

Guidance on Cryptoassets

Consultation Paper

CP19/3*

January 2019

How to respond

We are asking for comments on this Consultation Paper (CP) by **Friday 5 April 2019**.

You can send them to us using the form on our website at: www.fca.org.uk/cp19-03-response-form

Or in writing to:

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1 Summary

Introduction

- 1.1** Cryptoassets have attracted significant and growing attention from consumers, markets, governments and regulators globally.
- 1.2** In October 2018, the UK Cryptoassets Taskforce ('the Taskforce') published a report that set out the UK's policy and regulatory approach to cryptoassets and Distributed Ledger Technology ('DLT').¹ It assessed the risks and potential benefits of cryptoassets, identified potential harms, set out a plan for regulation in the UK and detailed the different activities that should be assessed for regulation.
- 1.3** The Taskforce found that while activity in the UK has grown in recent years, the number of firms² carrying out cryptoasset activities in the UK remains small and the overall size of the UK market represents a small percentage of the overall global cryptoasset market. Mainstream financial services firms are entering the market, and a small derivatives market is beginning to develop. However, there is growing evidence at a global level of increasing harm.
- 1.4** The Taskforce set out a number of commitments, including providing extra clarity to firms about where current cryptoasset activities are regulated, and exploring whether unregulated activities should be captured by regulation in the future. This Guidance consultation document responds to the first of those commitments.
- 1.5** The Financial Conduct Authority's (FCA's) role is to make sure financial markets work well by ensuring that consumers are protected from harm, the integrity of the UK financial system is enhanced and protected, and that competition works in the interest of consumers. The FCA is also a technology neutral regulator, so the use of new technology alone does not alter how we make judgements in relation to the regulatory perimeter. Guidance on the regulatory perimeter helps achieve these objectives by providing clarity on what financial services and activities are regulated and unregulated.
- 1.6** This Guidance focuses on where cryptoassets interact with our 'perimeter'. In particular, it looks at where cryptoassets would be considered 'Specified Investments' under the Regulated Activities Order (RAO),³ 'Financial Instruments' such as 'Transferable Securities' under the Markets in Financial Instruments Directive II (MiFID II),⁴ or captured under the Payment Services Regulations (PSRs),⁵ or the E-Money Regulations (EMRs).⁶ It also covers where cryptoassets would not be considered 'Specified Investments' under the RAO.

1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

2 In this consultation paper, unless the context indicates otherwise, we have used the term firm to refer broadly to market participants rather than the Glossary definition of 'authorised persons'.

3 www.legislation.gov.uk/ukksi/2001/544/contents/made

4 <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=EN>

5 www.legislation.gov.uk/ukksi/2017/752/contents/made

6 www.legislation.gov.uk/ukksi/2011/99/contents/made

Overview of this Consultation

1.7 This document sets out the following:

- In Chapter 2 we set out the wider context to the Guidance. We explain key concepts related to cryptoassets, an overview of the UK market, and our assessment of harm. We also explain what action we have taken to date and will take alongside the other Taskforce members to mitigate this harm. There is a particular focus on how this Guidance contributes to mitigating harm.
- In Chapter 3 we set out the Guidance on how cryptoassets can be subject to FCA regulation. We use the framework developed by the Taskforce for different types of cryptoassets, explain whether they are within the FCA's regulatory remit, and if so, what this means for market participants, supported by case studies. We provide a Q&A section on some of the more common questions that we are asked, as well as in areas where there may be complexity. We then highlight where the FCA is able to further assist firms through our Innovate initiative.

Why we are consulting

1.8 We are consulting on Guidance for cryptoassets in order to provide regulatory clarity for market participants carrying on activities in this space. The cryptoasset market, and the underlying DLT technology, is developing quickly and participants need to be clear on where they are conducting activities that fall within the scope of the FCA's regulatory remit and for which they require authorisation. It may be a criminal offence to carry on regulated activities without the relevant authorisations.

1.9 We also want to support consumers to understand the cryptoasset market and the implications for the types of protections they are afforded depending on the product.

1.10 The final Guidance will help market participants to understand whether the cryptoassets they employ are within the regulatory perimeter. This will alert market participants to pertinent issues and should help them better understand whether they need to be authorised and what rules or regulations apply to their business.

Who this applies to

1.11 This consultation is relevant to:

- firms issuing or creating cryptoassets
- firms marketing cryptoasset products and services
- firms buying or selling cryptoassets
- firms holding or storing cryptoassets
- financial advisers
- professional advisers
- investment managers
- recognised investment exchanges
- consumers and consumer organisations

- 1.12** This is not an exhaustive list, and it is likely that the consultation will be relevant to additional stakeholders, whether regulated or not.

Outcomes we are seeking

- 1.13** We hope to clarify FCA expectations for firms carrying on cryptoasset activities within the UK.
- 1.14** If a firm acts in line with this Guidance, the FCA will consider them to have complied with regard to the aspects of the requirement to which the Guidance relates. This Guidance represents the FCA's views and does not bind the courts, but it can be persuasive in any determination by courts, for example enforcing contracts.
- 1.15** The final Guidance will enable firms to understand whether certain cryptoassets fall within the regulatory perimeter. This should allow firms to have increased certainty around their activities while meeting our own regulatory objectives of consumer protection, enhancing market integrity and promoting effective competition in the interest of consumers. We encourage firms to seek expert advice if you are unsure whether the products you offer fall within the regulatory perimeter.

Unintended consequences of our intervention

- 1.16** We have tried to make sure that our Guidance is as clear and complete as possible so we don't create inappropriate barriers to entry, or conflicts with our aims and objectives.
- 1.17** As part of the consultation process we will consider feedback from stakeholders before finalising our Guidance to mitigate unintended consequences. We will also continue to monitor developments in the market.

Measuring success

- 1.18** We want this Guidance to provide regulatory clarity for firms, and by doing so create greater market integrity and consumer protection for the cryptoasset market. We can measure our success in achieving this in a number of ways:
- reviewing responses to this consultation to assess the current understanding of the perimeter
 - evaluating qualitative feedback from stakeholders during and after the consultation period
 - an increase in the number and accuracy of authorisations submissions by firms undertaking cryptoasset activities
 - fewer referrals to our Unauthorised Business Division (UBD) and Financial Promotions team which is indicative that firms (and their advisers) are clearer when authorisation is needed and where our financial promotion rules apply
- 1.19** A secondary outcome of this guidance is to support consumers to better understand the cryptoasset market. We can potentially measure this by:

- conducting a follow up consumer survey in 12 months
- analysing calls through the FCA Contact Centre to assess consumer understanding of cryptoassets in relation to the regulatory perimeter

Equality and diversity considerations

- 1.20** We have considered the equality and diversity issues that may arise from our proposals which are intended to provide clarification in respect of our existing regulatory perimeter.
- 1.21** The technological aspect of cryptoassets could potentially create equality and diversity considerations for certain consumers. The complex nature of cryptoassets, and misinformation targeted at certain demographics is something we are considering as part of our wider consumer research work into cryptoassets. We will continue to consider the equality and diversity implications of the proposals during the consultation period, and will revisit them when publishing the final rules. In the meantime, we welcome your input on this.

Implications of EU withdrawal

- 1.22** In March 2018, the UK and the European Union (EU) reached agreement on the terms of a prospective implementation (or transitional) period following the UK's withdrawal from the EU.
- 1.23** The implementation period is intended to operate from 29 March 2019 until at least the end of December 2020. During this time, EU law will still apply in the UK, in accordance with the overall withdrawal agreement. This means that firms, funds and trading venues will continue to benefit from passporting between the UK and the European Economic Area (EEA) as they do today. Obligations derived from EU law will continue to apply and firms must continue with implementation plans for EU legislation that is still to come into effect before the end of December 2020.
- 1.24** The implementation period forms part of the withdrawal agreement, which is still subject to ratification. We continue to work to ensure the UK's legal and regulatory framework for financial markets will also continue to function in the absence of a withdrawal agreement or implementation period.
- 1.25** While important for all firms, including those carrying on cryptoasset activities, upcoming legislation such as the transposition of the Fifth Anti-Money Laundering Directive (5AMLD) is relevant – especially for firms using exchange tokens.

Next steps

- 1.26** Please send any written responses to Parma Bains, The Financial Conduct Authority, 12 Endeavour Square, London, E20 1JN or fcacrypto@fca.org.uk. Alternatively, you can use the online form. Please send any responses by Friday 5 April 2019.

Regulatory changes

- 1.27** Firms should note that Her Majesty's Treasury (HMT) will be publishing a consultation paper in early 2019 on exploring legislative change to potentially broaden the FCA's regulatory remit to bring in further types of cryptoassets.

2 The wider context

- 2.1** In this chapter, we set out the wider context to the Guidance. We explain the key concepts related to cryptoassets, an overview of the UK market, our assessment of harm and what action we have taken to date. Additionally, we have looked at broader actions of the other Taskforce members, to allow us to present a holistic view on how the harms that we believe result from cryptoasset activities are being mitigated more broadly, and the role that this Guidance document plays in that mitigation.

Key Concepts

- 2.2** Below we have defined the key overarching concepts relating to the categorisation of cryptoassets – namely exchange tokens, security tokens and utility tokens; and the underlying technology on which cryptoassets operate – Distributed Ledger Technology (DLT).

Categories of cryptoassets

- 2.3** We refer to cryptoassets as a broad term, and we have used the term 'tokens' to denote different forms of cryptoassets. This allows us to focus on the activities and functions of different types of cryptoassets while also being a neutral term that does not denote a direct comparison with fiat currency.
- 2.4** There is no single agreed definition of cryptoassets, but generally, cryptoassets are a cryptographically secured digital representation of value or contractual rights that is powered by forms of DLT and can be stored, transferred or traded electronically.⁷ Examples of cryptoassets include Bitcoin and Litecoin (which we categorise as exchange tokens), as well as other types of tokens issued through the Initial Coin Offerings (ICOs) process (which will vary in type).
- 2.5** In line with the Taskforce, we have categorised cryptoassets into three types of tokens;
- **Exchange tokens:** these are not issued or backed by any central authority and are intended and designed to be used as a means of exchange. They are, usually, a decentralised tool for buying and selling goods and services without traditional intermediaries. These tokens are usually outside the perimeter.
 - **Security tokens:** these are tokens with specific characteristics that mean they meet the definition of a Specified Investment like a share or a debt instrument (described in more detail in Chapter 3) as set out in the RAO, and are within the perimeter.
 - **Utility tokens:** these tokens grant holders access to a current or prospective product or service but do not grant holders rights that are the same as those granted by Specified Investments. Although utility tokens are not Specified Investments, they might meet the definition of e-money in certain circumstances (as could other tokens), in which case activities in relation to them may be within the perimeter.

⁷ www.ucl.ac.uk/laws/sites/laws/files/02_mckee_ucl-blockchain.pdf

2.6 Cryptoassets vary significantly in the rights they grant their owners, as well as their actual and potential uses. Given the variety and complexity of applications, the Taskforce developed a framework which takes into account the different uses of the three types of cryptoassets identified above. Cryptoassets are typically used:

- **As a means of exchange**, usually functioning as a decentralised tool to enable the buying and selling of goods and services, or to facilitate regulated payment services.
- **For investment**, with firms and consumers gaining direct exposure by holding and trading cryptoassets, or indirect exposure by holding or trading financial instruments that reference cryptoassets.
- **To support capital raising and/or the creation of decentralised networks** through ICOs or other distribution mechanisms.

