Response to UK regulatory approach to cryptoassets and stablecoins:

Consultation and call for evidence (March 2021)

This response is provided by a working group of the Centre for Commercial Law at the University of Aberdeen. The working group consists of Dr Burcu Yüksel Ripley and Ms Mary Gilmore-Maurer.

1. Do you have views on continuing to use a classification that is broadly consistent with existing guidance issued by UK authorities, supplemented with new categories where needed?

This seems sensible to us. In terms of classification, consistency among the UK authorities would also help consumers and businesses to develop a good understanding of categories. A flexible approach would also be welcome to enable new categories to supplement the classification as needed in parallel to technological progress. Timely, continuous and consistent guidance is important as new categories arise.

2. Do you have views on the proposed new regulated category of 'stable tokens'?

It appears to us that stable tokens is emerging as a new category, and therefore the proposed new regulated category of stable tokens seems sensible to us.

3. Do you have views on the government's proposed objectives and principles for cryptoassets regulation? Do you have views on which should be prioritised, or where there may be tension between them?

We think that the government's proposed objectives and principles for cryptoassets regulation are, in principle, framed well to balance different interests at stake. Practical application would however matter.

There is now a race among countries to harness technology in financial sector, and therefore the objective of "promoting competition, innovation and supporting UK competitiveness" is an important one which may perhaps work as an overarching objective.

The principle of "ensuring the approach is proportionate, focussed on where risks and opportunities are most urgent or acute" is particularly important. We think that application of disproportionate or overly burdensome regulation to entities may have the risk of incentivising entities towards unregulated activities or areas.

The principle of "ensuring the approach is agile, able to reflect international discussions and aligned to the future government approach to financial services and payments regulation" is also important:

- In terms of international discussions, we note that, due to divergent approaches, legal or regulatory harmonisation at the international level would be challenging and slow in this area. Development of soft laws, model laws or international standards might be more feasible to achieve in this area. It would be useful to keep dialogue open with other countries and international organisations.
- In terms of alignment to future government approach to financial services and payments regulation, we think that coherency among regulatory framework is essential. We are aware of the UK government's work on access to cash and submitted a response to the call for evidence on that area (CCL response to call for evidence on access to cash 23.11.2020 - Final.pdf (abdn.ac.uk)). In that response, we noted that in the area of payments the trend has been gradually shifting worldwide

towards non-cash payments in parallel to technological progress and that the demand for the use of paper-based payments methods, particularly cash, is decreasing which is a pattern consistent with the evolution of payments and is being speed up with the COVID-19 situation. We took the view that while protecting access to cash where necessary is essential, more data on demand for use of cash post-COVID-19 would be needed for developing appropriate policies on access to cash and for assessing whether there is a real need for legislation in this area. We therefore take this opportunity to note that a coherent approach in the area of payments is essential.

In relation to each of the principles, we would strongly support the use of a 'regulatory sandbox' approach, which has been applied and tested in other sectors, for example the energy sector (see https://www.ofgem.gov.uk/news-blog/our-blog/ofgem-launches-new-enhanced-energy-regulation-sandbox-service). In the current context, we note the government's support for DLT-based services through the FCA sandbox. We think that this approach allows for initial regulatory oversight, consumer protection and commercial certainty, whilst providing flexibility. In relation to blockchain, this approach is also being used elsewhere, for example the EU which has proposed a 'Pan-European blockchain regulatory sandbox'. In addition, the use of a regulatory sandbox supports a 'staged and proportionate approach', for example in relation to developing a future-proof classification of tokens. We also refer to the European Blockchain Partnership, which is planning the pan-European regulatory sandbox in cooperation with the European Commission for use cases, covering for example data portability, B2B data spaces, smart contracts, and digital identity (Self-Sovereign Identity) in the health, environment, mobility, energy and other key sectors. Significant areas of synergy are likely to be created by aligning part of the UK approach to this initiative.

4. Do you agree with the approach outlined, in which the regulatory perimeter, objectives and principles are set by government and HMT, with detailed rules to follow set by the UK's independent regulators?

We see the value in the proposed approach in terms of keeping up with the pace of developments in this rapidly evolving area, but we think that concerns might be raised as to whether the proposed approach would provide sufficient legal foreseeability and certainty. As we noted above in question 1, we think that it would also be necessary to ensure alignment between the approaches of each of the UK's independent regulators. This would be better facilitated through an overarching legal framework and sector-specific guidelines.

