April 30, 2023

Andrew Griffith MP, Economic Secretary to the Treasury
c/o Payments and Fintech
HM Treasury
1 Horse Guards Road
SW1A 2HQ

By email: cryptoasset.consultation@hmtreasury.gov.uk

Dear Sir,

Re Future regulatory regime for cryptoassets – consultation

The Institute of International Finance (**IIF**) welcomes the opportunity to respond to HM Treasury's (**HMT's**) consultation on the future financial services regulatory regime for cryptoassets, released February 1, 2023.

We commend HMT for tackling these important issues in a timely and consultative way. We welcome the UK authorities', including HMT's, thoughtful and deliberate approach to ensuring a fit-for-purpose regulatory regime that will maintain a commitment to financial innovation while also strengthening consumer protection, market integrity, and financial stability.

We also welcome the UK authorities' engagement with international standard-setting efforts around these topics including those of the Financial Stability Board (**FSB**) and Committee on Payments and Market Infrastructures (**CPMI**). The IIF recently submitted to the FSB's consultation on cryptoassets and stablecoins, with strong member input, and this submission is also framed with input from those members affected by the UK's regime.

In line with that submission, and our earlier submission to the Basel Committee on Banking Supervision (**BCBS**) on the prudential treatment of crypto-asset exposures, we advocate for a measured approach that does not unduly restrict the ability of regulated financial institutions to prudently engage in cryptoasset activities, such that associated risks will be subject to robust sound risk management practices.

We continue to strongly advocate for **technology neutrality** as a guiding principle for regulation in this space, and agree with the principle of **"same risk, same regulatory outcome"**.

In this regard, the policy rationale for placing new cryptoasset activities under the designated activities regime (**DAR**) rather than the Regulated Activities Order (**RAO**) would benefit from additional articulation. The scope of both regimes and how they will interact would similarly benefit from clarification. At first sight, the DAR regime appears designed as a lighter-touch regime in some ways, though the risks of client asset loss and market manipulation may be akin to those arising from existing regulated activities. Recognizing the future DAR regime has yet to be enacted or implemented through secondary legislation, it is understandably difficult to evaluate its effectiveness. A DAR regime, in principle, is unobjectionable, though the details will be essential.

As a first approximation, crypto-asset activities, at least those involving client money or client assets custody, should be subject to a financial services style **licensing regime**, rather than a registration regime, pending clearly enunciated criteria.

We would make additional observations on **articulation and scope** of the new regimes for stablecoins and cryptoassets that HMT and the other UK authorities are building:

1. We strongly welcome that "it is not the government's intention to include tokenised deposits (which operate on blockchains and may represent unsecured debt claims) within the scope of regulated activity for Phase 1."[1] Bank deposits are one place where extensive regulatory frameworks already exist. **Tokenized bank deposits** are different from stablecoins and cryptoassets, depending on how structured, and need to be distinguished as such. We accordingly seek clarification that they would not be covered by the scope of cryptoassets as defined by this consultation. The use of new technology such as distributed ledger technology (**DLT**) to deliver an existing product that is already subject to regulation, to include deposit tokens, should not change the legal nature of that product or the rules that apply to it, with no change in liability.

2. **In addition,** HMT should clarify that none of the proposed regimes in phase 1 or 2 is intended to apply to **books and records** systems using DLT or blockchain infrastructure, including internal Treasury or other systems covering multiple affiliates within a financial institution group. Accordingly, the definition of cryptoassets should exclude tokens that are used solely for the internal bookkeeping records of a financial institution.

3. We support HMT's proposals to **phase in** GBP stablecoins used for payments initially, to be followed by cryptoassets more broadly (noting that securities tokens are already regulated). While creating a regime in stages may be easier from an implementation and compliance perspective, at the same time, the phasing creates some uncertainty and may defer regulatory clarity. We would encourage HMT to further specify the future phasing-in of particular types of cryptoassets or activities into the regime to mitigate this, considering the necessary transition periods before implementation is due.