2.7 While cryptoassets can be used as a means of exchange, they are not considered to be a currency or money, as both the Bank of England and the G20 Finance Ministers and Central Bank Governors have previously set out. They are too volatile to be a good store of value, they are not widely accepted as a means of exchange, and they are not used as a unit of account.⁸

Distributed Ledger Technology

2.8 The Taskforce developed a framework for different types of cryptoassets, which is underpinned by DLT.

2.9 As with cryptoassets, while there is no single formal definition of DLT, it can be described as a set of technological solutions that enables a single, sequenced, standardised and cryptographically-secured record of activity to be safely distributed to, and acted upon by, a network of varied participants. This record could contain transactions, asset holdings or identity data. This contrasts with a traditional centralised ledger system, owned and operated by a single trusted entity.

2.10 DLT in its blockchain form was first used in Bitcoin to facilitate peer-to-peer payments without a central third party. Blockchain is a type of DLT that has a specific set of features, organising its data in a chain of blocks. Each block contains data that are verified, validated and then 'chained' to the next block. Blockchain is a subset of DLT, and the Bitcoin Blockchain is a specific form of a blockchain. Today, all cryptoassets utilise various forms of DLT (be it blockchain or otherwise), although the use cases of DLT extends far beyond financial services.

2.11 We have previously shared our position on DLT as part of a Feedback Statement that we published in December 2017. DLT was also covered in the recent Cryptoasset Taskforce report.⁹

⁸ For further detail, see, for example: 'The future of money – speech by Mark Carney', Bank of England, 2018, www.bankofengland.co.uk/speech/2018/mark-carney-speech-to-the-inaugural-scottish-economics-conference; and 'Communiqué – Finance Ministers and Central Bank Governors', G20, 2018, https://g20.org/sites/default/files/media/communique_-_fmcgbg_march_2018.pdf

⁹ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

The UK cryptoasset market

- 2.12** Reliable and comprehensive data on the cryptoasset market are not yet available, given the market is still in its early stages and developing rapidly. The Taskforce has been able to identify that the UK is not a major market for cryptoasset trading.
- 2.13** For example, there are fewer than 15 cryptoasset spot exchanges with headquarters in the UK, out of a global market of 231. They appear to have a combined daily trading volume close to \$200 million which accounts for close to 1% of the daily global trade in cryptoassets. Only 4 of these 15 spot exchanges regularly post daily individual trading volumes above \$30 million, which represents a low volume relative to the wider global market.¹⁰
- 2.14** However, we have seen some growth areas, for example in the number of exchange and utility tokens. There are currently over 2,000 exchange and utility tokens in the market, and given the rapidly changing nature of the market, these numbers are growing quickly.¹¹
- 2.15** By contrast, in 2018 we saw a significant reduction in capital raised in ICOs compared to the 2017 amount and global ICO funding was \$65m in November 2018, compared to over \$823m in November 2017.¹² There are a number of reasons for this fall, with commentators identifying investor caution as a response to the large amount of fraudulent ICOs as well as a high failure rate of new enterprises that use the ICO process. This can also lead to ICOs missing their target collections. The underlying volatility of cryptoassets used may also be an issue as they are used, in many cases, for payments in ICOs.
- 2.16** In terms of acceptance, cryptoassets are not widely used as a means of exchange in the UK. No major high street or online retailer accepts them as a form of payment and less than 600 independent shops, bars and cafes around the UK accept Bitcoin.¹³
- 2.17** In terms of cryptoassets being used as a form of speculative investment, data from cryptoasset exchanges show that trading in sterling against Bitcoin makes up just 0.39% of 24 hour global trading volumes in cryptoassets.¹⁴ However, this may underestimate the volume of trades from the UK as traders will first convert to another currency which is more widely accepted. Online consumer surveys suggest that cryptoasset ownership rates among UK survey respondents are between 5-10% (in line with other G7 economies), however figures for the wider population are likely to be lower.¹⁵ The FCA has commissioned qualitative and quantitative research on UK consumers' understanding and attitude towards cryptoassets. This research is still underway, but we expect it to give us a clearer picture on the ownership of cryptoassets in the UK.
- 2.18** In relation to capital raising activity, the Taskforce estimated that there are 56 projects in the UK that have used ICOs, accounting for less than 5% of projects globally.¹⁶

10 '24 hour volume rankings', CoinMarketCap, as of 04.12.2018, <https://coinmarketcap.com/exchanges/volume/24-hour/>

11 <https://coinmarketcap.com/all/views/all/>

12 Token Data, monthly reported total of capital raised in ICOs, December 2018

13 <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/digital-currencies/written/82252.pdf>

14 www.cryptocompare.com/coins/btc/analysis/USD

15 'Global cryptocurrency survey results', Dalia Research, 2018, https://daliaresearch.com/wp-content/uploads/2018/05/2018-05-07_Pressrelease_Global_Cryptocurrency_Survey-Google-Docs.pdf; and 'Cracking the code on cryptocurrency', ING, 2018, https://think.ing.com/uploads/reports/ING_International_Survey_Mobile_Banking_2018.pdf

16 Figures based on Coinschedule market research, shared with the Taskforce on the 20.08.2018

Market research shows that these funding rounds account for less than 1% of the \$24 billion raised globally.¹⁷ The majority of tokens that are issued through ICOs to the market tend to be marketed as utility tokens, although it is difficult to comment on whether those tokens are true utility tokens, or whether they are marketed as utility tokens despite having the intrinsic structure of tokens that we would consider securities. The Guidance will focus on this area to make sure that firms are aware when their tokens may be considered securities, and therefore fall within the FCA's regulatory perimeter. This is an issue we will be paying increasing attention to, especially where those preparing ICOs attempt to avoid regulation by marketing securities as utility tokens.

The harm we have observed

- 2.19** Whilst there is limited evidence of the current generation of cryptoassets delivering benefits, this is a rapidly developing market and benefits may arise in the future. We have already seen potential benefits on a small scale in the sandbox, particularly around increased speed and a reduction in cost of cross border money remittance with cryptoassets as a vehicle for exchange.

Harm to consumers

- 2.20** Cryptoassets pose a range of substantial risks to consumers, which stem from consumers purchasing unsuitable products without having access to adequate information. This can include fraudulent activity, as well as the immaturity or failings of the market infrastructure and services.
- 2.21** Consumers may experience unexpected or large losses. While this is true of many types of investments, cryptoasset investors should be particularly aware of the volatility that many tokens experience, and the limited information available on how these tokens work. Preliminary findings from our consumer research suggest that consumers can overestimate their knowledge of cryptoassets and the underlying technology, with some respondents believing that, due to language such as 'mining' and 'coins', they were investing in tangible assets.
- 2.22** Leveraged derivatives, like Contracts for Differences (CFDs) and futures, referencing cryptoassets carry a high risk of loss due to the volatility of cryptoassets and the impact of product fees such as financing costs and spreads,. They can also be difficult to value due to a lack of transparency¹⁸ in the price formation of the underlying cryptoasset.¹⁹
- 2.23** The potential to misunderstand the nature of these assets can be compounded by poor practices in relation to advertising. Adverts often overstate benefits and rarely warn of volatility risks, the fact consumers can lose their investment, the absence of a secondary market for many offerings, and the lack of regulation. These often play on

17 This is less than ICOs issued by entities within other countries, like the United States (\$6.7 billion), Singapore (\$1.3 billion), Switzerland (\$1.1 billion) but more than raised by entities in Japan (\$0.1 billion). This market research was undertaken by Coin Schedule on 20.08.2018 and compared against other sources including CoinDesk, Autonomous Next, Token Data and ICO tracking websites

18 www.fca.org.uk/scamsmart/cryptocurrency-investment-scams

19 www.fca.org.uk/news/press-releases/fca-proposes-permanent-measures-retail-cfds-and-binary-options

consumers' aspirations for 'easy money and wealth' and 'fear of missing out'. Often social media plays a significant role in influencing consumers' behavior.

- 2.24** 'Whitepaper' documents that typically accompany ICOs are not standardised and often feature information considered to be exaggerated or misleading. Given the lack of clear information, consumers may not understand that many of these projects are high-risk and at an early stage, and therefore may not suit their risk tolerance, financial sophistication or financial resources. These documents are not prospectuses, are not approved by a regulatory authority and do not, generally, provide the level of detail contained in a prospectus in relation to the company, the business and the product.
- 2.25** Consumers may buy cryptoassets without being aware of the limited regulatory protections for those cryptoassets that fall outside the FCA's regulatory remit like the lack of recourse to the Financial Services Compensation Scheme (FSCS), and the Financial Ombudsman Service (FOS). This can be more problematic when firms offer both regulated and unregulated products at the same time, as it can be harder for consumers to determine which products provide recourse. We would always expect a regulated firm selling unregulated products to be clear with consumers about this. Where products are regulated, recourse is only available in limited circumstances like mis-selling – losing money in an investment does not automatically mean recourse is available.
- 2.26** Fraudulent activity is likely to exist across the range of cryptoassets, but evidence suggests there are significant risks associated with ICOs, particularly around high failure rates, or fraudulent ICOs. Recent research looked at listed tokens in 2017 with data provided for those ICOs with over \$50 million in market capitalisation and found that 78% of these listed tokens were scams.²⁰
- 2.27** The FCA works closely with other authorities such as the police, Advertising Standards Authority and Trading Standards in order to reduce fraudulent activity. We may also consider other laws and non-financial rules and regulations which may also apply to authorised and unauthorised firms, like the Advertising Codes, general common law, criminal law, and the General Data Protection Regulation (GDPR) amongst others.
- 2.28** Poor cyber security can also lead to hackers taking advantage of systems and stealing cryptoassets through cybercrime. Cryptoassets are now viewed as high-value targets for theft. Both users, and service providers like custodians/wallet providers and exchanges are increasingly being targeted by cybercriminals to obtain the private keys which enable consumers to access and transfer their cryptoassets.²¹ In the first half of 2018 alone, \$731 million worth of cryptoassets were stolen from exchanges. This included \$500 million from a hack on the Coincheck exchange and \$40 million from a hack on the Coinrail exchange.²² By October 2018, hacking of exchanges increased to \$927 million.²³
- 2.29** Monitoring operational harms is demanding given the cyber environment and large scale technological changes taking place within the cryptoasset industry. Mitigating operational harms, including ensuring operational resilience, is a vital part of protecting the UK's financial system, institutions and consumers.

20 www.esma.europa.eu/sites/default/files/library/esma22-106-1338_smsg_advice_-_report_on_icos_and_crypto-assets.pdf

21 www.ncsc.gov.uk/report/weekly-threat-report-2nd-february-2018

22 https://cdn2.hubspot.net/hubfs/4345106/crypto_aml_report_2018q2.pdf?submissionGuid=6e9724d0-8832-43ea-8ce0-206eb4605548

23 https://ciphertrace.com/wp-content/uploads/2018/10/crypto_aml_report_2018q3.pdf

Harm through financial crime

- 2.30** Cryptoassets can sometimes offer potential anonymity and the ability to move money between countries and individuals. This lack of transparency and regulatory oversight for certain cryptoassets means that there are risks from financial crime, including money laundering and the financing of terrorism.
- 2.31** UK law enforcement authorities are working with international partners to develop their understanding of the role cryptoassets can play in money laundering. Europol estimates that £3-4 billion is laundered using cryptoassets each year in Europe. This remains a relatively small proportion of total funds estimated to be laundered in Europe, however, which stands at £100 billion.²⁴ However, a recent Financial Action Task Force (FATF) report to the G20 noted that suspicious transaction reporting linked to cryptoassets is rising globally.²⁵

Harm to market integrity

- 2.32** Market volatility and the lack of transparency and oversight may also heighten the potential risk of market manipulation and insider dealing on exchanges and trading platforms. This can be further exacerbated by exchanges and trading platforms not having adequate systems and controls to protect against market manipulation and insider dealing.
- 2.33** For cryptoassets and related markets, vulnerability to market manipulation and insider dealing is heightened by several factors:
- the market is immature which means existing systems and controls may not be effective and may require further development to appropriately address the risks
 - there is a lack of information about the identity of participants and their activity inherent in some cryptoassets
 - the novel nature of the market may create new risks, including new abusive behaviours which are not captured by current regulation and market monitoring and surveillance arrangements
- 2.34** This document does not provide guidance on Market Abuse Regulation (MAR) but sets out some of the broad regulatory requirements that market participants such as issuers of tokens, exchanges and trading platforms, among others, will need to consider when engaging with cryptoassets that fall within our regulatory perimeter.