5. What are your views on the extent to which the UK's approach should align to those in other jurisdictions?

Due to cross-border nature of cryptoassets, we think that a great degree of alignment (particularly in terminology, classification, and treatment) would be desirable. However, we are of the view that this may not be feasible to achieve any time soon in practice at least through legal harmonisation due to divergent approaches among countries. As we have noted above in question 3, we think that development of soft laws, model laws or international standards might be more feasible and practical to achieve in this area.

We are aware and welcome that HMT and the UK authorities are closely monitoring the developments in the EU and beyond.

In the context of the EU, the European Central Bank (ECB) and the European Commission are jointly reviewing a broad range of policy, legal and technical questions emerging from a possible introduction of a digital euro. Furthermore, the EU already classifies cryptoassets

that qualify as "financial instruments" under the Markets in Financial Instruments Directive. These have been subject to EU securities markets legislation. In light of the emergence of cryptoassets and DLT, in September 2020 the European Commission proposed a pilot regime for market infrastructures that use financial instruments in cryptoasset form. This can be considered as an example of an innovative and flexible approach, as the pilot regime allows for exemptions from existing rules, whilst enabling regulators and companies to test innovative solutions for the use of DLT. On the other hand, for cryptoassets which currently do not qualify as "financial instruments", deposits or structured deposits under EU financial services legislation, the European Commission has similarly proposed a specific new framework to replace existing national rules currently governing those cryptoassets and to establish specific rules for stablecoins, ie the Proposal for the Markets in Crypto-Assets Regulation (MiCA). The aim is to encourage innovation, while ensuring the protection of consumers and the integrity of cryptocurrency exchanges, for example in relation to insider trading. Parties covered by the regulation include both the entities issuing cryptoassets and the firms providing the services related to cryptoassets in addition to firms operating digital wallets and cryptocurrency exchanges. Given the UK and EU partnership post-Brexit and the Trade and Cooperation Agreement, we think that a degree of cooperation with the EU in approach to cryptoassets would be desirable.

Beyond the EU and for further cross-jurisdictional comparison, we also refer to the US Library of Congress Index of Regulation of Cryptocurrency available at https://www.loc.gov/law/help/cryptocurrency/world-survey.php.

6. Do you agree with the government's assessment of risks and opportunities?

Yes, we agree overall.

In relation to the risks to competition, we also note the similarities of the technology underlying cryptoassets with dual-or multisided platforms that display certain network effects as alluded to in the consultation. Links have been made in this regard to the Sharing Economy, aspects of which may be informative to the government's considerations in seeking to mitigate risks to competition. Network effects occur when one party is able to lock in parties located on one side of the transaction or platform, as such acquiring a dominant position in relation to those parties. A further issue arises where a platform acquires the power to reference rivals, increasing the potential for collusion or, alternatively, discriminatory behaviour. In this context, we use the understanding of 'Sharing Economy' as designating business activities that facilitate exchanges between parties through one or several electronic platforms.

7. Do you have views on the proposed initial scope of UK cryptoasset regulation as summarised above?

The proposed initial scope of UK cryptoasset regulation seems sensible to us. We also think that it may not always be necessarily so straightforward to decide whether and what regulation may apply to a particular cryptoasset instrument or activity and therefore further guidance on this might be useful to help ensure predictability and certainty.

8. Do you agree that this approach best balances the government's stated objectives and principles?

Yes, this approach seems sensible to us in the light of the government's objectives and principles and under the current cryptoassets landscape.

9. Do you agree that the activities and functions outlined above are sufficient to capture the activities that should fall within the scope of regulation?

Yes, we agree that they are sufficient at present under the *current* cryptoassets landscape, however we see value for the government to continue to be prepared for fast moving innovations in this sector.

10. Do you agree that the government should primarily use existing payments regulations as the basis of the requirements for a new stable token regime, applying enhanced requirements where appropriate on the basis of mitigating relevant risks? What other existing legislation and specific requirements should also be considered?

We take the view that there is merit in considering a new and specific regulation on cryptoassets including stable tokens, but we note that this might take some time to develop and implement. We therefore think that the proposed approach of using existing payments regulations as the basis of the requirements for a new stable token regime and applying enhanced requirements where appropriate on the basis of mitigating relevant risks may be achieved more quickly. However, it may run the risk of further complicating the financial regulatory environment.