4. While we broadly welcome the proposed **cross-border scope** of the regime as applying to activities in the UK, and activities directed at the UK, we consider it key that similar principles are used as apply to traditional finance, so that (for example) the overseas persons exclusion applies to newly regulated crypto-asset activities, both under the RAO and to any activities to which the DAR applies. We would support clarity that reverse solicitation is possible. We would also in principle support the use of an equivalence regime where this would allow mutual recognition of other jurisdictions' frameworks based on outcomes and alignment with international standards and other regimes. Cryptoasset markets are global in nature, so maintaining UK investor access to global liquidity is important. While providing adequate consumer protection, UK authorities should bear in mind the risk of effectively requiring UK customers to use less liquid local venues.

5. We welcome HMT's approach to **custodial liability** stating that "the government is exploring taking a proportionate approach which may not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control."

[1] Footnote, p. 15. Our view is that they are digital representations of commercial bank money.

Lastly, we endorse the 'agile and flexible' policy principle adopted by HMT, and we fully support the importance of an approach to regulation that recognizes the **dynamic nature** of this asset class and advances a framework designed to evolve in line with its evolution.

In **Annex 1** we provide detailed answers to selected consultation questions, and in **Annex 2** commentary on some other points in the consultation paper. Not all the consultation questions are tackled, given the IIF's remit as a global trade association with a particular focus on issues with cross-border or global implications.

The IIF and its members stand ready to engage in additional discussions and consultations on these topics, or to clarify any aspect of our submission.

Yours sincerely,

Jessica Renier
Managing Director, Digital Finance

Annex 1

Comments on selected consultation questions

Not all the consultation questions are tackled, given the IIF's remit as a global trade association with a particular focus on issues with cross-border or global implications.

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17	3. Do you see any potential challenges or issues with HM Treasury's intention to use the DAR to legislate for certain cryptoasset activities?	We strongly advocate for **technology neutrality** as a guiding principle for regulation in this space, and agree with the principle of **"same risk, same regulatory outcome"**. In this regard, the policy rationale for placing new crypto-asset activities under the designated activities regime (**DAR**) rather than the Regulated Activities Order (**RAO**) would benefit from additional articulation.[2] The scope of both regimes and how they will interact would similarly benefit from clarification. At first sight, the DAR regime appears designed as a lighter-touch regime in some ways, though the risks of client asset loss and market manipulation may be akin to those arising from existing regulated activities. Recognizing the future DAR regime has yet to be enacted or implemented through secondary legislation, it is understandably difficult to evaluate its effectiveness. A DAR regime, in principle, is unobjectionable, though the details will be essential. As a first approximation, cryptoasset activities (differentiated from "specified investments"), at least those involving client money or client assets custody, should be subject to a financial services style **licensing regime**, rather than a registration regime, pending clearly enunciated criteria.
23	5. Is the delineation and interaction between the regime for fiat- backed stablecoins (phase 1) and the	The two ecosystems (stablecoin arrangements and cryptoassets) are highly interlinked and are enabled by each other. It would be helpful if HMT would

[2] This recognizes that "the government's intention is to expand the list of 'specified investments' in Part III of the RAO to include cryptoassets. An amendment to the RAO power, Section 22(4) of FSMA, made through the FS&M Bill affirms the use of the RAO power for the financial services regulation of cryptoassets." (Consultation paper at paragraph 2.7)