How we intend to address this harm

- 2.35** The Taskforce agreed to take action to mitigate the risks that cryptoassets pose to consumers and market integrity; to prevent the use of cryptoassets for illicit activity; to guard against future threats to financial stability and to encourage responsible development of legitimate DLT and cryptoasset-related activity in the UK.

²⁴ www.bbc.co.uk/news/technology-43025787

²⁵ www.fatf-gafi.org/media/fatf/documents/reports/FATF-Report-G20-FM-CBG-July-2018.pdf

2.36 To achieve this, the Taskforce report committed:

- HMT to consult in 2019 on potentially expanding the FCA's regulatory perimeter to bring in further types of cryptoassets
- HMT to consult in 2019 on the transposition of the EU's Fifth Anti-Money Laundering Directive (5AMLD), and broadening the Anti-Money Laundering/Counter Terrorist Financing (AML/CTF) regulation further in relation to cryptoassets
- The FCA to consult separately on a potential prohibition on the sale to retail consumers of derivative products and transferable securities linked to certain cryptoassets.
- The FCA to consult on Guidance in relation to the existing regulatory perimeter²⁶

2.37 Overall, the Guidance aims to reduce harms by increasing clarity. This is not only relevant for firms who are undertaking activities which require FCA authorisation, but also for participants undertaking broader financial services activities. For example:

- Considering the application of the financial promotion rules, including ensuring communications are marketed in a way which is clear, fair and not misleading
- Considering the application of the prospectus directive
- Considering the application of relevant financial crime controls

2.38 Below we have explained how this Guidance document should mitigate some of the more specific harms identified, using our statutory objectives of consumer protection, market integrity and competition as a guide.

Consumer protection harms

2.39 In mitigating consumer harm, publishing Guidance will make it clear that firms carrying on regulated cryptoasset activities in the UK must obtain the appropriate authorisation from the FCA. Consumers should be able to determine if a cryptoasset falls within the perimeter, and can then use services like the [FCA Register](#) to make sure the firms they are dealing with have the necessary permissions for the regulated activities they may be carrying on.

2.40 This Guidance highlights some of the requirements and permissions that participants such as custodians/wallet providers, and exchanges and trading platforms will need to consider when carrying on regulated cryptoasset activities.

2.41 In this Guidance, we note future consultations and how cryptoassets and market participants may be affected by the transposition of 5AMLD, although this Guidance does not consult on 5AMLD. Firms should be aware of how existing anti-money laundering requirements apply to their business and activities.

Market integrity harms

2.42 A combination of market immaturity, volatility, and a lack of credible information or oversight raises concerns about market integrity, manipulation and insider dealing. This may prevent the market from functioning effectively and damage confidence in the reputation of the market.

²⁶ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf

- 2.43** The aim of this Guidance is to clarify what is regulated by the FCA, where regulation applies and what this means for firms. This means that firms that carry on regulated activities will need to be authorised and will need to make sure they follow the appropriate rules, both contained within this Guidance, and broader regulation (eg MAR).

Competition harms

- 2.44** Publishing Guidance should reduce legal uncertainty and assist firms to develop legitimate cryptoasset activities and business models. This may improve participation in the cryptoasset market and competition in the interest of consumers.

Other FCA actions

- 2.45** This publication builds on a number of steps the FCA has taken over recent years, including:
- Consulted on restricting the sale, marketing and distribution of CFDs and similar products to retail customers
 - We have taken a number of steps to improve public awareness of the risks associated with all types of cryptoassets, including through media appearances and issuing consumer and firm warnings. In addition, cryptoassets have been added to the [FCA's ScamSmart Warning List](#), a campaign that aims to help consumers over the age of 55 falling victim to scams and investment fraud.
 - Providing support to innovative businesses looking to understand how their business interacts with regulation, including becoming authorised. Where businesses require further support, our Regulatory Sandbox provides an environment where cutting edge innovation can be tested with real consumers in a controlled environment.
 - In 2017, the FCA started a dialogue on the potential for DLT in the financial markets, and published a Discussion Paper and Feedback Statement.²⁷

Next steps

- 2.46** This consultation, focused on the existing regulatory perimeter, represents the first important step for the FCA in delivering against the commitments set out in the Taskforce report. This will also help inform future work we carry out on cryptoassets, both independently and as part of the Taskforce. This consultation means we can share our position on areas that we feel are complex or contentious, and provide regulatory clarity for firms and consumers.
- 2.47** The consultation period will be open until Friday 5 April 2019 and we welcome input from any interested stakeholders.
- 2.48** At the end of the consultation period, we will consider the feedback we have received. We will then publish a Policy Statement that outlines our final Guidance. We intend to publish this final Guidance by summer 2019.

²⁷ For further detail, see: 'Feedback statement 17/4: distributed ledger technology', FCA, 2017, www.fca.org.uk/publications/feedback-statements/fs17-4-distributed-ledger-technology

3 Perimeter Guidance

Overview of the regulatory perimeter

3.1 The FCA's aim and purpose is set out in the Financial Services and Markets Act 2000 (FSMA).²⁸ We have a single strategic objective – to make sure that the relevant markets function well. The strategic objective is underpinned by three statutory 'operational objectives':

- to secure an appropriate degree of protection for consumers
- to protect and enhance the integrity of the UK's financial system
- to promote effective competition in the interest of consumers

3.2 The 'regulatory perimeter' describes the boundary that separates regulated and unregulated financial services activities. Activities that fall within the FCA's perimeter are regulated and require authorisation from us (or the Prudential Regulatory Authority if they relate to certain deposit-taking/insurance activities) before a firm can carry them out. The perimeter includes specified activities and investments set out in the FSMA and the RAO.²⁹ Regulated activities can also be set through EU law, which is then transposed into domestic law or can apply directly. MiFID II recognises various 'Financial Instruments';³⁰ these are certain categories of investments to which MiFID applies, which have been mapped to the RAO. For example, providing advice in relation to a Specified Investment like a share may amount to the regulated activity of 'advising on investments' which would likely require authorisation. Whereas providing advice in relation to something other than a Specified Investment, such as a commodity, like gold, is not within the regulatory perimeter, and is not a regulated activity, and will not require authorisation.

3.3 We appreciate that people may purchase cryptoassets for speculative purposes, anticipating that their value will increase. We also appreciate that there are a number of factors that may increase their value, including speculative trading on secondary markets (usually cryptoasset exchanges). This is similar to the purchase of a number of goods, the value of which the investor expects to increase over time (residential or commercial property, wines, cars, artwork etc).

3.4 However, the fact that a cryptoasset is acquired for value (in exchange for a certain number of cryptoassets or for payment in fiat currency) does not necessarily make it a Specified Investment under the RAO, nor a Financial Instrument under MiFID.

Understanding this Guidance

3.5 The Guidance clarifies where the different categories of cryptoasset tokens fall in relation to the FCA's regulatory perimeter. It outlines where tokens are likely to be:

28 www.legislation.gov.uk/ukxi/2001/544/contents/made

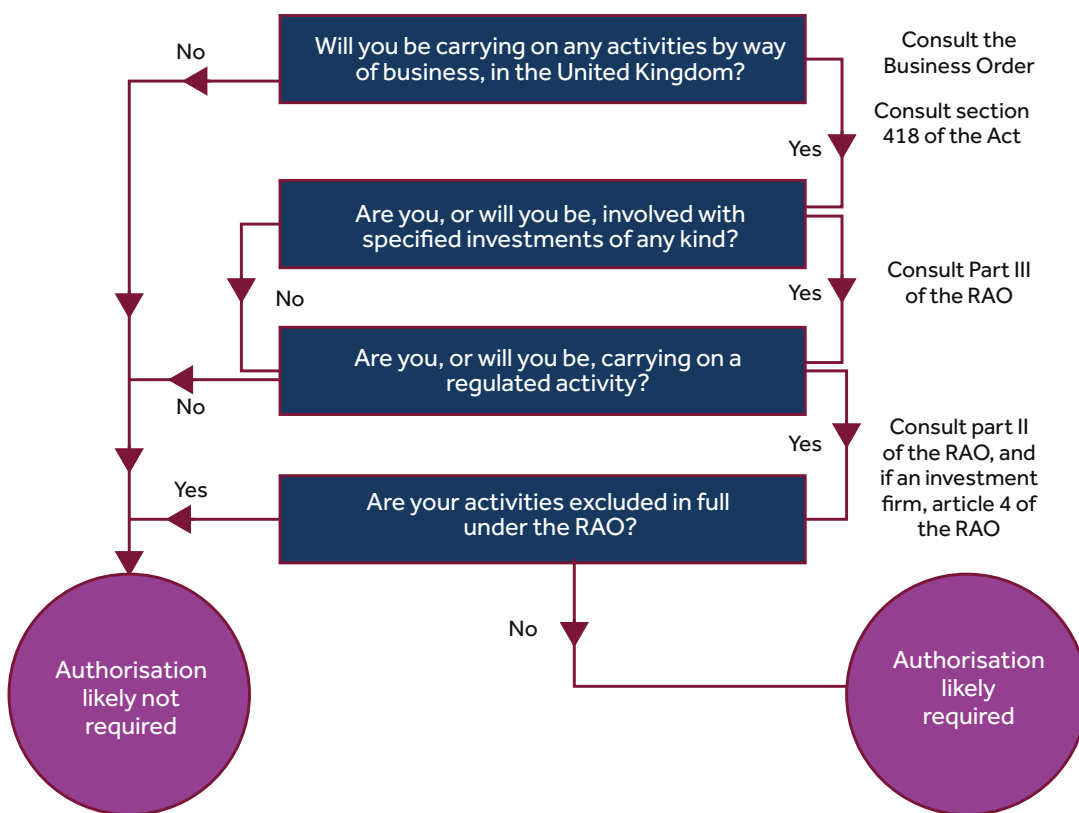
29 www.legislation.gov.uk/ukxi/2001/544/part/II/made

30 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065>

- Specified Investments under the RAO
- Financial Instruments under MiFID II
- E-Money under the EMRs
- captured under the PSRs

3.6 There are a number of different elements that firms need to take into account when considering the regulated perimeter. Figure 1 shows some of these considerations; however, the focus of this guidance is predominantly on the second step, understanding Specified Investments. This is the area market participants have told us they struggle the most to understand and we agree that it warrants further regulatory clarity.

Figure 1: Do I need to be authorised by the FCA?



3.7 Before we examine Specified Investments in more detail, we have provided below a brief overview of what we mean when describing 'by way of business' and 'territoriality'.

By way of business

- 3.8** By way of business is covered in detail in PERG 2.3 but some of the key factors in determining where an activity is carried on by way of business is whether a person receives remuneration (monetary or non-monetary) and whether a person is carrying on that activity with a degree of regularity and for commercial purposes (so they are gaining some sort of direct financial benefit of some kind). For instance, if an individual were to advise a few friends occasionally about which security tokens they recommend their friends buy, and they receive no benefit for doing this, this may not satisfy the by way of business test. However, if an individual holds themselves out as an adviser and advises people on a regular basis as to which security tokens to buy, and they receive some benefit as a result, such as charging a fee or receiving a reward from the issuer of the tokens, this is more likely to be considered activity by way of business.

