Treasury Committee publishes report on crypto assets

The Treasury Committee today published its report on crypto assets, following the launch in February of this year of its Digital Currencies enquiry. A copy of the report is available here.

The report is wide ranging, covering the advantages and disadvantages of crypto assets and distributed ledger technology, price volatility, initial coin offerings, money laundering and broader financial crime, market manipulation, financial stability, and proposals on regulatory direction for the UK. Overall the report could be described as "cautiously positive" for the crypto industry in the UK – providing a way forward that is strongly opposed to the more grey areas within the industry, but remaining supportive of the crypto industry where it is done right.

This article sets out some of the key recommendations coming out of the report and our view on what this means for the crypto assets industry in the UK.

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Broad regulatory direction

Arguably the most important aspect of the report is the recommendation to regulate in some way, as a minimum, crypto asset exchanges and issuers of initial coin offerings (ICOs). The Committee's position in broad terms is that retail investors in particular need to be given greater protection "as a matter of urgency", and therefore the report recommends doing this by way of an amendment to the Regulated Activities Order (RAO), which the report suggests would be a more expedient way of regulating rather than creating a new regulatory framework bespoke to crypto assets. This approach would give the FCA "the necessary legal powers to execute its duties of protecting consumers and maintaining market integrity", in the quickest possible fashion. The Committee suggests that, as a minimum, regulation should seek to address consumer protection and anti-money laundering – therefore leaving the door open for regulation going beyond just these areas.

We believe that the crypto assets market in the UK will support this type of direction – indeed this recommendation closely follows CryptoUK's approach suggested in its evidence given to the Committee. However without further detail on how the RAO would be amended (including related rules around financial promotions presumably) and what regulatory rules crypto exchanges and ICO issuers would be required to follow accordingly, it remains to be seen how positive this recommendation will be for the industry. With respect to crypto exchanges, regulation of this type will almost certainly lead to consolidation as smaller exchanges struggle with the cost of compliance, but will ensure a significantly improved base level of consumer protection across the exchange eco-system in the UK.

Initial coin offerings

It is fair to say that, according to the report, limited positive views on ICOs exist within the Committee. A number of sections set out the Committee's concerns around ICOs in the UK and the generally negative effects that it suggests they have on consumers. Accordingly the report goes so far to suggest that regulation of ICOs should be dealt with as a matter of priority in order to close what it considers to be a regulatory loophole (the Committee makes clear that it strongly believes that investors buy into ICOs "in the hope of selling them at a profit", making any alternative reason for investing effectively an attempt to circumvent regulation). The Committee's conclusion is that "the development of ICOs has exposed a regulatory loophole that is being exploited to the detriment of ordinary investors".

Even more concerningly for ICO issuers, the report suggests that investor protections around ICOs should be brought into line with those in the United States – a jurisdiction famous (at least within crypto circles) for providing a highly restrictive regime on ICOs. The report does not include any discussion on what specific US investor protections it would suggest are adopted but presumably the reference is to the application of existing securities regulations for ICOs such that they are issued in the same way as equities. This may point to a suggestion that regulatory approaches such as those in Gibraltar or Malta with respect to ICOs may not be the ones that win out in the UK, although the position on the detail is unclear at this time.

As a result, the publication of this report is likely to do three things in the short term:

1. accelerate some of the currently planned ICOs in the UK seeking to issue "utility tokens" (currently unregulated crypto assets)
2. effectively shut down those unregulated ICOs which are not so accelerated, pending further regulatory clarity
3. push ICOs towards issuing in line with existing securities laws (primarily the Prospectus Directive) rather than being unregulated

Whether utility tokens will continue to exist following the proposed amendment to the RAO remains to be seen, and will depend on how the RAO is amended. On the other hand, the report is likely good news for those industry participants dealing in "security tokens" (crypto assets that fall within existing securities definitions) which will be buoyed by the indirect endorsement.

Money laundering and terrorist financing

In terms of the use of crypto assets for money laundering and terrorist financing activities, the report suggests that this is an issue and there is a growing risk of this becoming significant. Accordingly the Committee suggests that the transposition of the 5th Money Laundering Directive (5MLD) (currently scheduled for end of 2019 in the UK) be expedited in order to bring crypto exchanges and wallet providers within scope of existing anti-money laundering requirements. The report goes so far as to suggest that this be done regardless of the outcome of Brexit, which is not unexpected but useful to see in writing. It suggests that the FCA be the regulator to supervise anti-money laundering.