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	broader cryptoassets regime (phase 2) clear? If not, then please explain why.	elaborate on how the rules and guidance for phases 1 and 2 will be aligned, the scope of both regimes clearly delineated, and whether implementation of those rules/guidance will be aligned or if implementation will also be staggered. Further clarity should be provided on activities in scope as discussed above.
23	6. Does the phased approach that the UK is proposing create any potential challenges for market participants? If so, then please explain why.	Phasing can introduce complexity, and we would appreciate more clarity on the likely sub-phases within phase 2, although we recognize the dynamic nature of these innovations may affect timing. At the same time, we acknowledge that some topics, such as decentralized finance (**DeFi**), are still the subject of further work being undertaken by IOSCO and other bodies. Irrespective of phasing, regulatory clarity across all cryptoassets would support greater innovation and improved consumer protection.
33	7. Do you agree with the proposed territorial scope of the regime? If not, then please explain why and what alternative you would suggest.	We welcome HMT's focus on the need to define an effective cross-border framework that allows safe provision of cryptoasset services into the UK. Aligned with the overall proposed approach to cryptoasset regulation, we believe that an extension of the existing overseas frameworks to cryptoassets would be required. The overall regime for cryptoassets must remain consistent with the existing regime and cross-border access routes for other financial assets, avoiding a differentiated regime that would increase complexity. Specifically, we would support that the overseas persons exclusion applies to newly regulated crypto-asset activities, both under the RAO and to any activities to which the DAR applies. Where active promotion is not permitted cross-border, we would support clarity that reverse solicitation is possible, as a general overlaying principle. We would also in principle support the use of an equivalence regime where this would allow mutual recognition of other jurisdictions' frameworks based on outcomes and alignment with international standards. This implies that the UK regime should aim to align to international standards and not differ too markedly from other regimes, and that gaps in coverage should also be

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		avoided. This will be important, as enforcement in relation to cross-border activity can be expected to be difficult, so it is desirable to have a globally consistent framework to the extent possible. Cryptoasset markets are global in nature, so maintaining UK investor access to global liquidity is important. While providing adequate consumer protection, UK authorities should bear in mind the risk of effectively requiring UK customers to use less liquid local venues.
40	17. Do you agree with the proposed necessary information test for cryptoasset admission disclosure documents?	The list of necessary information seems somewhat truncated. It is suggested that the general principle applicable to public offers of securities requiring that all information necessary to enable an informed assessment of the investment be provided to the investor be borne in mind when framing tailored disclosure requirements for cryptoassets. Such requirements would normally include information (including financial information) about the issuer (where applicable), about the cryptoassets themselves, about the use of proceeds, about the secondary market arrangements, legal and regulatory information, including the geographies in which the assets are offered, material risks, and disclosure and management of potential conflicts of interest. There is also a need for clear guidance/rules on ongoing disclosures and their frequency in recognition of the volatility of cryptoasset markets, so that disclosure is updated to reflect changes in risk. We note that retail consumers may require different informational disclosure than that required by investors in public offerings. Further guidance from the Financial Conduct Authority (**FCA**) on what such documents should look like could be helpful.
44	20. Do you have views on the key elements of the proposed cryptoassets trading [venues] regime including prudential, conduct, operational resilience and reporting requirements?	The paper states that "firms operating cryptoasset trading venues would likely require subsidiarisation in the UK given their critical role in the cryptoasset value chain." We consider that subsidiarization should not be required if the UK authorities determine that:

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		• the venue in question is based in, and authorized to operate by, a jurisdiction that has an equivalent regime in terms of regulatory and supervisory outcomes; and • the home jurisdiction supervisor has entered one or more MOUs with the FCA (bilaterally or multilaterally) that appropriately address information sharing and supervisory and enforcement cooperation aspects. Also, clarity on whether client assets would need to be ringfenced within the UK is desirable. In our members' view, such ringfencing can be undesirable, and could be replaced with conditional deference to such equivalent overseas regimes.
53	23. Do you agree with HM Treasury's proposal to apply and adapt existing frameworks for traditional finance custodians under Article 40 of the RAO for cryptoasset custody activities?	We consider that, as this is a heightened customer risk area, custody of cryptoassets should be regulated under the RAO and not the DAR, for those parts of the custody activity that are not currently regulated.
53	24. Do you have views on the key elements of the proposed cryptoassets custody regime, including prudential, conduct and operational resilience requirements?	**Custody framework** Cryptoasset custody should be regulated on par with traditional custody. We therefore welcome HM Treasury's proposed approach of using existing regulatory frameworks for traditional finance custodians as a basis for developing a UK cryptoasset custody framework. We support HM Treasury's proposal to use existing custody provisions in the Client Assets Sourcebook (CASS) to design custody requirements for cryptoassets. Final regulatory standards for cryptoasset custody should be based on the following principles: i) segregation of client assets from firm/principal assets; ii) adherence to regulatory requirements and best practices for client asset safety and recordkeeping; and iii) identification and mitigation of risk across