Territoriality

- 3.9** The general prohibition provides that the requirement to be authorised only applies in relation to activities that are carried on by way of business in the UK. Given the decentralised nature of cryptoassets with a large cross-border element, it can be difficult to determine where the activity is carried on.
- 3.10** PERG 2.4 provides details around the link between regulated activities and the United Kingdom. It sets out that even where part of the activity is outside the UK, a person may still be carrying on a regulated activity in the UK. For example, a firm that is situated in the UK and is safeguarding and administering security tokens (Specified Investments) for clients overseas will be carrying on activities in the UK even though the client may be situated outside the UK.

Specified investments

- 3.11** The PERG manual in the FCA Handbook gives further details about Specified Investments and Financial Instruments including transferable securities. Further details to help businesses navigate the PSRs and EMRs can be found in PERG as well as the [FCA's Approach to Payment Services and Electronic Money](#).
- 3.12** The Guidance takes a step-by-step approach to help firms determine whether certain cryptoassets fall within the perimeter:
- Step 1: Listing investments set out in the RAO and MiFID that a cryptoasset might constitute
 - Step 2: Guidance on how these apply to cryptoassets for the areas where we have observed greater market development
 - Step 3: Case studies to give practical examples of how the Guidance works in practice
 - Step 4: An indicative list of market participants that carry on cryptoasset activities, and the types of permissions they may need if they are using tokens that are within our perimeter
 - Step 5: Q&A section to give guidance on more nuanced, complex, or frequently asked questions
- 3.13** The Guidance reflects some of the business models we have observed in the UK market through tools available to the FCA like the sandbox, as well as our broader policy, authorisation, supervision and enforcement work.

Application of this Guidance

- 3.14** The FCA is a technology neutral regulator, and the use of new technology alone does not alter how we consider it fits within the regulatory perimeter. However, while our tech-neutrality means we're agnostic about the type of technology used, the choice of technology may influence the way in which regulation applies. While the use of a certain technology won't usually have an impact on the permissions the firm requires, it might have an impact on the unique risks associated with the carrying on of certain regulated activity.
- 3.15** For example, the fact that a business model uses DLT does not impact on our assessment in relation to the perimeter. However, the use of DLT may raise operational issues that are unique and novel to that technology and we consider these as part of our ongoing regulation.
- 3.16** In this Guidance, we have used the term 'tokens' to denote different forms of cryptoassets. For us, 'cryptoasset' is a broad term that captures the different types of tokens. It is also a neutral term that does not denote a direct comparison with fiat currency.
- 3.17** We use the term 'security token' to define those tokens that constitute Specified Investments.
- 3.18** We use the expression 'issuers of tokens' to cover a number of entities including developers, designers, firms who issue tokens and certain intermediaries, since determining precisely who the issuer or issuers are is not always easy or possible. While we use the term 'issuers' in this paper in all of these ways, 'issuer' under the Prospectus Directive means something narrower and refers to the legal issuer of the securities e.g. the company – where this applies, we make it clear by linking the term to rules like the Prospectus Directive.
- 3.19** Cryptoassets can take many forms and be structured in different ways. Although we recognise three broad categories of cryptoassets: exchange, security and utility tokens, it is important to know that these categories are not mutually exclusive, nor exhaustive of the types of cryptoassets that can exist. For example, a token issued as a utility token (to access a current or prospective product or service) might, during the course of its lifecycle, be used as an exchange token (that could be used as a means of exchange).
- 3.20** Assessing whether a cryptoasset is within the perimeter can only be done on a case-by-case basis, with reference to a number of different factors. Although one or more of these factors might indicate that the cryptoasset in question is, or is not, within the perimeter, they are not always determinative. Ultimately, it is a firm's responsibility to make sure that it has the correct permissions for the activities it intends to engage in and we encourage market participants to obtain independent advice if they think the position remains unclear.

Do I need to be authorised by the FCA

- 3.21** If you carry on regulated cryptoasset activities involving cryptoassets that meet the definition of a Specified Investment as set out in the RAO, i.e. security tokens, you will need to make sure you are appropriately authorised or exempt. This is the same regardless of technology – if you are carrying on a regulated activity, it is likely you will need to be authorised. You will also need to ensure you have appropriate authorisation if your token constitutes e-money, or is used to facilitate regulated payments services.

3.22 Issuers of tokens may themselves not need to be authorised, however certain requirements related to the issuance of the tokens may still apply, for example prospectus and transparency requirements.³¹

What happens if I carry on regulated activities without any permissions

3.23 Section 19 of FSMA sets out the 'general prohibition'. The general prohibition states that no person may carry on a regulated activity, or purport to do so (claim to do so), unless they are an authorised person, or they are an exempt person. Firms carrying on regulated activities in relation to cryptoassets, as with any firms carrying on regulated activities generally, must make sure they have the correct authorisation.

3.24 Section 23 of FSMA sets out the legal consequences for breaching the general prohibition. It provides that a person who contravenes the general prohibition is guilty of an offence and may face up to 2 years' imprisonment or an unlimited fine, or both.

3.25 For example, if a person provides advice in relation to security tokens that amounts to the regulated activity of advising on investments (article 53 of the RAO), but is not authorised or exempt, they may be in breach of the general prohibition.

3.26 A breach of the general prohibition is a criminal offence and carries a maximum penalty of 2 years imprisonment or an unlimited fine, or both.

How do I know if my token is a Specified Investment?

3.27 Given the complexity of many tokens, it is not always easy to determine whether a token is a Specified Investment, specifically those types of Specified Investment that are securities, like shares or debt instruments. There are a few factors that are indicative of a security. These factors may include, but are not limited to:

- the contractual rights and obligations the token-holder has by virtue of holding or owning that cryptoasset
- any contractual entitlement to profit-share (like dividends), revenues, or other payment or benefit of any kind
- any contractual entitlement to ownership in, or control of, the token issuer or other relevant person (like voting rights)
- the language used in relevant documentation, like token 'whitepapers', that suggests the tokens are intended to function as an investment, although it should be noted that the substance of the token will determine whether an instrument is a Specified Investment, and not necessarily the labels used
 - For example, if a whitepaper declares a token to be a utility token, but the contractual rights that it confers would make it a Specified Investment, we would consider it to be a security token.
- whether the token is transferable and tradeable on cryptoasset exchanges or any other type of exchange or market
- a direct flow of payment from the issuer or other relevant party to token holders may be one of the indicators that the token is a security, although an indirect flow of payment (for instance through profits or payments derived exclusively from the secondary market) would not necessarily indicate the contrary.

31 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32017R1129>

- If the flow of payment were a contractual entitlement we would consider this to be a strong indication that the token is a security, irrespective of whether the flow of payment is direct or indirect (or whether other ownership rights are present).

3.28 You can see the full list of Specified Investments in Part III of the RAO.³²

Financial promotions and cryptoassets

3.29 Section 21 of FSMA³³ provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity unless that person is an authorised person or the content of the communication is approved by an authorised person. Issuing a financial promotion in breach of section 21 FSMA is a criminal offence.

3.30 We expect market participants to apply the financial promotion rules and communicate financial promotions for products and services, whether regulated or unregulated, in a way which is clear, fair and not misleading. It is a legal requirement that firms make clear in their promotions which activities are, and are not, regulated, especially when highlighting their FCA authorised status. For example, an authorised firm may decide to offer access to unregulated cryptoassets (such as exchange tokens, like Bitcoin or Ether). The firm must not, in any way, communicate that their authorisation extends to those unregulated cryptoassets, and communication should be transparent to ensure consumers are aware which activities the firm is authorised for.³⁴

What are exchange tokens?

3.31 Exchange tokens (like Bitcoin, Litecoin etc.) are not issued or backed by any central authority and can be used directly as a means of exchange. These tokens can enable the buying and selling of goods and services without the need for traditional intermediaries such as central or commercial banks (e.g. on a peer-to-peer basis). Exchange tokens have been referred to in other frameworks as: 'crypto coins', 'payment tokens', 'cryptocurrencies', and are usually decentralised. These exchange tokens can be used independently of a platform and are not limited to use within a specific network or only for goods and services offered by a specific issuer.

3.32 Exchange tokens are used in a way similar to traditional fiat currency. However, while exchange tokens can be used as a means of exchange, they are not currently recognised as legal tender in the UK, and they are not considered to be a currency or money.

3.33 They are much more volatile than currencies and commodities, and as such they are not widely accepted as a means of exchange in the UK outside crypto and digital communities, and they are not typically used as a unit of account or a store of value.

3.34 These factors mean that very few merchants accept exchange tokens as a payment tool; numbers are limited to fewer than 600 in the UK.³⁵

³² www.legislation.gov.uk/ukxi/2001/544/part/III/made

³³ www.legislation.gov.uk/ukxi/2001/544/contents/made

³⁴ www.fca.org.uk/publication/correspondence/dear-ceo-letter-promotions-regulated-unregulated-business.pdf

³⁵ <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/treasury-committee/digital-currencies/written/82252.pdf>

3.35 Exchange tokens typically do not grant the holder any of the rights associated with the Specified Investments within our perimeter. This is because they tend to be decentralised, with no central issuer obliged to honour those contractual rights – if any existed.

3.36 While we are aware that exchange tokens can be acquired and held for the purpose of speculation rather than exchange, as token-holders may anticipate that the value of these tokens will increase in the future on cryptoasset markets, we do not view this as being sufficient for exchange tokens to constitute Specified Investments. The analogy would be an individual holding different fiat currency or a commodity, both of which are unregulated, in the hope of a gain.

3.37 Exchange tokens can be ‘pegged to’, or backed by, fiat currency, other cryptoassets or other forms of assets to stabilise their volatility. They can also be algorithmically stabilised for the purposes of exchange on a decentralised network. This stabilisation of a cryptoasset is a form of token sometimes referred to as a ‘stablecoin’ (please see 3.65 for more information).

Does the FCA regulate exchange tokens?

3.38 Exchange tokens currently fall outside the regulatory perimeter. This means that the transferring, buying and selling of these tokens, including the commercial operation of cryptoasset exchanges for exchange tokens, are activities not currently regulated by the FCA.

3.39 For example, if you are an exchange, and all you do is facilitate transactions of Bitcoins, Ether, Litecoin or other exchange tokens between participants, you are not carrying on a regulated activity.

3.40 This is in line with our approach to other investment-like products that remain outside our regulatory perimeter, like assets that some might consider having speculative value (eg fine wine or art).

3.41 However, firms should note that 5AMLD will be transposed into UK law by the end of 2019. 5AMLD will extend AML/CTF regulation to entities carrying out the following activities, pending formal consultation by HMT in 2019:

- exchange between cryptoassets and fiat currencies
- exchange between one or more other forms of cryptoassets
- transfer of cryptoassets³⁶
- safekeeping or administration of cryptoassets or instruments enabling control over cryptoassets
- participation in and provision of financial services related to an issuer’s offer and/or sale of a cryptoasset

3.42 It should be noted that this refers to an AML regime, and does not have the effect of bringing any participant into the full FSMA regulatory perimeter. We are not consulting on it in this consultation paper.

³⁶ In this context of cryptoassets, transfer means to conduct a transaction on behalf of another natural or legal person that moves a cryptoasset from one cryptoasset address or account to another

Q1: Do you agree that exchange tokens do not constitute specified investments and do not fall within the FCA's regulatory perimeter? If not, please explain why.

What are security tokens?