We think that the digital, decentralised and cross-border nature of stable tokens needs to be factored in for a new stable token regime. We also think that this might be an area where international collaboration and coordination as well as development of soft laws, model laws or international standards might be useful.

11. Do you agree with the high-level requirements outlined? Do you consider that any additional requirements are needed?

Yes, we in principle agree with the high-level requirements outlined in this proposal.

12. Do you have views on whether single-fiat tokens should be required to meet the requirements of e-money under the EMRs, with possible adaptation and additional requirements where needed?

We think that these requirements may serve as a basis for single-fiat tokens, and be adapted and expanded as necessary.

13. Do you have views on whether exclusions to the authorisation regime are needed in relation to the stable tokens regime, in light of the government's objectives? If so, which activities do you think should be excluded?

We think that the authorisation regime should have a certain degree flexibility to accommodate situations where risks are deemed to be low for example due to the size of the stable token issuer's customer base or of reserve assets, the value of stable tokens issued or individual transactions, or the interconnectedness with the financial system. Such flexibility could be implemented for example via the regulatory sandbox approach, which could also contribute to the decision as to which functions might be sufficiently low-risk and therefore appropriate to exclude.

14. What are your views on the appropriate classification and treatment of (unbacked) tokens that seek to maintain a stable value through the use of algorithms?

We think that the classification and treatment of such tokens is to be similar to that of exchange tokens due to the lack of backing arrangements.

15. Do you agree Part 5 of the Banking Act should apply to systems that facilitate the transfer of new types of stable tokens?

Yes, we in principle agree, subject to the points we have noted above in question 10.

16. Do you have views on potentially extending Bank of England regulation of wider service providers in the stable token chain, where systemic?

Considering the possibility that service providers involved in the stable token chain could pose systemic risks, we think that extending Bank of England regulation of wider service providers in the stable token chain might be necessary to mitigate the risks in such circumstances.

17. Do you agree that Part 5 of FSBRA 2013 should apply to payment systems facilitating the transfer of new types of stable tokens?

Yes, we in principle agree, subject to the points we have noted above in question 10.

18. Do you have views on location and legal entity requirements?

We think that location and legal entity requirements may pose some difficulties in terms of introducing exterritorial effects to a digital environment. We see value in the government's consideration of whether firms actively marketing to UK consumers should be required to have a UK establishment and be authorised in the UK, and we are aware of similar considerations being taken into account elsewhere. We however note that given the digital, decentralised and cross-border nature of stable tokens, location requirements may not necessarily be effective in practice. There might be also issues around enforcement. We think that this might be an area where international collaboration and coordination as well as development of soft laws, model laws or international standards might be useful.

We also note a recent English High Court ruling in *Ion Science Ltd v Persons Unknown* (unreported, 21 December 2020) which might be of some relevance in terms of location/localisation purposes. In this ruling, the Court considered that the location of a cryptoasset (in the given case Bitcoin) is the place where the person or company who owned the coin or token is domiciled. The Court also found that a free-standing Bankers Trust order could be made to compel disclosure of information outside the UK relating to cryptoasset exchanges.

19. Are there any areas of existing regulation where clarification or amendments are needed to support the use of security tokens?

We have no particular comment on this question.

20. What, specifically, are the potential benefits of the adoption of DLT by FMIs? What could be the benefits for trading, clearing and settlement?

We think that main potential benefits of the adoption of DLT would include transacting in real-time (which is particularly important for trading, clearing and settlement in terms of reducing transaction time, cost and risk), increased efficiency in data monitoring, traceability and transparency, high-level security and immunity, and as a result, building trust among the participants of the platform. DLT is also being applied and tested in specific sectors, such as energy, to support for example peer-to-peer transactions in electricity and gas markets. The technology allows online transactions between individuals without the need of a trusted middleman/platform, which can decrease transaction costs and increase competition.

On a broader scale, we also note the work of the UN Blockchain Commission for Sustainable Development (https://sdg.iisd.org/news/white-paper-explores-blockchain-use-for-sdgs/). A 2018 IISD White Paper highlighted the potential for Blockchain, as the underlying technology for cryptoassets, to accelerate the Sustainable Development Goals. The paper sets out several principles around which blockchain technology should be designed, including "do no harm" (in terms of ethical concerns regarding privacy and the rights individuals) and "design 'with' not 'for'" (individuals as stakeholders should inform the design of any blockchain initiative). Further papers have now been published in this series.