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		end-to-end lifecycle, with security central to design architecture and operations of technical infrastructure. **Prudential** It is important that existing rules for non-crypto custody, which work well, are not disturbed or changed in the process. In relation to the future development of prudential rules by the FCA, we believe UK policymakers should take an off-balance sheet approach to custody of cryptoassets. It is essential that any capital and liquidity requirements associated with cryptoasset custody do not make custody unfeasible at scale for banks and prevent qualified institutions such as custodians from providing institutional-grade solutions that addresses identified risks of this novel asset class. **Custodial liability** A key issue that arose during the legislative consideration of the EU's Markets in Crypto Asset Regulation (MiCA) was the need to clearly establish the extent of custodial liability for the loss of client assets. Making custodians liable for losses outside of their control (e.g. DLT hacks and malfunctions) would make cryptoasset custody unviable for regulated entities and prevent qualified custodians from entering the market. We therefore welcome the consultation highlighting that "the government is exploring taking a proportionate approach which may not impose full, uncapped liability on the custodian in the event of a malfunction or hack that was not within the custodian's control".[3] **Books and records usage of DLT/blockchain**

[3] At paragraph 8.5.

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		Consistent with the core principle of "same risk, same regulatory outcome," and as a prime example of a technology neutral approach to regulation, the adoption by a financial institution of a blockchain or DLT based internal books and records system should not be subject to additional regulation, as the adoption and operation of such system would have been subject to existing regulations governing internal books and records, while the existing supervision and oversight of the financial institution will ensure that such system does not pose additional risks when compared to a traditional books and records system. Changing the design philosophy of a system shouldn't change the regulatory regime if underlying activity and risk remain the same. Consequently, book entries on such an internal DLT or blockchain based book entry system (Book Entry Tokens) should not be considered cryptoassets from a legal perspective, as the Book Entry Tokens are the book entries representing records that are internal to the financial institution posing no additional risk than book entries in existing electronic books and records systems in use today.
The60	27. Do you agree that the prohibitions against market abuse should be broadly similar to those in MAR? Are there any abusive practices unique to cryptoassets that would not be captured by the offences in MAR?	We agree, but we are also concerned that the regime is not ambitious enough or that the authorities may be prepared to accept poor outcomes in regard to market cleanliness. The following statement is potentially of concern: 'it is important to note that the government does not expect to be able to achieve the same outcomes as MAR (at least in the foreseeable future)."[4] We consider any new regime should not be "built to fail", as moral hazard and reputational risk lies in that direction.

[4] Table 9.A on page 58.

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60	28. Does the proposed approach place an appropriate and proportionate level of responsibility on trading venues in addressing abusive behaviour?	We observe that securities market supervision was transferred from exchanges to the regulator in 2000 because individual market operators were unable to look across to the entire market. While there may be aspects of blockchains that are public, there are aspects (e.g., who controls blockchain wallets) that are not. We also wish to point out that exchanges, unlike regulators, cannot readily "see" across the whole market, including around off-chain transactions, and for this reason, the FCA as market regulator needs to stand ready to undertake supervision of these markets' cleanliness alongside individual exchanges. As such, there is quite a strong public policy case for overall market supervision to be conducted by the supervisor, rather than being entirely or mainly devolved to venue operators. Further consideration should be given to this important design choice, in our view.
60	29. What steps can be taken to encourage the development of RegTech to prevent, detect and disrupt market abuse?	Clearly, requirements on exchanges to police for market abuse, if strict enough, will drive investment in more and better RegTech solutions. Key will however be the role of the regulator as potentially the only agent able to piece together the whole of the market including across asset classes and platforms.
65	32. What types of regulatory safeguards would have been most effective in preventing the collapse of Celsius and other cryptoasset lending platforms earlier this year?	The collapses of Celsius and other crypto platforms are still being investigated. In many cases, poor governance controls and poor management and segregation of client assets are at the heart of the problems uncovered. Root causes of the issues related to Celsius and other crypto asset lending platforms include: • **Opacity**: In some of these cases there were hundreds of entities with unclear relationships between them that was not adequately documented. Unlisted groups have relatively limited disclosure obligations. Celsius and other similar organizations lacked the