- 3.43** Security tokens are those tokens that meet the definition of a Specified Investment as set out in the RAO, and possibly also a Financial Instrument under MiFID II. For example, these tokens have characteristics which mean they are the same as or akin to traditional instruments like shares, debentures or units in a collective investment scheme.
- 3.44** Security tokens include tokens that grant holders some, or all, of the rights conferred on shareholders or debt-holders, as well as those tokens that give rights to other tokens that are themselves Specified Investments.
- 3.45** We consider a security to refer broadly to an instrument (i.e. a record, whether written or not) which indicates an ownership position in an entity, a creditor relationship with an entity, or other rights to ownership or profit. Security tokens are securities because they grant certain rights associated with traditional securities.
- 3.46** Security tokens are the type of cryptoasset which falls within the regulatory perimeter. However, the details depend on the type of Specified Investment and so we have provided more detailed guidance below.

The most relevant Specified Investments for tokens

- 3.47** The full list of Specified Investments is in the RAO with detailed guidance provided in PERG 2.6 but the most relevant of those Specified Investments for tokens, given the market we have observed, are likely to be the following:

Shares

- The Specified Investment category of shares etc under article 76 of the RAO includes shares or stock in the capital of
 - any body corporate (wherever incorporated); and
 - any unincorporated body constituted under the law of a country or territory outside the UK.
- Whether or not a particular form of overseas body is a body corporate depends on whether the law under which it is established confers on it the status of incorporation. Separate legal personality is a significant but not determinative factor; another significant factor is that the body survives a change of member. The definition also applies to overseas unincorporated bodies, but these bodies must have a share capital.³⁷
- Shares can also be transferable securities under MiFID. We consider that all shares and (securitised debt) that are negotiable on the capital markets fall within the definition of transferable securities; we do not take the view that the shares must be listed to be a transferable security under MIFID. Negotiability means that the

37 www.legislation.gov.uk/ukksi/2001/544/part/II/made and PERG 2.6.9

tokens must be capable of being traded on the capital markets. Factors that may suggest a token is negotiable on the capital markets include: it can be transferred from one person to another and so ownership of the token is transferred, and, it gives the person who acquires it good legal title to the token.³⁸

How this applies to tokens

- Tokens that give holders similar rights to shares, like voting rights, or access to a dividend of company profits or the distribution of capital upon liquidation, are likely to be security tokens. Tokens that represent ownership or control are also likely to be considered security tokens, as shares tend to represent ownership (through dividends and capital distribution) and control (through voting).
- However, this is not always the case as some tokens give voting rights on direction without it being considered control. For example, a token that provides the token holder with the right to vote on future ICOs the firm will invest in and no other rights would likely not be considered a share as the voting rights don't confer control-like decisions on the future of the firm.
- The voting rights that are typically associated with being a shareholder are quite specific and governed by company law. Whether a token represents a share in the capital of a body corporate or similar entity incorporated outside the UK will depend on the operation of company and corporate law. A right to vote in general meetings of shareholders may be one indicator but voting and other rights may differ from share to share.
- For a token to be considered a transferable security for MIFID purposes, it must be negotiable on the capital markets (that is, capable of being traded on the capital market), therefore tokens that confer rights like ownership and control (amongst others), and, importantly, are capable of being tradable on the capital markets are likely to be considered transferable securities. It is also important to note that even if a token which looks like a share is not a transferable security under MiFID (for instance, it has restrictions on transferability), it may still be capable of being a Specified Investment.
- Ultimately, whether a token is a share will also depend on the operation of, amongst other things, company and corporate law. It may be that even if a token is considered a share by the issuer, as a matter of law this might not be possible or accurate (e.g. if the issuer is not an incorporated entity), but the token may constitute another type of Specified Investment nonetheless (like a debenture).

What this looks like in practice

- **Case study 1:** Firm AB issues tokens that provide the token holder with a share of the company's profits to be paid annually. The tokens also provide the holder with voting rights. The tokens are structured so they can be easily transferred between two individuals and a change of ownership can be recorded. The tokens can also be traded on cryptoasset exchanges.
 - This token confers rights similar to those given by shares and is likely to be considered a Specified Investment. The negotiability suggests that the token will also be considered a transferable security. This token will be considered a security token.

38 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0065> and PERG 13.4 Q 28

- **Case study 2:** Firm CD, incorporated in the UK, has created a social trading platform, called the CD Platform, for users to easily exchange fiat currencies for exchange tokens. The firm issues 'CD Tokens' which are exchanged for fiat funds and these tokens are used to purchase other exchange tokens.
 - This alone is not enough to categorise the CD Tokens as security tokens. However, the CD Tokens also confer on the holder a right of ownership of the CD Platform proportionate to the number of CD Tokens held, and a right to participate in the profits of CD Platform (if any), to be paid annually in the form of a dividend.
 - These tokens are likely to be the same as or similar to shares and the tokens are therefore security tokens.
- **Case study 3:** Firm EF issues a token that it describes in its whitepaper document as a 'pure utility token'. The token allows the holder to access a product the firm is still developing. The token also allows the holder to share in profits in line with their holdings, once the product launches. The developers have been careful to make sure the token will not be able to be traded on the capital markets.
 - Despite the token being described as a utility token in the whitepaper, its lack of tradability and the fact that it offers access to a future product – this token would likely still be considered a Specified Investment given it confers on the holder rights similar to Specified Investments, i.e. conferring on the holding the right to share in profits in line with their holdings. This token is likely to be a security token.

Debt instruments

- Article 77 (debentures) includes debentures, debenture stock, loan stock, bonds, certificates of deposit, and any other instrument creating or acknowledging indebtedness (subject to certain exclusions).³⁹
- All forms of debt securities (other than government and public securities) that are negotiable on the capital markets also fall within the definition of transferable securities under MiFID. Debt securities do not need to be listed. As there is no restriction on maturity, this category also includes some money market instruments.⁴⁰

How this applies to tokens

- A token that creates or acknowledges indebtedness by representing money owed to the token holder is considered a debenture and constitutes a security token. Suggestions that a token represents debt owed by the issuer or other relevant person to the token holder may be an indicator that the token is a debenture.
- If a token is negotiable on the capital markets (for example because it can be transferred from one person to another who then acquires legal title of the token), then it might be considered a transferable security under MiFID too.

³⁹ www.legislation.gov.uk/ukxi/2001/544/part/II/made and PERG 2.6.11

⁴⁰ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0065&from=en>

What this looks like in practice

- **Case study 4:** To generate working capital, company GH issues tokens that grant holders the right to be repaid their investment in full by a certain date and also entitle holders to regular payments of interest on the capital amount. The GH tokens are freely traded on cryptoasset markets.
 - These tokens are likely to be considered instruments that create or acknowledge the debt owed by the issuer to the token holder and are therefore likely to qualify as debt instruments. Because they are negotiable on the capital market, they are also likely to constitute transferable securities.

Warrants

- Article 79 of the RAO provides for the Specified Investment category of warrants. Warrants are one of several categories of Specified Investments that are expressed in terms of the rights they confer in relation to other categories of Specified Investment. The rights conferred must be rights to 'subscribe' for the relevant investments. This means that they are rights to acquire the investments directly from the issuer of the investments and by way of the issue of new investments rather than by purchasing investments that have already been issued.⁴¹

How this applies to tokens

- If a firm issued A tokens that grant token holders the right to subscribe for B tokens in the future, and B tokens are themselves Specified Investments (for example, shares or debentures), A tokens will likely constitute warrants and will therefore be securities.

Certificates representing certain securities

- Article 80 of the RAO covers certificates or other instruments that confer contractual or property rights over other investments (like shares or debentures), subject to the two following conditions:
 - the investment must be owned by someone other than the person on whom the certificates confer the rights
 - the consent of that person is not required for the transfer of those investments
- We consider that depository receipts also fall within this category.⁴²

How this applies to tokens

- A token might confer rights in relation to tokenised shares or tokenised debentures, including depository receipts on the holder. These are likely to be security tokens.

Units in collective investment schemes

- A collective investment scheme means any arrangement, the purpose or effect of which is to enable persons taking part in the arrangements to participate in or receive profits or income arising from the investment or sums paid out of such profits or income. The participants do not have day-to-day control over

41 PERG 2.6.13

42 PERG 2.6.15

the management of the investment and contributions of the participants, and profits from which payments are to be made, are pooled and/or the investment are managed as a whole by or on behalf of the operator of the scheme. Certain arrangements are excluded.⁴³

- The specified investment category under article 81 of the RAO is units in a collective investment scheme and includes units in a unit trust scheme or authorised contractual scheme, shares in open-ended investment companies and rights in respect of most limited partnerships and all limited partnership schemes.
- Shares in, or securities of, an open-ended investment company are treated differently from shares in other companies. They are excluded from the Specified Investment category of shares. This does not mean that they are not investments but simply that they are treated in the same way as units in other forms of collective investment scheme.⁴⁴

How this applies to tokens

- A token that acts as a vehicle through which profits or income are shared or pooled, or where the investment is managed as a whole by a market participant, for instance the issuer of tokens, is likely to be a collective investment scheme. References to pooled investments, pooled contributions or pooled profits in a whitepaper could also be a factor in a token being considered a security.

What this looks like in practice

- **Case Study 5:** Firm IJ invests in fine art using the funds it receives and pools from investors and hires it out for use at corporate events for a fee. It issues tokens to investors in proportion to their contributions. These tokens also entitle the investors to receive a share of the fees generated by the art rental, and the profits it makes when it sells the art from time to time. The token holders have no day-to-day control over the art or the rental fees. The token holders' contributions are pooled, so are the rental fees and profits from art sales, and the art is managed as a whole by IJ. The tokens that represent the participants' share in the investment are therefore likely to constitute units in a collective investment scheme.

Rights and interests in investments

- Right to or interests in certain investments, including those listed above from shares to units in a collective investment scheme, also constitute Specified Investments under the RAO in their own right. Tokens that represent rights to or interests in other Specified Investments are therefore likely to constitute securities.

How this applies to tokens

- A firm may issue a token that represents a right in a share, although the token itself does not represent or have characteristics of a share. This token is a security token.

⁴³ www.legislation.gov.uk/ukpga/2000/8/section/235

⁴⁴ PERG 2.6.17

What this looks like in practice

- **Case study 6:** Firm KL issues a token that references a share in firm PB. The token is structured so it can't be traded in the capital markets or transferred from one person to another.
 - This token is considered a Specified Investment, but not a transferable security. The token is classified as a security token.

Other considerations

- 3.48** Tokens can be considered transferable securities under MiFID as well as Specified Investments under the RAO. When identifying transferable securities, in addition to those considerations discussed above, we take into consideration the answers the European Commission (EC) has provided in the Q&A on MiFID.⁴⁵ We will also have regard to material from the EC and the European Securities and Markets Authority (ESMA).
- 3.49** Firms and consumers can also gain exposure to exchange tokens through financial instruments which reference these tokens like CFDs, options, futures, exchange traded notes, units of collective investment schemes, or alternative investment funds. These instruments derive their value from referencing the cryptoasset, but they're not cryptoassets themselves.
- 3.50** Products that reference tokens, like derivative instruments, are very likely to fall within the regulatory perimeter as Specified Investments (either as options, futures or contracts for difference under the RAO). These products are also capable of being financial instruments under MiFID II.

Q2: Do you agree with our assessment of how security tokens can be categorised as a specified investment or financial instrument? If not, please explain why.

What are utility tokens?

- 3.51** Utility tokens provide consumers with access to a current or prospective service or product and often grant rights similar to pre-payment vouchers. In some instances, they might have similarities with, or be the same as, rewards-based crowdfunding. Here, participants contribute funds to a project in exchange, usually, for some reward, for example access to products or services at a discount.
- 3.52** Much like exchange tokens, utility tokens can usually be traded on the secondary markets and be used for speculative investment purposes. This does not mean these tokens constitute Specified Investments.