21. What are the potential drawbacks of DLT for wholesale markets and FMIs?

We think that the main potential drawbacks of DLT would include the following:

- Technological: This in particular relates to how platforms using different types of DLT and codes will interoperate, whether data will be able to be standardised in the same manner in different platforms and whether sufficient infrastructure, budget and training would be available to platform participants to make this work;
- Legal: This in particular relates to lack of legal standards for DLT platforms, for instance in data protection and compliance, lack of legal certainty and predictability regarding the legal status and validity of transactions conducted via the platform, and further legal complications in cross-border context in terms of applicable law;
- Psychological: This is likely to arise due to the lack of technological understanding and the 'novel and untested' label that DLT currently has, and potential reservations against diverting from the traditional model to a novel and untested model.

22. Is UK regulation or legislation fit for purpose in terms of the adoption of DLT in wholesale markets and FMIs in the UK? How can FMI regulation/legislation by optimised for DLT?

We think that the adequacy of the existing legal framework in supporting the adoption of DLT needs to be carefully assessed. As noted above, this is to be in particular in relation to ensuring legal standards (eg data protection and compliance) for DLT platforms, ensuring legal certainty and predictability regarding the legal status and validity of transactions conducted via the platform and addressing cross-border legal implications.

In optimising the legal framework for DLT, we think that it would be useful for the UK to consider the adoption of the UNCITRAL Model Law on Electronic Transferable Records (2017) | United Nations Commission On International Trade Law (MLETR) which aims to enable the legal use of electronic transferable records both domestically and across borders. The MLETR can accommodate the use of all technologies and of all models, including tokens and distributed ledgers, and in different business areas including finance/fintech. Under the MLETR, an electronic transferable record is deemed to be functionally equivalent to a transferable document or instrument "if that record contains the information required to be contained in a transferable document or instrument, and a reliable method is used to: (a) identify that electronic record as the electronic transferable record; (b) render that electronic record capable of being subject to control from its creation until it ceases to have any effect or validity; and (c) retain the integrity of that electronic record". This would help clarify the functional and legal equivalence of electronic and paper-based documents. It is also worth noting that the importance of the MLETR is increasing in response to COVID-19, and there are calls from international organisations on governments to consider the adoption of the MLETR to facilitate digitalisation (see eg International Chamber of Commerce's memo on this in relation to trade finance transactions: icc-memo-on-essential-steps-to-safeguard-trade-finance-operations.pdf (iccwbo.org)).

23. What are the wider industry incentives or obstacles to the adoption of DLT in wholesale markets and FMIs in the UK?

We are not in a position to comment on this from practical experience, however we think that the points we have made above to questions 20 and 21 are relevant to this question too.

24. If market coordination is required to deliver the benefits of DLT, what form could it take?

We have no particular comment on this question at this stage.

25. Would common standards, for example on interoperability, transparency/confidentiality, security or governance, help drive the uptake of DLT/new technology in financial markets? Where would common standards be most beneficial?

Yes, we think that common standards would help drive the uptake of DLT particularly on interoperability, data standardisation, data protection and compliance.

26. What should the UK government and regulators be doing to help facilitate the adoption of DLT/new technology across financial markets/FMIs?

We think that the UK government and regulators can help facilitate the adoption of DLT by addressing the legal, technological and psychological challenges we have noted above in question 21.

27. Do you see value in the government capturing tokens typically used by retail consumers as a form of speculative investment under the regulatory perimeter in the future?

Yes, we see value in this in particular from a consumer protection point of view.

28. Do you have any views on how the government should bring these tokens into the regulatory perimeter in the future?

We have no particular comment on this question at this stage, but we note that there would be challenges in bringing these tokens into the regulatory perimeter in an effective way in practice due to their digital, decentralised and cross-border nature and due to the idea behind their creation of non-regulation or self-regulation of the platform.

29. What are the risks and opportunities you see in relation to DeFi?

The main risks in relation to DeFi from our perspective is high risk of user error, lack of user awareness and understanding of suitable financial options available to them, and issues associated with permisisonless platforms (including scalability, high energy consumption, and environment and sustainability concerns).

We think that DeFi may offer opportunities such as enhancing users' control over assets, reducing costs and time due to peer-to-peer operation, improving system resilience by eliminating single points of failure due to decentralisation, and easing access for individuals to financial services.

30. Do you have any evidence of risks to consumers when using tokens as a form of speculative investment or through DeFi that may be of interest to the government and UK authorities?

We are not in a position to provide evidence on this aspect.