

UK's Approach To Regulating Crypto-Assets Looks 'Measured'

By Tom Zanki

Law360 (November 16, 2018, 8:31 PM EST) -- The U.K. appears ready to move forward on regulating cryptocurrency-related assets, seeking what some attorneys describe as a measured approach that is likely to expand regulation to protect mom-and-pop investors from dicey crypto-backed investments, while trying to avoid dampening innovation in the underlying technology supporting digital assets.

U.K. authorities revealed their thinking in a recent task force report by Her Majesty's Treasury, the Bank of England and the Financial Conduct Authority, which promises more detailed proposals in the coming weeks and months that could bring more crypto-related assets within its regulation.

"The FCA is worried about cryptoassets and their risks," said Withers LLP partner Harvey Knight, a former lawyer for the U.K.'s Financial Services Authority. "They want to regulate them and they want to stop retail consumers being sold products that reference them."

By the same token, the task force maintains that the distributed-ledger technology that powers digital currencies has broad potential to innovate financial services and additional sectors.

This outlook is consistent with U.K. efforts to distinguish itself as an innovation-friendly hub by creating concepts like its "regulatory sandbox," which provides something of a playground for financial-service startups to test new products under fewer regulatory restrictions.

Morgan Lewis & Bockius LLP partner William Yonge said U.K. authorities want to be considered at the "top of tree" among global regulators in terms of fostering innovation while providing a safe place to do business.

"They want innovators to thrive, but only within the constraints of a well-regulated environment, which seeks to mitigate the risks to consumers and market integrity and prevents the use of cryptoassets for illicit activity," Yonge said.

The increased government attention to cryptoassets in the U.K. and elsewhere follows broader concerns of price volatility — bitcoin has plunged more than 70 percent this year from its 2017 peak — and the relatively unregulated status globally of cryptoassets, which are newfangled products that can mirror securities, commodities or currencies depending on the circumstances.

The FCA has said it would follow its Oct. 29 report with more detailed proposals later this year and in early 2019. Notably, the City watchdog plans to launch a consultation early next year on whether to ban

the sale to retail investors of derivatives — such as contracts for difference, options and futures — that are based on cryptocurrencies like bitcoin, given concerns about the lack of consumer protections in the underlying markets supporting these nascent products.

Worried that the pseudo-anonymous nature of crypto-based transactions can lure financial crime or terrorist financing, U.K. regulators also plan to propose anti-money laundering rules that go beyond European Union directives. Lawyers say some clarity around money-laundering rules could prove beneficial for institutional investors that to date have been wary about making crypto-related investments because of their legal ambiguity.

"One of the biggest barriers to institutional adoption of crypto as an asset class is that there isn't certainty around the AML and KYC (know-your-customer) treatment of those assets," Latham & Watkins LLP associate Sam Maxson said. "If we get guidance in that area, I think that would be very welcome for a number of institutional players."

In addition, the FCA plans to provide guidance before the end of 2018 that clarifies what cryptoassets fall within its regulatory scope and whether it needs to extend its sphere to capture certain assets that operate similarly to regulated securities but are designed to avoid regulation.

Even though U.K. authorities are warning of additional oversight, lawyers say the U.K. task force's report was more restrained than a prior report generated by British lawmakers in September that described the crypto market as a "wild west." That report, by Parliament's Treasury Committee, urgently demanded that regulators crack down on crypto-related activity, including initial coin offerings, which are capital-raising ventures by cryptocurrency startups.

The U.K.'s task force report doesn't go that far, suggesting a case-by-case approach when overseeing ICOs, which regulators acknowledge can be rife with scams but can also provide streamlined capital-raising alternatives for early stage firms struggling to raise money.

Morgan Lewis associate Steven Lightstone also noted that the task force's report doesn't contain proposals to directly regulate "exchange tokens" like bitcoin or other cryptocurrencies that are used as a means of exchange, or "utility tokens," which are designed to access a particular product or service. Details remain to be ironed out, but Lightstone described the task force's approach as "more measured."

"The full force of this report will come out in the more detailed rules that will be proposed in the consultations due at the end of the year and the start of next year," Lightstone said.

U.K. regulators also stressed in their report they want to encourage "responsible development of legitimate" use of distributed-ledger technology, including blockchain, which involves decentralized databases that advocates say can lead to speedier transactions. The U.K. has invited firms that practice distributed-ledger technology to participate in its "sandbox."

"They are continuing to learn, continuing to engage with the sector in order to understand the technology," Maxson said. "The approach they have taken is to ensure they understand the technology, so that they can assess its benefits and potential risks before seeking to introduce additional regulation."

Going forward, the U.K. is urging more international coordination in regulating crypto-related activity, which can be seen as ironic given Britain's plans to exit the EU. But many agree that some international

coordination is needed given the cross-border nature of transactions involving cryptocurrencies, which aren't backed by any sovereign government or central bank.

The U.K. task force said it considers a “consistent international approach to respond to exchange tokens ... essential, to ensure global regulatory coherence and avoid arbitrage in a market that is not confined to national boundaries and involves highly mobile actors.”

The global response to regulating cryptoassets is far from unified.

Countries like China have adopted hard stances calling for outright bans on cryptocurrency, while Switzerland is seen as more lenient and the U.K. and Japan are somewhere in between, according to a PricewaterhouseCoopers LLP report this year.

The U.S. has been fleshing out its approach through enforcement actions and public statements, broadly concluding that many cryptocurrency sales resemble securities transactions and will be regulated as such. William Hinman, director of the U.S. Securities and Exchange Commission's Division of Corporation Finance, said at a recent fintech conference that the agency plans to issue “plain English” guidance that will advise ICO issuers on the regulatory rules of the road, according to media reports.

It's not clear that any global consensus toward regulating cryptoassets is imminent. But to the extent that nations find common ground, lawyers say the odds of effective regulation will improve.

“It's clear that the way forward here is to [keep] a patchwork of different regulatory regimes from proliferating and try to seek as much overlap as we can,” Yonge said.

--Editing by Pamela Wilkinson and Orlando Lorenzo.