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		transparency for underlying assets which is available in a public blockchain. • **Leverage**: Many failed crypto platforms were highly leveraged so that returns and losses were magnified due to borrowed money. They also suffered from procyclicality, amplifying losses. Leverage limits and/or similar liquidity limits could be applied to crypto lending platforms to address liquidity risk. • **Governance**: Many of the platforms were not regulated entities or were investment funds and not exchanges or banks as some users apparently believed they were. Many were "Decentralized In Name Only". As a result, users were junior subordinated creditors and not depositors with the protections that would have afforded. • **Cross-border**: The international nature of the companies involved has made issues harder to resolve. This makes restitution efforts more complex due to legal uncertainty. • **Accounting** for cryptoassets is also an issue that should be considered at the national and international levels. Where crypto assets providers have assets in one denomination (such as ETH) and liabilities in another (such as USD), there should be an expectation that the assets denominated in non-fiat should be marked to market daily, to avoid liability mismatches. The failure to mark cryptoassets to market has indeed been alleged as a factor in the collapse of Celsius,[5] and accounting and governance failures were also prominent in the collapse of FTX. In relation to accounting, we are of the view that more clarity on the international accounting standards applicable to the activity of

[5] See the complaint in *KeyFi, Inc. v. Celsius Network Limited And Celsius Keyfi LLC*, at paragraph 82: "… Celsius paid a portion of interest on deposits in CEL tokens and a portion of interest in other cryptoassets such as bitcoin and ether. With respect to consumers who chose to be paid in the cryptoasset they deposited (rather than CEL tokens), Celsius logged those liabilities on its books in a U.S. dollar denominated basis from 2018 through 2020 despite the fact that it paid its customers out in the underlying token. It then failed to mark-to-market those assets in its internal ledger as those cryptoassets appreciated, creating a substantial hole in its accounting." These are untested allegations only.

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		safeguarding of cryptoassets is desirable and should be referred to the International Accounting Standards Board (IASB) as an urgent issue.
65	35. Should regulatory treatment differentiate between lending (where title of the asset is transferred) vs staking or supplying liquidity (where title of the asset is not transferred)?	We consider that the activities of staking and lending are different, and the regulatory treatment should distinguish them. We would also point out that in some forms of staking, title is transferred and the underlying staked cryptoassets form part of the bankruptcy estate of the custodian or the service provider of the staking activity. This form of staking should also be treated differently than staking where title is not transferred and where the underlying staked cryptoassets are protected for the beneficial owner even in the bankruptcy of the custodian or the staking service provider.
69	38. Do you agree with HM Treasury's overall approach in seeking the same regulatory outcomes across comparable "DeFi" and "CeFi" activities, but likely through a different set of regulatory tools, and different timelines?	We support the "same risk, same regulatory outcome" approach and would highlight that regulation needs to take into account distinct structures of DeFi and aim at identifying and holding responsible those parties that effectively control the risks. In our view, the various options being asked about are not differentiated clearly enough to be able to definitively opine with a preference between them.
69	40. Which parts of the DeFi value chain are most suitable for establishing "regulatory hooks" (in addition to those already surfaced through the FCA-hosted cryptoasset sprint in May 2022)?	As a general principle, regulatory obligations should be imposed on the party in the best position to manage the risk, and not be applied by default to the party most immediately within the supervisory or regulatory perimeter. Possible regulatory hooks around DeFi are those elements of the crypto ecosystem that enable DeFi (e.g., stablecoin issuers, centralized crypto exchanges and hosted wallet service providers, etc.) which are part of the Phase 2 scope of proposals. The recent IIF staff paper on DeFi also identified several entities associated with DeFi projects as possible objects of regulation, being the business entity associated with the project and its directors; other holders of equity in the business entity associated with the project; an incorporated decentralized autonomous organization (**DAO**); holders of governance tokens controlling a