⁴⁵ https://ec.europa.eu/info/law/markets-financial-instruments-mifid-ii-directive-2014-65-eu/implementation/guidance-implementation-law_en

Does the FCA regulate utility tokens?

- 3.53** As utility tokens do not typically exhibit features that would make them the same as securities, they won't be captured in the regulatory regime, unless they meet the definition of e-money (see below).

What this looks like in practice

- **Case study 7:** Firm MN issues a token that grants the holder early access to a new line of clothing to be released by the firm, at a discounted rate. This would be similar to rewards-based crowdfunding where consumers have contributed to a project in exchange for early access to items from the new firm's new clothing line. This token will be considered a utility token, and not considered a Specified investment as set out in the RAO, nor a MiFID Financial Instrument.
- **Case study 8:** Firm OP operates an online casino. It issues tokens through an ICO that allows the token holders to use the casino. Any winnings are paid out in the OP Tokens. OP Token holders are also able to vote on which new betting games to add to the online casino's products, however the accompanying whitepaper to the ICO expressly states that Firm OP is not obliged to honour the outcome of any such vote. The tokens grant no additional rights in respect of any payments, ownership or control.

The rights these tokens grant token holders are not the rights we associate with Specified Investments. The tokens are not securities.

This would not be a Specified Investment as set out in the RAO, nor a MiFID Financial Instrument.
- **Case Study 9:** Firm QR, a well-known luxury car manufacturer, issues a token that allows the token holder the right to test drive a new limited-edition car for an hour. The token will be tradable on secondary markets where the price can increase or decrease depending on the demand for the limited-edition car, but will not confer any additional rights on the token-holder like payments, ownership or control etc. This will be a utility token.
- **Case study 10:** Firm ST is a cryptoasset firm that is raising funds to build a network for data. The firm issues tokens that give the token holder the right to data held within the network, but the tokens do not confer additional rights on the token-holder like profit, ownership or control. The tokens are not tradable on secondary markets. This will be a utility token.

Q3: Do you agree with our assessment of utility tokens? If not, please explain why.

Can cryptoassets be used to facilitate regulated payments services

- 3.54** Exchange tokens can be used to facilitate regulated payment services such as international money remittance, and we have seen a number of use cases in the sandbox where exchange tokens have been used like this to make things cheaper and faster on a small scale.
- 3.55** In the UK, the PSRs set out 8 different payments services in Schedule 1 Part 1.⁴⁶ These regulated payments services include, amongst other things, services relating

46 www.legislation.gov.uk/uksi/2017/752/schedule/1/part/1/made

to the operation of payment accounts – for example, cash deposits and withdrawals from current accounts – execution of payment transactions, card issuing, merchant acquiring, and money remittance.

3.56 Schedule 1 Part 2 of the PSRs includes a list of activities that do not constitute a payment service in the UK, like payment transactions executed wholly in cash and directly between the payer and the payee, without any intermediary intervention.⁴⁷ The use of cryptoassets are not covered by the scope of the PSRs⁴⁸ because they only cover activities with regards to funds which are defined as 'banknotes and coins, scriptural money and electronic money' (regulation 2 of the PSRs). The PSRs cover each side of the remittance, but do not cover the use of cryptoassets in between which act as the vehicle for remittance.

What this looks like in practice

3.57 **Sandbox case study 1.** Exchange tokens can be used to facilitate cross-border payments which are regulated by the FCA such as money remittance services and this business model has been tested in our regulatory sandbox. In one test, a firm received fiat funds (e.g. GBP) from a payer to transfer to a payee in a different jurisdiction and in another fiat currency. After receiving the fiat funds from the payer, the firm converted them to a cryptoasset which was then converted to the target fiat currency (e.g. ZAR). The payee received a pay out in fiat currency. Neither payer nor payee took any direct exposure to cryptoassets; the cryptoasset was only used as an intermediary with the aim to make fiat cross-border transfers faster and cheaper.

- The firm was registered as a Small Payments Institution (money remittance). As part of the parameters of their test, the firm was restricted to 25 retail clients. The firm held cash reserves to cover the full amount of any retail transfer. The test with retail customers was limited to £5000 per transaction and a maximum of 1000 transactions.

Q4: Do you agree with our assessment that exchange tokens could be used to facilitate regulated payments?

Q5: Are there other use cases of cryptoassets being used to facilitate payments where further Guidance could be beneficial? If so, please state what they are.

Can cryptoassets be considered e-money?

3.58 Yes, in some instances, and depending on how they're structured, cryptoassets can constitute e-money.

3.59 Payment services regulation under the PSRs only covers activities involving funds, which can include bank notes, cash and e-money. E-money issuance is regulated under the EMRs⁴⁹ and is a regulated activity under article 9B of the RAO.⁵⁰ E-money is electronically stored monetary value as represented by a claim on the electronic money issuer which is:

47 www.legislation.gov.uk/uksi/2017/752/schedule/1/part/2/made

48 Unless the cryptoasset in question meets the definition of e-money.

49 www.legislation.gov.uk/uksi/2011/99/contents/made

50 www.legislation.gov.uk/uksi/2002/682/made?view=plain

- issued on receipt of funds for the purpose of making payment transactions
- accepted by a person other than the electronic money issuer
- not excluded by regulation 3 of the EMRs

3.60 Exchange tokens like Bitcoin, Ether and other equivalents are unlikely to represent e-money because, amongst other things, they are not usually centrally issued on the receipt of funds, nor do they represent a claim against an issuer.

3.61 However, it's important to note that any category of cryptoasset has the potential to be e-money depending on its structure and whether it meets the definition of e-money explained above.

3.62 E-money must enable users to make payment transactions with third parties, so must be accepted by more parties than just the issuer. E-money includes fiat balances in various types of online wallets or prepaid cards.

3.63 Electronic storage of monetary value includes the possibility of using DLT and cryptographically secured tokens to represent fiat funds, e.g. GBP or EUR. Cryptoassets that establish a new sort of unit of account rather than representing fiat funds are unlikely to amount to e-money unless the value of the unit is pegged to a fiat currency, but even then it will still depend on the facts of each case.

3.64 Within the sandbox many firms have facilitated DLT-based e-money to provide more efficient, automated and transparent services, including for international payments.

3.65 Some tokens might be stabilised by being pegged to a fiat currency, most commonly the USD, and most commonly with a 1:1 backing. This is a form of 'stablecoin' known as a 'fiat backed', 'fiat collateralised' or 'deposit backed' stablecoin. This stablecoin looks to hold a consistent value with the fiat currency, and is theoretically 'backed' by fiat currency. Any token that is pegged to a currency, like USD or GBP, and is used for the payment of goods or services on a network could potentially meet the definition of e-money. However, the token must also meet the requirements above. Tokens may also be stabilised through other means, for instance, being backed by certain assets (which may include Specified Investments), a basket of cryptoassets, or potentially through algorithms that maintain the supply of the token.

Q6: Do you agree with our assessment of stablecoins in respect of the perimeter?

What this looks like in practice

- **Sandbox case study 2:** We have seen sandbox firms testing tokens pegged to fiat currency, and these firms, depending on the structure and service provided, have been authorised either as e-money or payments services institutions. One firm is preparing to test a digital payments system that incorporates a transaction monitoring and profiling tool to identify transactions that may involve money laundering or terrorist financing. The consumer sends the remittance amount to the testing firm. The firm then tokenises the funds and transmits the tokens across their proprietary blockchain system. The tokens are exchanged into the recipient country's currency and sent to the recipient. Transfers take place while being monitored by the firm's sophisticated monitoring system. The testing parameters include a restriction of pegging the firm's token to the USD at 1:1 to minimise foreign exchange (FX) risk.

- Q7: Do all the sections above cover the main types of business models and tokens that are being developed in the market?**
- Q8: Are there other significant tokens or models that we haven't considered?**

What does all of this mean for my firm?

- 3.66** Where a person is engaged in activity by way of business in the UK, that relates to a security token, or to a token that constitutes e-money, or is involved in payment services, they should consider whether those activities require authorisation.
- 3.67** This activity will determine what 'permissions' a firm requires from the FCA. The FCA is technology neutral in its considerations on whether a firm is carrying out a regulated activity. For example, the permissions that apply as a consequence of carrying on a regulated activity in relation to security tokens is not different to traditional securities. The list of market participants and regulated activities in this section is an indication of the types of market participants that should be considering if they need permissions, and the types of activities that would be regulated.
- 3.68** Regulation may apply to any market participants carrying out regulated activities, including, but not limited to
- exchanges and trading platforms
 - payments providers
 - custodians / wallet providers
 - advisers, brokers and other intermediaries
- 3.69** Securities issuance is not regulated in the same way we would regulate other market participants (like exchanges and advisers), however some regulation may still apply, for example the Prospectus Directive and Market Abuse Regulations (amongst others).
- 3.70** For example, a firm wanting to create infrastructure for the buying, selling and transferring of security tokens (commonly known as exchanges or trading platforms) must ensure it has the appropriate permissions for the activities it wants to carry

out. These will likely include arranging deals in investments (article 25(1) of the RAO), and making arrangements with a view to investments (article 25 (2) of the RAO). If the tokens also constitute Financial Instruments under MiFID, the firm may also need to have permission to operate a multi-lateral trading facility or, an organised trading facility (article 25D and 25DA of the RAO), depending on how the exchange operates. In the cryptoasset space, these firms often provide custody services as wallet providers too. The provision of custody services in relation to securities may be a regulated activity, and firms must make sure they have the relevant permissions like safeguarding and administering investments (article 40 of the RAO).

3.71 Of course, these exchanges and trading platforms may be carrying out a whole host of related regulated activities and firms should consult PERG to get the full list of regulated activities that exchanges and trading platforms may be carrying on and the permissions required.

3.72 Table 1 indicates some of the main market participants that are likely to be carrying out regulated activities in the cryptoasset space. It also provides a high-level overview of some of the more common services they are likely to provide, and the permissions required to carry these out. The table is not exhaustive and should only be used as an indicative aid. Firms might also carry on a number of these activities, not just one. The table does not cover instances where exclusions might apply for certain market participants carrying on certain activities. We encourage firms to consult PERG for a more detailed list, and seek legal advice. Firms providing innovative propositions with genuine consumer benefits can contact the Innovate team if they are unsure about which regulated activities apply to their business models (further information in chapter 5).

Table 1: Indicative list of market participants and permissions

Market Participants	Potential activities	Indicative list of permissions
Issuers of tokens	Issue tokens, including issuing tokens through ICOs.	A company does not need regulatory permissions specifically to act as issuer of its own securities such as shares, but will need to consider regulations that may apply to the issuance. Such rules and regulations include, but are not limited to: <ul style="list-style-type: none"> • Prospectus Directive • Disclosure Guidance and Transparency Rules • AML and KYC • if the offer is made available internationally, local laws in each jurisdiction where the offer is available • for companies seeking listing on a regulated exchange, the Listing Rules • rules of the relevant trading exchange or platform
Advisers and other Intermediaries	Provide advice to consumers regarding different tokens and may help facilitate the purchasing of tokens.	For those advising, permissions may include, but are not limited to: <ul style="list-style-type: none"> • advising on investments If the intermediaries facilitate the purchasing of tokens, permissions may include, but are not limited to: <ul style="list-style-type: none"> • dealing in investments as principal • dealing in investments as agent • arranging deals in investments • making arrangements with a view to investments • sending dematerialised instructions

Market Participants	Potential activities	Indicative list of permissions
Exchanges and trading platforms	Facilitate transactions between market participants.	Depending on the operation/scope of the exchange, permissions may include, but are not limited to: <ul style="list-style-type: none"> operating a multi-lateral, or, organised trading facility dealing in investments as principal dealing in investments as agent arranging deals in investments safeguarding and administering investments making arrangements with a view to investments sending dematerialised instructions
Wallet providers and custodians	Provide the secure storage of tokens.	Depending on the scope of activity, relevant permissions may include, but are not limited to: <ul style="list-style-type: none"> managing investments safeguarding and administering investments
Payments providers	Enable customers to pay merchants using a cryptoasset, or transfer fiat currency via a cryptoasset.	Depending on the nature and scope of the activity, relevant permission may include, but are not limited to: <ul style="list-style-type: none"> issuing e-money Payments Services Regulations may also apply, including, but not limited to: <ul style="list-style-type: none"> money remittance cash placement Depending on the structure of the tokens, E-Money Regulations may also apply.