Assuming that 5MLD is transposed into UK law without "gold plating" (being where the UK imposes more onerous requirements than 5MLD requires), this recommendation is not likely to be of significant long term impact on the legitimate end of the crypto exchange industry in the UK as it stands – virtually all legitimate crypto exchanges in the UK operate as if they were already required to perform AML and KYC. What this will do is significantly focus the mind on ongoing compliance, and give regulators a weapon in the armoury to take on the less legitimate end of the market. The market will now be poised to see what (if any) gold plating of 5MLD is proposed as part of transposition, to determine the extent of their ongoing compliance burden.

Advertising and investor protection

The report shows that the Committee holds particular concerns around advertising of crypto offerings to retail users and investors, and the claims being made in order to attract customers. In particular the report expresses concern at the FCA's inability to be able to regulate this activity, given that its perimeter does not extend to these types of services, and also considers the position with respect to consumer detriment once they have "bought in" – for example with respect to loss of passwords (through forgetting or via cyber-attack), mis-selling, and fraud. Overall the report strongly advocates for the FCA to be given greater powers to be able to control marketing and consumer protection in the crypto sector (and specifically mentions crypto exchanges and ICO issuers in this context).

This type of approach is likely to be welcomed within the crypto exchange industry, and less so within the ICO issuing community. For the former, this is a natural part of the regulatory regime which it has been advocating for in the UK and to a great extent will likely require minimal changes for the legitimate end of the industry. For ICO issuers this is another blow – many unregulated utility token issuances rely heavily on widespread marketing campaigns, "bounty programs" and other viral marketing tools that will likely be significantly curtailed as a result of the Committee's recommendations.

Other considerations

In considering the question of market manipulation within the crypto markets, the report is clear that this is a problem to be dealt with. In line with its recommendations for the FCA to lead as regulator in this sector, it calls on the FCA to respond to the report with its views on how it will regulate to avoid market manipulation. How the FCA will respond is not clear at this point, given the global nature of these markets – it is likely that cross-border cooperation between regulators will be crucial.

The report also considers the risks of crypto assets to the financial stability of the UK, and concludes that there is limited risk at this time. It asks the Bank of England and FCA to continue to monitor developments in the sector, and financial institutions' exposure to crypto assets. This of course is in line with the PRA's recent Dear CEO letter to the banking industry on financial stability and crypto assets.

One other point to consider is that the report comes at a time when the European Union is independently considering its own crypto regulation, specifically for ICOs. The proposed EU legislation introduces a voluntary regime that ICO issuers could 'opt-in' to. Issuers choosing to comply with the regime would subject themselves to requirements including KYC/AML as well as a cap on ICO proceeds of EUR 8 million. In return those issuers would benefit from an EU-wide passport permitting the offering of their ICO in all member states. The legislative proposal is scheduled to be put before the EU's Committee on Economic and Monetary Affairs (ECON) in November, before being considered by the European Parliament and the European Council (separately) at the end of the year, ahead of a final conclusive vote expected in early 2019. Whether the UK's approach ends up following a solution of this nature is yet to be seen, but staying in step on crypto with the EU would seem sensible even post Brexit for a market as global as ICO issuance.

Overall

The Committee’s report is an extremely useful piece of regulatory clarity with respect to crypto assets in the UK and charts a potential path for the UK to become one of the world leaders in the field of crypto, if the political will is there to support the industry. The report notes that “regulation in the UK may enable the market place to move to a more mature business model that improves customer outcomes and enables it to grow sustainably” – but crucial from here will be if the Government decides to encourage growth in the industry or not. The unsaid suggestion is that, if the Government chooses not to encourage growth in the sector then heavy regulation (or even perhaps bans in certain areas) could be possible.

In many ways, none of the recommendations are hugely surprising – the Committee has taken a progressive and balanced view from the start of the process and has been sensible in its review of the evidence given from all sides of the debate, and as a result the conclusions coming out of that evidence have been usefully targeted at the areas most in need of regulatory consideration. One thing is for sure – there are some winners and clear losers from this report. Assuming that the Government does choose to encourage growth in crypto, the crypto exchange industry in the long term is likely to be a winner out of this report – at least for those that are able to deal with the increased compliance burden. On the other hand the unregulated ICO market does not fare well out of the report and must now be braced for significant change in the way it operates – expect major reductions in UK ICO issuance in the short term whilst the market rebalances to deal with this news.

What the overall tenor of the report does indicate is that the will exists within the Government to provide some support to the crypto industry, which is a significant step in bringing the industry in from the cold. The industry will now await the arrival of the FCA’s response to the Committee’s report to determine where the UK goes from here, as well as the report of the Cryptoassets Task Force in early October – given that the report states that “the current ambiguity surrounding the Government’s and the regulators’ positions is clearly not sustainable”, the industry should expect further significant developments on the way in the short term.