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		DeFi app (or at least, voting holders); developers writing the code; and the smart contract code itself. The last two possibilities are likely to be controversial. Where code is developed which has both legitimate and illegitimate users, it is not clear why developers – as opposed to those who use the code – should be responsible. On the other hand, where code can only be used in an illegitimate way, there may be a good case to sanction developers, particularly where they can be identified more easily than other actors and where there are reasons to be believe they may have substantial assets. That said, in jurisdictions (such as the U.S.) with constitutionally protected free speech, regulators will always have difficulty frontally sanctioning the expressive activity of publishing code (for example, on GitHub). Sanctioning code itself has an element of science fiction about it. However, as smart contracts will increasingly come to control large amounts of assets, it may make sense to allow for those assets to be confiscated, where it is not possible to identify any human actors or legal persons in control of those assets, at least where it cannot be shown those assets belong to innocent users. Of course, such confiscations would need to take place through some entity or individuals in control of the relevant protocol (including potentially an unincorporated DAO).
72	45. Should staking (excluding "layer 1 staking") be considered alongside cryptoasset lending as an activity to be regulated in phase 2?	Yes.

Annex 2

Comments on other proposals/points

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14	[I]t is not the government's intention for [Financial Services Consumer Scheme] FSCS protections to apply to investor losses arising from cryptoasset exposures,	We agree with the government's intention not to apply the FSCS protections to apply to investor losses arising from cryptoasset exposures, as contagion could be created. However, there may be existing financial products that provide indirect exposure to cryptoassets for which FSCS protection is already available, and this should not be wound back either. Any proposal for a segregated scheme would need more in-depth consideration. See also the discussion of the custodian liability point below (in answer to page 53).
15	In particular, the DAR, a new regime set out in the FS&M Bill, is designed to enable HM Treasury to designate certain activities in order to make regulations relating to the performance of that activity, including prohibiting the activity in its entirety or setting direct requirements.	It would be helpful to clarify in what circumstances crypto related activity could come within the DAR rather than the RAO, having regard to the ostensible purpose of the DAR regime, as explained in the Explanatory Notes to the FSMA 2022 Bill, at paragraph 124 of the Lords version.[6]
15	2.9 HM Treasury does not currently intend to expand the definition of "financial instrument" in Part 1 of Schedule 2 to the RAO to include presently unregulated cryptoassets.	We agree that the definition of "financial instrument" in Part 1 of Schedule 2 to the RAO should not be expanded to include presently unregulated cryptoassets.

[6] This states, "Many activities related to financial markets came to be subject to EU law as a response to the global financial crisis. These activities need to continue to be subject to rules when retained EU law has been revoked. Bringing these activities inside the current framework for regulated activities through the RAO would not be appropriate, as it would require all businesses and individuals engaging in those activities to become authorised persons, and to be supervised as if they are offering financial services directly in the way described above. This would be a disproportionate burden on those firms."

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21	It is not the government's intention to include tokenised deposits (which operate on blockchains and may represent unsecured debt claims) within the scope of regulated activity for Phase 1.	We strongly welcome that "it is not the government's intention to include tokenised deposits (which operate on blockchains and may represent unsecured debt claims) within the scope of regulated activity for Phase 1."[7] Bank deposits are one place where extensive regulatory frameworks already exist. Tokenized bank deposits are different from stablecoins and cryptoassets, depending on how structured, and need to be distinguished as such. We accordingly seek clarification that they would not be covered by the scope of cryptoassets as defined by this consultation. The use of new technology such as DLT to deliver an existing product that is already subject to regulation, to include deposit tokens, should not change the legal nature of that product or the rules that apply to it with no change in liability.
22	While the stablecoin and broader cryptoasset regimes are being developed according to different timelines, HM Treasury and the regulators are designing both in a consistent and compatible way	We strongly agree that the stablecoin and broader cryptoasset regimes should be designed in a compatible and consistent way and would urge a careful read-across to ensure duplicative or inconsistent requirements are avoided, as the two ecosystems (stablecoin arrangements and cryptoassets intermediation, custody, trading, etc.) are interlinked and are enabled by each other. There should also be very clear delineation between categories taking into account the scope of existing specified investments, e.g. so it is clear that an asset backed stablecoin does not qualify as a collective investment scheme and that a fiat backed stablecoin does not qualify as an instrument creating or acknowledging indebtedness.