3.73 Figure 2 sets out some of the key market participants in the cryptoasset market, the types of regulated activities they are likely to be carrying on.

Figure 2: Cryptoasset value chain



3.74 Firms are responsible for making sure they are appropriately authorised for all the regulated activities that they are carrying on. Carrying on a regulated activity without authorisation is a breach of the general prohibition and is a criminal offence. Carrying on regulated activity without the correct authorisation is a breach of Section 20 FSMA.

Q9: Are there other key market participants that are a part of the cryptoasset market value chain?

Q10: Are there activities that market participants carry on in the cryptoasset market that do not map neatly into traditional securities?

Do I need to publish a prospectus?

3.75 If a token is a transferable security and the tokens will either be offered to the public in the UK or admitted to trading on a regulated market, an issuer will need to publish a prospectus unless an exemption applies.

3.76 If a prospectus is required, the specific disclosure requirements will depend on the type of security (e.g. equity shares, corporate bonds). The obligations, such as those relating to the provision of historical financial information, are no different for a token issuer to an issuer of traditional securities. Broadly, the prospectus must provide prospective investors with information to make an informed investment decision and is a legal document for which the issuer has legal liability; it is important that all issuers of tokens work carefully with their legal and financial advisers to fully address the disclosure requirements under the Prospectus regime.

3.77 Issuers of tokens should consider whether any exemptions are relevant. For example, there is an exemption for offers made entirely in the UK for less than €8m in any 12-month period (in the case of cross border offers, there are currently different exemption thresholds in different EU Member States, and the position of such public offers will need to be carefully considered).

3.78 An issuer undertaking a non-exempt public offer of securities will need to have the prospectus reviewed and approved by the FCA, where the UK is the relevant home state regulator. The document will need to include disclosure on the issuer, the business and the securities. The specific requirements are laid out in Commission Regulation 809/2004⁵¹ (reproduced in Appendix 3 of the Prospectus Rules) and vary depending on the security type (generally with more extensive disclosure for equity than debt securities). Issuers of tokens should take note of the historic financial information requirements; for equity securities, historical financial information is required for 3 years (or since the issuer's incorporation), the last 2 of which must be prepared on a consistent basis and comparable with the issuer's next published accounts, as well as a confirmation that the issuer has sufficient working capital for its present requirements (at least 12 months from the date of the prospectus) and a capitalisation and indebtedness statement dated within 90 days of the document.

3.79 The above paragraph relates to public offer prospectuses. Similar disclosure requirements apply to companies issuing securities listed on the Official List

51 <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A02004R0809-20130828>

maintained by the FCA (listed securities) and admitted to trading on a recognised investment exchange (like the London Stock Exchange's Main Market).

- 3.80** New listed issuers of tokens also need to complete an eligibility review; in most cases the FCA can carry out the eligibility assessment at the same time as the prospectus review but it is helpful to engage early if there are questions about eligibility, for example, a lack of clarity as to whether the securities will be transferable.
- 3.81** Listed issuers of tokens should also consider their continuing obligations, in particular under the Disclosure Guidance and Transparency Rules and Market Abuse Regulation.

4 Q&A

Introduction

- 4.1** This Q&A supplements the Guidance, looking at some of the more common or nuanced questions. It must be considered with the Guidance and our PERG manual.

Exchange tokens

- 4.2** **Can exchange tokens be caught under e-money regulations?**
As exchange tokens seldom exhibit features that meet the definition of e-money, for example they are not usually issued on receipt of funds by any central authority or body, they are unlikely to be caught under e-money regulations. However, any token that reaches the definition of e-money could be considered e-money and would fall under the scope of the EMRs.

Security tokens

- 4.3** **Does a definition of security translate easily to the digital world?**
The FCA's approach to regulation is technology neutral. A technologically neutral approach means that the regulators do not mandate regulated firms to use a particular type of technology to facilitate their services. However, while our tech-neutrality means we're agnostic about the type of technology used, the choice of technology may influence the way regulation applies to take account of any unique risks associated with carrying on a certain activity.

The definition of security is technology neutral as well and remains consistent, whether the instrument is physical or digital. However, we appreciate there can be particular difficulty in categorising tokens as security tokens given the potential for tokens to change in structure over the course of their lifecycle (i.e. a utility token becoming an exchange token, or an exchange token becoming a utility token etc.) as well as the sometimes-ambiguous nature of rights conferred by tokens.

If you are still unsure whether your cryptoasset is a security, please refer to PERG 2.

- 4.4** **If you deem my token a security, what does this mean for my international business/clients/token holders? Can I still sell, distribute and market my token globally?**
If a token is considered a Specified Investment under the RAO including a Financial Instrument under MIFID and any activity in relation to it is carried on in or from the UK, it will be subject to relevant securities regulations in the UK. It is up to the firm to

identify whether their token would fall under the definition of a Specified Investment and (where relevant) a Financial Instrument under MiFID.⁵²

As the definition of a security is not homogenous globally, the nature of the token has to be assessed for every jurisdiction in which the token is sold or in which the firm operates separately to establish whether a specific token constitutes a security in this jurisdiction and therefore triggers the application of any respective securities regulation.

For instance, a person could contravene FSMA section 85(1) if they make an offer to the public in the United Kingdom of transferable securities without first making an approved prospectus available to the public. Other regulations should also be considered.

These rules are likely to impact the activities of issuers of tokens, exchanges, custodians / wallet providers amongst others.

4.5 Can I issue a security token without being FCA authorised?

The issuance of one's own securities does not require permission and issuers of security tokens will not be regulated in the way that exchanges and advisers are regulated.

However, despite the fact that issuers of tokens don't need to be authorised to issue their own securities, in the course of promoting their issuance, they may be advising on investments or carrying on other activities that may require permission.

If an issuer is issuing financial instruments which are admitted to trading on a European venue it must comply with all applicable rules in the FCA's Handbook and any relevant provisions in applicable European Union legislation, including the Prospectus Directive and Commission Regulation, and the Market Abuse Regulation, amongst others, some of which are outlined in Table 1 in the Perimeter Guidance chapter.

4.6 Would exchanges and other dealers need to be authorised to deal with security tokens? Do I have to ensure that all intermediaries that deal in my security tokens have the appropriate permissions?

Any intermediaries that help with the issuance of securities are likely to need permission. For example, venues that provide a platform for these security tokens may potentially be Multilateral Trading Facilities (MTFs), Organised Trading Facilities (OTFs) or simply arranging investments under the RAO and relevant regulation will apply.

If entities are unauthorised but are carrying on regulated activities they may be in breach of the general prohibition which is a criminal offence.

4.7 If I accept only cryptoassets as a form of payment for my token, can it still be a security token?

Yes. Unlike e-money regulations where a token must be issued on the receipt of fiat funds, security tokens will still be considered security tokens regardless of whether they are exchanged for fiat funds, exchange tokens, or other forms of cryptoassets. In certain cases (like airdrops), a token can also be a security, even if nothing is received

⁵² In general, the MIFID financial instrument categories have been mapped into the existing RAO specified investment categories. See PERG 13 Annex 2, which sets out how the various MIFID financial instrument categories map into the RAO specified investment categories. Whether a token is a MIFID financial instrument or not may have relevance for whether the regulatory requirements which apply to MIFID business will apply (for example, whether a platform trading in tokens could be an MTF or OTF), and for issuers who are issuing tokens which amount to transferable securities, whether prospectus requirements under the prospectus regime apply.

for it. We consider a token to be a security based on its structure: the intrinsic nature of the token is important, not the mechanism by which it was acquired.

4.8 I only pay out cryptoassets as a 'reward'. Can this amount to a security token?

Yes. A token that provides access to a current or prospective product or service is likely to be considered a utility token (and probably outside our regulatory perimeter). However, a token that confers a reward can potentially be considered a security token if the reward has the same or equivalent characteristics as Specified Investments, as detailed in the Guidance.

A utility token can, during its lifecycle, become a security token if the intrinsic characteristics of the token are altered to confer the same rights as a security.

4.9 I'm still not sure whether my token is a security, what should I do?

The Perimeter Guidance chapter clarifies how we determine a token to be a security, however definitive judgements can only be made on a case-by-case basis.

We recommend referring to PERG 2 for further guidance, and seeking appropriate legal advice if necessary. The Innovate team also supports innovative propositions, and details on eligibility criteria and how to apply can be found on our Innovate site.⁵³

4.10 If my token is a security in the UK, is it a security in the whole of the EU?

The UK RAO sets out 'Specified Investment' beyond the MIFID II definition of a 'Financial Instrument'.

However, the two regimes are very closely linked, and a security token in the UK is likely to be deemed a security token in the rest of the EU.

4.11 I think my cryptoasset is a security token, what does this mean?

If you determine that your cryptoasset is a security token, then it will be captured within our regulatory perimeter as a Specified Investment, and possibly a MiFID Financial Instrument. This means that activities associated with the cryptoasset are likely to be regulated and you will require authorisation and the relevant permissions.

For example, relevant regulation may apply to exchanges and trading platforms, advisers and intermediaries, and wallet providers and custodians amongst others. The issuance of securities is not regulated in the way that exchanges and advisers are regulated, however certain regulation may still apply, like the Prospectus Directive and Financial Promotions requirements.

For a complete overview of which regulated activities apply to market participants dealing with specified investments, please refer to PERG.

4.12 Are stablecoins also securities?

They can be. The term 'stablecoin' describes tokens whose value – measured in a traditional fiat currency, like GBP or USD – does not fluctuate substantially. In order to achieve that, the value of stablecoins is pegged to either; fiat currencies, other commodities or assets (e.g. gold and oil), a basket of other cryptoassets (e.g. Bitcoin and Ether) or determined through sophisticated algorithms.

53 www.fca.org.uk/firms/fca-innovate

Depending on the design and the rights associated with a specific stablecoin, they might meet the definition of e-money. This does not mean that the tokens will be securities, but the activities that relate to the e-money tokens may be regulated. However, in certain circumstances, the way the stablecoin is structured may mean that it amounts to a security, such as a fund unit, or a derivative.

Utility tokens

4.13 **My network is/aims to be fully decentralised and I will not have any control over the network anymore. Does this have an impact on whether the tokens could be regulated or not?**

No. The nature of the network does not determine whether a token is a security or not. A security token is determined by its intrinsic characteristics and the rights it confers on holders, as detailed in the Guidance chapter. However, the more decentralised the network the less likely it is that the token will confer enforceable rights against any particular entity, meaning it may not confer the same or equivalent rights as Specified Investments.

General questions

4.14 **What other consumer protections may apply under UK law to utility tokens or cryptocurrencies that are not specified investments (e.g. not subject to financial service regulation)?**

There are a number of broader financial services rules and regulations market participants should be aware of including, but not limited to: financial promotion rules, conduct of business rules, principles for business rules and the accountability regime.

Other non-financial rules and regulations may also apply to authorised and unauthorised firms, like the Advertising Codes regulated by the Advertising Standards Authority, Trading Standards, general common law, criminal law, and GDPR amongst others.

