January 2022 – feedback due 23 March 2022
- "Qualifying cryptoassets" will be treated "Restricted Mass Market Investments", subject to FinProm restriction in s21 FSMA
- Notably, the FinProm restriction will apply to any in-scope promotion capable of having an effect in the UK, even where it is communicated by an overseas person
- In practice, all promotions of investment activity – dealing, managing, advising and arranging - relating to qualifying cryptoassets must be signed off by s21 approver and comply with COBS 4 rules - doesn't affect regulatory status of underlying cryptoassets themselves
- Risk warnings to be required, e.g. "**Don't invest unless you're prepared to lose all your money**" and where the financial promotion is made via a website, app or other digital medium, the text: "**Take 2 mins to learn more**" with a link which, when activated, delivers an appropriate risk summary in a pop-up box (or equivalent)
- "Direct offer" FinProms (e.g. including a form to respond) can only be made to investors in some categories, e.g. HNWI



Institutional investment in cryptoassets

Investing in cryptoassets poses different problems for different types of institutional investor:

- **Asset managers:** a key issue is how they can meet their suitability duty
- **SIPP providers:** key issues are how they can meet their due diligence requirements for risky assets, and the regulatory capital charge for non-standard assets
- **Insurance-based pension providers:** investments in cryptoassets will not be a permitted link (although they may be a permitted link if the cryptoassets are part of the assets held by authorised funds)
- **Banks:** cryptoassets are not suitable for liquidity purposes and attract a high risk weight given credit and market risk

Custody risk is applicable to all investors



4 Pension scheme investment



Pension scheme investment – legal issues

1. Do trustees have the power?

2. Trustee fiduciary duties

3. Trustee policies

4. Custody

5. Investing in regulated markets

Pension scheme investment

1. Do trustees have the power?

- Check terms of investment power in the scheme rules
- Wide statutory power in s.34(1) of the Pensions Act 1995
- Trustees may feel more comfortable amending rules to explicitly list cryptocurrencies as acceptable form of investment



Pension scheme investment

2. Trustee fiduciary duties

- Would investing in cryptocurrencies be consistent with trustees' fiduciary duties?
 - In making investments, pension trustees must take such care as an ordinary prudent person would take if he invested "*for the benefit of other people for whom he felt morally bound to provide*" - *Re Whiteley* [1886] 33 Ch D 347
 - Trustees must invest in members' best (financial) interests - *Cowan v Scargill* [1984] 2 All ER 750, Regulation 4(2) of *The Occupational Pension Schemes (Investment) Regulations 2005*
- Trustees would need to take written professional investment advice – s.36(3) of the Pensions Act 1995



Pension scheme investment

3. Trustee policies

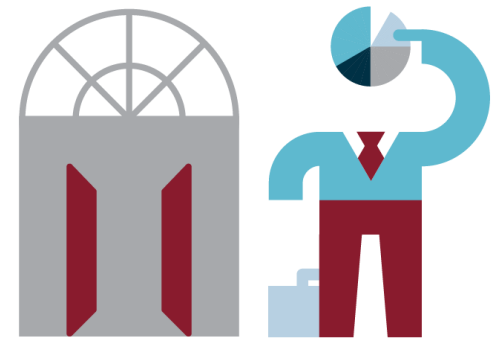
- For DB – consider Integrated Risk Management (IRM) policy
- For DB and DC – consider Statement of Investment Principles (SIP)
- ESG considerations?



Pension scheme investment

4. Custody

- Direct ownership of cryptocurrency is through "private keys"
- If private key is lost, cryptocurrency can no longer be accessed
- Who would hold trustees' private keys?



Pension scheme investment

5. Investing in regulated markets

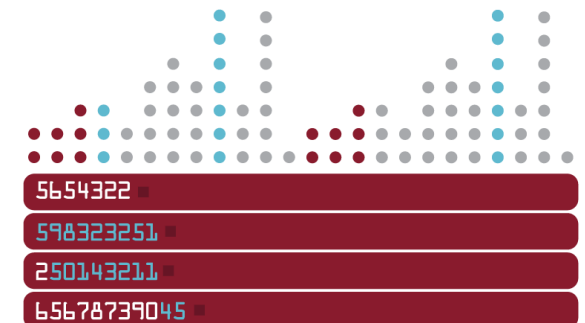
- Trustees must ensure that the *"assets of the scheme ... consist predominantly of investments admitted to trading on regulated markets"* and *"investment in assets which are not admitted to trading on such markets must ... be kept to a prudent level"*.

*Regulations 4(5) and (6) of The Occupational Pension Schemes
(Investment) Regulations 2005*



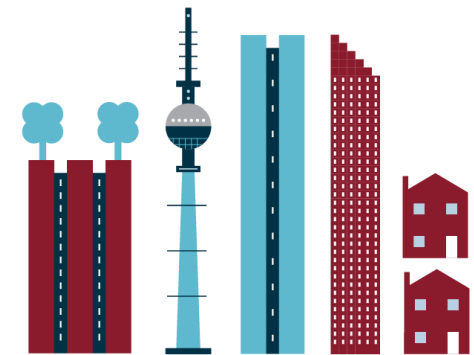
Pension scheme investment – concluding remarks (1)

- Direct investment of pension assets into underlying cryptocurrencies unlikely – regulated market restrictions / custody issues
- But pension schemes generally don't invest directly in underlying assets (e.g. real estate, company shareholdings)
- Instead, pension assets are typically units in funds held on regulated markets



Pension scheme investment – concluding remarks (2)

- More likely (in the near term) that DC trustees rather than DB trustees would become involved in cryptocurrencies – DC trustees could make cryptocurrency funds available for "self-select" members?
- But would need FCA to change their position – FCA currently will not authorise a cryptocurrency "exchange traded fund" (ETF)
- Regulators in other nations (e.g. Germany, Canada, Sweden, USA) have given green light to exchange-traded products linked to cryptocurrencies



5 Concluding remarks



Cryptocurrencies in the mainstream?

- Cryptocurrency needs to become mainstream
- Cryptocurrencies are pervasive if not yet penetrative
- Significant opportunity but there is also significant potential for consumer harm
- Regulation needs to evolve and quickly
- Regulatory objectives for doing so need to be clear
- The key issue is likely to be international cooperation and standardisation

Any questions?



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