[7] Footnote, p. 15. Our view is that they are digital representations of commercial bank money.

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26	[W]e expect the same framework will be adopted for all types of cryptoassets as they come into regulation rather than having separate, overlapping regimes.	We support HMT's expectation that the same framework will be adopted for all types of cryptoassets as they come into regulation rather than having separate, overlapping regimes.
27	Further detail to be set out in due course (table entries on Issuance activities and Payment activities).	Further detail on the rules/regulatory outcomes expected in regard to Issuance activities and Payment activities should be provided as soon as possible, also in view of the close link of these issues to the Phase 1 stablecoin regime.
29	Further consideration will be given to the risks of such combined activities in the cryptoasset sector, and whether and how existing controls on combinations of activity in traditional finance could be applicable.	We seek further details on how and when the "further consideration" mentioned will take place and the degree to which experience from the FMI sandbox will be relevant. This is key, given the costs of unwinding arrangements later if it is determined activities need to be disaggregated. Any ongoing lack of regulatory clarity will be problematic for financial institutions and the crypto ecosystem.
31	4.21 For these reasons, HM Treasury's starting point is that crypto-backed tokens should be regulated in the same way as unbacked cryptoassets	We agree with HMT's starting point that crypto-backed tokens should be regulated in the same way as unbacked cryptoassets.
32	HM Treasury is not proposing to ban algorithmic tokens or to leave them outside the regulatory perimeter … However, given the undercollateralised nature of these tokens, so-called algorithmic stablecoins share characteristics with unbacked cryptoassets. As such, they would not qualify as a stablecoin under the proposed regime for fiat-backed stablecoins …	We support the idea that undercollateralized algorithmic tokens should not qualify as fiat-backed stablecoins and are not suitable as a trusted means of payment. Presumably, HMT's intention is that algorithmic tokens should continue to be made available, as unbacked cryptoassets. The authorities will need to be very vigilant around marketing of such tokens, given the high risk of misleading consumers, and around their fulfilling any stability and redeemability expectations that their marketing and branding gives rise to.
50	The government is exploring taking a proportionate approach which may not impose full, uncapped liability on the custodian in	We support the proposition that crypto custodians should not have full, uncapped liability, as long as they are subject to

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	the event of a malfunction or hack that was not within the custodian's control.	rigorous regulation and oversight and do all things reasonably necessary or appropriate to discharge their responsibilities, including their cybersecurity and insider risk management responsibilities. Their custody requirements and expectations should be similar to those that exist today for traditional assets. Furthermore, custodians should not have liabilities for public blockchains or protocols beyond their reasonable control, having done due diligence on reasonably anticipated risks. Custodians do not have the ability, for example, to change code deficiencies in the protocol or fix network instabilities, and must connect to the public blockchain or protocol in order to custody the relevant crypto-asset on behalf of their customers. Otherwise, such regulations would push the custody of the related cryptoassets outside the custody of regulated financial institutions to the detriment of consumers.
51	This [newly regulated crypto custody] activity would be broader than the closest equivalent regulated activity (Article 40 of the RAO) as it would capture firms that only safeguard (but not administer) assets (e.g. firms that solely safeguard cryptographic private keys which provide access to cryptoassets).	We agree that firms that solely safeguard cryptoassets, but not administer them, should be counted as conducting custody activities for present purposes. We would also think it needs to be clarified whether crypto administrative activities will be regulated.
53	Availability of [financial services compensation scheme (FSCS)] protection for claims against failed authorised cryptoasset custodians under consideration and to be determined by FCA.	This is a key point. Elsewhere in the consultation paper (p. 14) it is stated it is not the government's intention for FSCS protections to apply to investor losses arising from cryptoasset exposures. We seek clarification whether losses arising from crypto custodians are intended to be within or outside the FSCS. If they are within, key issues become who will contribute, and whether the crypto related fund will be separate from the other funds the FSCS administers, which we would strongly recommend.