4.15 **What are our expectations where a firm has or seeks FCA authorisation for certain activities, but also carries on activities related to cryptoassets outside the perimeter?**

A firm that is authorised by the FCA, or seeking FCA authorisation, but also carries on activities related to cryptoassets outside the perimeter, must make sure there is sufficient (and for consumers clearly visible) separation between the activities.

For instance, when marketing unregulated cryptoasset products, the firm must not be unclear, unfair or misleading in its marketing and make sure customers are aware the cryptoasset activity is unregulated.

In the UK, regulated entities can conduct an unregulated activity (e.g. in relation to those cryptoassets that aren't regulated products) provided those activities do not affect their ability to comply with the rules and requirements set out in the respective regimes. Of course, all firms need to be clear in differentiating their regulated and unregulated activities (including within any marketing materials).

In addition to financial promotion rules, the firm will be subject to other rules that the firm should be aware of, including Principles for Business⁵⁴, Conduct of Business⁵⁵ and the Senior Managers and Certification Regime (SMCR).⁵⁶

For instance, some of the Principles for Business apply to 'ancillary activities' (that is, unregulated activities carried on in connection with, or held out for being for the purpose of a regulated activity). Principles 3, 4 and 11 apply to unregulated activities of authorised firms more generally (for Principle 3, this is limited to unregulated activities which may have a negative impact on the integrity of the UK financial system, or the ability of the firm to meet the suitability Threshold Condition).

54 www.handbook.fca.org.uk/handbook/PRIN.pdf

55 www.handbook.fca.org.uk/handbook/COBS.pdf

56 www.handbook.fca.org.uk/handbook/SYSC/4/7.html?date=2016-03-07

5 What if I have further questions about cryptoassets?

- 5.1** We appreciate that it can be difficult to determine whether certain tokens fall inside our regulatory perimeter. We also realise that once that determination is made you may still have questions on whether you need to be authorised, and if so, for which activities – and the types of permissions you will need.
- 5.2** We hope the Guidance and Q&A provide more clarity, and this should be read in conjunction with PERG to provide a detailed understanding. However, we know that this area develops quickly, and new business models don't always map neatly into our regulatory framework.
- 5.3** We are committed to fostering innovation that supports our objectives, and enabling innovation that works in the interest of consumers. Innovation can come from diverse sources, like start-ups and technology providers as well as regulated firms, including large financial institutions. They all have the potential to challenge existing business models, products and methodologies to benefit consumers and markets as a whole.
- 5.4** New technology plays a fundamental and increasingly pivotal role in delivering innovative products and services that can improve on those currently available, offering consumers easier access to, and better, financial services. Equally, some products may not be suitable for certain consumers. Our objectives as a regulator mean that we need to strike a balance between supporting innovation and ensuring consumers are adequately protected.

FCA Innovate

- 5.5** Our Innovate initiative supports the FCA's objectives of protecting consumers, enhancing and protecting UK market integrity, and making sure competition works in the interest of consumers.
- 5.6** The initiative is aligned to the competition objective by seeking to reduce barriers to entry through clarifying regulatory expectations, examining our own rules and processes and providing a test environment for the most innovative ideas. We also help firms compete at scale by minimising international barriers where possible. Through our different service offerings, we also aim to make sure any gaps in policy in relation to new technologies are identified and resolved, ensuring consumers are protected from harm.
- 5.7** Our suite of services can act as tools for gathering information and expertise on new technologies and business models, helping us to discharge our objectives more effectively.
- 5.8** We also want to add more flexibility to our regulatory framework and identify barriers to entry for innovative firms through our policy work. By reviewing our regulatory

approach, we aim to encourage and support innovation, providing it will not erode consumer protection or the integrity of the financial system.

- 5.9** Both our 'direct support' and 'sandbox' services have provided support to firms with innovative propositions that use cryptoassets. These include firms testing money remittance services using cryptoassets as the intermediary currency, firms using cryptoassets as payment in relation to insurance, firms issuing debt and equity on DLT platforms, supporting firms with appropriate permissions for their business models or outlining whether any permissions are required.

Direct Support

- 5.10** Firms can request support from our direct support service by completing a [request for support form](#). This service operates on a rolling basis and all applications are judged against the eligibility criteria available online.
- 5.11** The Direct Support team provides a dedicated contact for innovator businesses that are considering applying for authorisation or a variation of permission, need support when doing so, or do not need to be authorised but could benefit from our support. The team can also help businesses understand our regulatory regime and the challenges they may face when developing an innovative product or business model.
- 5.12** If required, the Direct Support function offers an end-to-end process which includes initial support in understanding applicable regulation (if any is necessary), support through the authorisation process (if required), and a dedicated supervisor for 12 months following authorisation.
- 5.13** Almost 20 per cent of applications for support during 2018 have been cryptoasset-related propositions. These applications covered a wide variety of cryptoasset business models.

- **Direct Support case study:** One firm has developed a custodial wallet to allow users who have undergone 'know your customer' (KYC) and AML checks to top-up their wallet with cryptoassets and use them with retailers to purchase goods and services without the retailer or the consumer having to manage their private keys, custody funds or wait for transaction finality. The Direct Support team met the firm to outline the perimeter in relation to payment services.

Regulatory Sandbox

- 5.14** The sandbox allows firms to test their innovative propositions in the market, with real consumers, within the confines of a controlled environment. As part of the test, we may require firms to apply additional restrictions in addition to the standard permissions to provide extra safeguards for consumers and to protect market integrity.
- 5.15** This service operates on a cohort basis, with two cohorts per year and further information, including application forms (when application windows are open), can be found on the [sandbox section of our website](#).
- 5.16** The sandbox is open to authorised firms, unauthorised firms that require authorisation and technology businesses. Any firm that wants to carry on a regulated activity will need to be authorised prior to testing, which the sandbox team can support on. The

sandbox offers tools like restricted authorisation, individual guidance, informal steers, waivers and no enforcement action letters.

5.17 In earlier cohorts, we saw a number of firms that use cryptoassets to facilitate regulated payments activities. In more recent cohorts, we have seen an increasing number of firms using cryptoassets to issue debt or equity instruments. Across our first four cohorts we have had 276 applicants, of which 89 moved forward to testing – a third of which used DLT or cryptoassets in some form. Below are three cases that illustrate cryptoasset propositions that have tested or are testing in the Regulatory Sandbox.

- **Sandbox Case Study 3:** A firm within the FCA's Sandbox used a permissionless DLT network to mimic the traditional issuance process for a short-term debt instrument, while another used a permissionless DLT network to test a platform to issue a structured product.

In a small-scale test, cost reductions were achieved by a high degree of automation and by removing costs including clearing, settlement and custody of a traditionally issued structured product.

Due to the permissionless DLT network, ownership of an asset is recorded publicly which increases transparency for investors who do not rely on the registrar/custodian to hold the record of ownership anymore. This eliminates the need for reconciliation between network participants because they share the same record of ownership, supporting more efficient settlement operations.

- One firm was authorised for arranging deals and making arrangements plus holding client assets for another test. To enhance consumer protection during the test, they were limited to 50 customers (only 14 participated), were limited by the investment amount per user (£250,000) and could only onboard investors who were self-certified restricted investors, self-certified HNW investors or self-certified sophisticated investors. Issuance value was kept small and maturity short.
- The second test involved a partnership between the firm listed above and separate firm. To limit risk of customer loss during the test, the firm tested a 100% principle protected note with a short maturity and a small notional amount. Their limit was for 30 investors but in the end there were only 13 participants.
- **Sandbox Case Study 4:** A firm in the sandbox will be testing the use of smart contracts to facilitate flight delay and cancellation insurance products as an insurance intermediary. The proposition enables consumers to purchase insurance on their flight using selected exchange tokens or fiat currency and also receive claim payments in the same method. The smart contract receives information on the status of the relevant flight to facilitate automatic payouts in the event of a delay or cancellation.
 - The firm will require authorisation as an insurance intermediary prior to beginning their test. The test will be limited to a maximum of 1000 customers.

6 Next Steps

6.1 This section outlines our next steps after the publication of this consultation paper.

Upcoming work

Action	Owner	Timing
Consult on a potential prohibition of the sale to retail consumers of derivatives referencing certain types of cryptoassets (for example, exchange tokens), including CFDs, options, futures and transferable securities	Financial Conduct Authority	2019
Publish findings on consumer research on the use of cryptoassets	Financial Conduct Authority	Early 2019
Continue to monitor market developments and regularly review the UK's approach	UK Cryptoasset Taskforce	Ongoing

Consultation period

6.2 The consultation period will be open until Friday 5 April 2019. We invite responses from all interested stakeholders, and responses can be submitted either in writing to the address listed at the beginning of this report, or via email to fcacrypto@fca.org.uk.

6.3 Once the consultation period is over, we will analyse and consider all responses before publishing final Guidance on the existing regulatory perimeter in relation to cryptoassets no later than summer 2019.

HMT's consultation on proposed legislative change

6.4 This Guidance is the next step of broader work being conducted, both by the FCA and the broader UK Cryptoasset Taskforce.

6.5 HMT will publish a consultation in 2019 that looks at options for potentially bringing in further cryptoasset related activity into the regulatory perimeter. The FCA will continue to engage with HMT on this work.

6.6 Any legislative change will require the FCA to consult on the new activities to be brought into the regulatory perimeter, and the FCA will work with HMT on this. The nature of the work will depend on the outcomes to the consultations published by both the FCA and HMT.

Annex 1

Questions in this paper

- Q1:** Do you agree that exchange tokens do not constitute specified investments and do not fall within the FCA's regulatory perimeter? If not, please explain why.
- Q2:** Do you agree with our assessment of how security tokens can be categorised as a specified investment or financial instrument? If not, please explain why.
- Q3:** Do you agree with our assessment of utility tokens? If not, please explain why.
- Q4:** Do you agree with our assessment that exchange tokens could be used to facilitate regulated payments?
- Q5:** Are there other use cases of cryptoassets being used to facilitate payments where further Guidance could be beneficial? If so, please state what they are.
- Q6:** Do you agree with our assessment of stablecoins in respect of the perimeter?
- Q7:** Do all the sections above cover the main types of business models and tokens that are being developed in the market?
- Q8:** Are there other significant tokens or models that we haven't considered?
- Q9:** Are there other key market participants that are a part of the cryptoasset market value chain?
- Q10:** Are there activities that market participants carry on in the cryptoasset market that do not map neatly into traditional securities?

Annex 2

Abbreviations used in this paper

SAMLD	The Fifth Anti-Money Laundering Directive
AML/CTF	Anti-Money Laundering/Counter Terrorist Financing
CfD	Contract for Difference
DLT	Distributed Ledger Technology
EC	European Commission
EEA	European Economic Area
EMRs	E-Money Regulations 2011
ESMA	European Securities and Markets Authority
EU	European Union
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Service
FSCS	Financial Services Compensation Scheme
FSMA	Financial Services and Markets Act 2000
FX	Foreign Exchange
GDPR	General Data Protection Regulations
HMT	Her Majesty's Treasury
ICO	Initial Coin Offering
KYC	Know Your Customer
MAR	Market Abuse Regulations
MiFID II	Markets in Financial Instruments Directive
MTF	Multilateral Trading Facility

OTF	Organised Trading Facility
PERG	Perimeter Guidance Manual
PSRs	Payment Services Regulations 2017
RAO	Regulated Activities Order
SMCR	Senior Managers & Certification Regime
SME	Small and Medium sized Enterprise
The Taskforce	UK Cryptoasset Taskforce
UBD	Unauthorised Business Division

We have developed the policy in this Consultation Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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