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56	This global market makes it difficult for any single jurisdiction to effectively address the risks of market abuse. There is, at present, no agreement between international regulators on how to divide up the oversight or how to enable this in practical terms, although work is being undertaken in international forums to enable cooperation as regimes are developed.	This type of dividing up would be very helpful also in stablecoins oversight, as we told the FSB in our December 15, 2022 submission on cryptoassets and stablecoins regulation and supervision.
57	HM Treasury is seeking to additionally achieve the following outcomes: • aspirationally, market prices should reflect genuine forces of supply and demand and should not be manipulated …	Market prices should always reflect genuine forces of supply and demand and should not be manipulated. This should be the law and not a mere "aspiration".
62	HM Treasury believes there is a strong case for developing a cryptoasset lending and borrowing regime as a priority Phase 2 activity.	We strongly support this effort to develop a cryptoasset lending and borrowing regime as a priority Phase 2 activity. As stated elsewhere, we would appreciate more clarity on the likely sub-phases within Phase 2. Clarity should be provided also on scope delineation with the activities encompassed in 'dealing in crypto assets'.
62	The government's proposal, set out below, requires platforms to disclose important information to customers, such as the terms of legal ownership, collateral, and margin calls. However, given the wide range of lending business models and unique challenges described in this chapter, the proposed approach does not pursue all of the same outcomes delivered by different traditional lending and borrowing regulations, such as FSCS protection, affordability assessments and forbearance periods.	We would advocate for the principle of "same risk, same regulatory outcome" to be kept firmly in mind when framing requirements for crypto lending businesses. This also means that when risks are similar to more traditional lending, regulatory treatment should be appropriately similar.
67	The work of international organisations is especially important in this area (again noting the highly borderless nature of DeFi organisations) and we are not intending to front run this by developing a prescriptive framework for [DeFi for] the UK that	We appreciate that HMT intends to avoid developing a prescriptive framework covering DeFi for the UK at this stage and

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	would need to be fundamentally re-shaped once international approaches and standards crystalise. With this in mind, HM Treasury is considering a range of approaches and seeking views.	is recognizing the priority and the importance of the work of international organizations in this area. We acknowledge that some topics such as DeFi are not yet ready for "prime time", pending further work being undertaken by IOSCO and other bodies.
67	[T]he objective is not to regulate the activity of developing software, but if software developers go on to maintain, run and operate systems used for regulated financial activities (e.g. exchange, lending) then they should be subject to financial services regulation.	As per the FCA's cryptoasset sprint in May 2022, interface providers and other actors facilitating consumer access to DeFi (e.g., aggregators and other consumer "front ends") rather than software developers should be responsible as they have the commercial beneficial interest and the potential conflicts of interest. On developer liability, see also our answer to Q. 40.
67	One option for regulating DeFi is to define a set of DeFi-specific activities – e.g. "establishing or operating a protocol" – as regulated activities under the RAO (or DAR).	Presumably, IOSCO's workstream on DeFi will further illustrate the options here, and HMT is urged to be aligned with developing approaches at IOSCO and elsewhere. One of the key issues will be around the scope of definition of DeFi, which could extend as far as the entire Bitcoin ecosystem on one definition. The ease with which clones of DeFi protocols can be "spun up" may mean that supervision is as important as regulation.[8]
71	Clearing – the handling of counterparty credit risk of both parties to a transaction – may also need to be a regulated cryptoasset activity.	We consider that cryptoassets clearing need not be regulated in the initial sub-phases of Phase 2 given the lack of prevalence of that activity in the market today.

[8] We refer further to our November 2022 staff paper on DeFi on use cases, challenges and opportunities.